

## What Negative Libor Would Mean For The Lending Market

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In today's low interest rate environment, banks and others that follow the leveraged lending and other credit markets are increasingly interested in the effects that negative rates could have on their existing loan facilities that bear interest based on floating rates.

On Feb. 10, 2016, in testimony to Congress' House Financial Services Committee, Federal Reserve Chair Janet Yellen did not say whether the Fed will increase its benchmark interest rate again in March after lifting it in December for the first time in nine years,[1] but in response to a question regarding whether the Fed has legal authority to implement negative rates, Yellen stated that she was "not aware of anything that would prevent [the Fed] from doing it." [2]

The European Central Bank has also been widely expected to push deposit rates further into negative territory, and[3] central banks in Japan and Switzerland among others have adopted a negative rate for commercial bank funds held on deposit at the central bank.[4] Instead of being paid by the central bank, the commercial bank now pays the central bank when it deposits money.[5] By charging the banks money to hold deposits, central bankers aim to make it more attractive for banks to deploy their reserves into the credit markets — which ideally will have a corresponding positive effect on the larger economy.

Economists, central bankers and others have begun to speculate that the various London Interbank Offered Rates, or Libor, the benchmark rates at which the largest banks lend to each other in the interbank market in various currencies and for various durations, may soon land in negative territory. Euribor, a similar rate for euro-denominated loans, is already in negative territory, as is Libor for Swiss franc-denominated loans.

Libor is important to those in the U.S. leveraged lending market because a majority of credit agreements governing commercial loans have interest payable, at the borrower's option, either at Libor plus a spread or margin or the "base rate" (typically the highest of one-month Libor plus 1 percent, the federal funds effective rate plus 0.5 percent or a major bank's "prime rate") plus a spread (which is usually 100 basis points lower than the Libor margin).



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Recently, some lenders have recognized the possibility of Libor being negative and, as a result, such lenders require that credit agreements have a “zero floor,” meaning that if Libor is less than zero, the rate shall be deemed to be zero for the purposes of the agreement. This follows a similar established practice in Europe. These new protections help the lender by eliminating the lender’s risk of the interest rate being less than the spread or margin or, in the extreme, of actually paying the borrower interest for loans made by the lender to the borrower. Despite the implementation of this fix in new agreements, however, questions remain regarding credit agreements signed before the “zero floor” convention was adopted or that otherwise lack a zero floor, and how Libor will be treated under these agreements in the event Libor is actually negative.[6]

### **Treatment of Negative Libor in Credit Agreements with No Floor**

There is no precedent for whether courts in the United States would support a decision by lenders to charge borrowers interest based on Libor of zero percent under a credit agreement with no zero floor in the event Libor were actually negative. Despite the lack of certainty, a court may decide that a lender should be able to charge a higher rate of interest than what the contractual rate is (based on a contractual rate that would subtract negative Libor from the spread) on the basis that there is an implied floor of zero under these credit agreements; lenders never intended to charge an interest rate lower than the spread. If the implied floor is zero, then the contractual rate is actually higher than what the words in the contract say in the event Libor is negative.

In order to find an implied Libor floor of zero in a contract that does not provide for one explicitly, the court would need to rely on an exception to the parol evidence rule. The notion behind the parol evidence rule is that a writing intended by the parties to be a final embodiment of their agreement should be protected from certain kinds of external evidence.[7] When the meanings of the disputed terms of a contract are clear and unequivocal, the court must interpret those terms according to their plain meaning.[8] When the terms are ambiguous, however, the court may consider extrinsic evidence.[9]

One exception to the parol evidence rule is “course of dealing or trade usage.”[10] With this exception, “a party engaged in a trade is bound by the usages of that trade even if ignorant of them, on the theory that everyone in the trade should know that trade’s usage.”[11] In other words, a court may consider trade usage even if the disputed terms are unambiguous.[12] Recent cases highlight federal New York courts’ interpretation of the “course of dealing or trade usage” exception to the parol evidence rule. In *Toto Inc. v. Sony Music Entertainment*, the district court found that although a court is generally confined to the language of a contract itself without the aid of extrinsic evidence, the court may consider proof that a contractual term has a specialized meaning within the context of a particular industry, if that proof establishes that the meaning of the language in question is fixed and invariable in the industry in question.[13]

Similarly, in *Little v. Landsman Development Corp.*, the district court stated that a contract must be construed according to the custom and use prevailing in a particular trade.[14]

Regarding negative Libor, a court may allow proof of custom or usage in order to show that the course of dealing in credit agreements is that the use of Libor as a component of interest rates is essentially a rough and market proxy for a nondistressed lender’s cost of funds (i.e., the cost associated with holding a deposit base in the relevant currency) and thus the spread is only intended to be additive to Libor, not subject to reduction under an interest rate determination formula. Thus, a spread should only be

additional interest charged on top of Libor, which results in “all-in” interest rates never being less than the spread.

### **Could All-In Rates Actually Be Negative?**

In most cases interest rate margins are large enough that even if Libor were to be negative, the result would be a decrease in spread but still a positive all-in interest rate. However, depending on how far Libor reaches into negative territory, there will be some agreements, particularly for investment grade and other high credit quality borrowers, where margins are low enough that the all-in rate may actually be negative. In these cases, it would be difficult for a borrower to argue that they are actually owed interest by the lenders. Credit agreements are generally written so that the borrower has an obligation to pay interest to the lenders, and there is no contractual mechanic for lenders to pay interest back to the borrower. As a result, in the event that courts decide (or lenders decide to concede) that negative Libor can reduce spreads in certain credit agreements if there is not a zero Libor floor, it seems very likely that at the very least there will be a zero floor on all-in rates and lenders will not be expected to pay borrowers interest for the loans they made to those borrowers.

### **“Alternative Rate of Interest” Provisions**

Another option for lenders to avoid getting hit with negative Libor is to possibly invoke “alternative rate of interest” provisions in credit agreements, which permit the lenders to stop making loans bearing interest based on Libor in the event that Libor does not “adequately and fairly reflect the cost to such” lenders of making those loans. The theory behind this provision is that in traditional credit agreements, most lenders either (1) have access to interbank lending markets and can borrow necessary funds at Libor that then on-lend in their various credit agreements (otherwise known as “match funding”) or (2) use Libor as a proxy for the costs associated with holding deposits so that match funding is not necessary, meaning Libor reflects their costs for making those loans and the spread is compensation for the lenders taking on the borrower’s credit risk. As a practical matter, in today’s markets some banks do not tend to actually match-fund in major currencies on a loan-by-loan basis. Additionally, many lenders are not banks that have access to interbank lending markets. So, if lenders do not actually have access to the funds they’ll lend to borrowers at a negative cost (i.e., they’re not being paid by whomever they borrow or take deposits from in order to hold onto those funds), it seems appropriate for them to invoke this provision in order not to be forced to pass along that negative cost to borrowers.

There are some theoretical and practical questions around this solution, however. From a theoretical standpoint, borrowers could argue that these provisions are intended to deal not with situations where Libor is so low as to be costly (or less profitable) for lenders, but with situations where Libor is “broken” or not reflecting the true market. Indeed, in many credit agreements this provision is labeled “Inability to Determine Rates.” Borrowers could argue that where Libor is negative, nobody could argue that Libor is “broken” or isn’t capable of being determined by actual market forces. Moreover, they could argue that, in theory, lenders could actually match-fund by borrowing at negative rates, so Libor would in fact reflect their true cost of funds. On the other hand, these are arguments of intent regarding a provision that has likely never actually been invoked in a credit agreement, and the text of these provisions does not refer to “broken” funding or an inability to determine Libor (and there is typically a corresponding provision that explicitly deals with that scenario in greater detail). Additionally, a theoretical ability of a lender to match-fund by borrowing at negative rates does not necessarily mean that the lender has an actual negative cost of funding its loans.

The practical issue with this solution is that these “alternative rate of interest” provisions do not

typically permit the lenders to charge some higher rate that reflects their true cost of funds, only to stop lending based on Libor. There would not be a mechanism for charging Libor at zero without amending the credit agreement, which would require borrowers' consent. So the lenders would need to approach each borrower individually and tell them that the lenders will not continue making Libor loans to that borrower unless it agrees to amend the credit agreement to provide for a zero floor. Given the large number of credit agreements that are potentially affected, approaching each such borrower individually to document these amendments may prove quite cumbersome.

Additionally, in syndicated deals many of these provisions require the "required lenders," usually defined as lenders holding over 50 percent of the credit facility, to invoke this provision, and potentially also the cooperation of the bank acting as administrative agent, meaning that lenders would generally need to be unified in their decision to invoke these provisions.

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[1] Paul Davidson, Fed's Yellen Cites Growing Risk to Economy, USA Today, Feb. 10, 2016, available at <http://www.usatoday.com/story/money/markets/2016/02/10/federal-reserve-janet-yellen-testimony-congress/80068490/>.

[2] Greg Robb, Yellen says Fed isn't sure whether it's legal to adopt negative rates, Market Watch, Feb 10, 2016, available at <http://www.marketwatch.com/story/yellen-says-fed-isnt-sure-whether-its-legal-to-adopt-negative-rates-2016-02-10>.

[3] Christopher Whittal and Min Zeng, Investors Fret as ECB Looks Poised to Get More Negative, Wall St. J., Mar. 6, 2016, available at <http://www.wsj.com/articles/investors-fret-as-ecb-looks-poised-to-get-more-negative-1457295794>.

[4] Andrew Walker, Why use negative interest rates? BBC News, Feb. 15, 2016, available at <http://www.bbc.com/news/business-32284393>.

[5] Charles Forelle, Everything You Need to Know About Negative Rates, Wall St. J., Feb. 28, 2016, available at <http://www.wsj.com/articles/everything-you-need-to-know-about-negative-rates-1456700481>.

[6] In addition to raising economic concerns for lenders, the prospect of charging negative Libor under these credit agreements would present many banks with operational issues in the event their systems are not set up to contemplate negative Libor.

[7] JOSEPH M. PERILLO, CONTRACTS (7th ed. 2014) at 113.

[8] Baldwin v. EMI Feist Catalog Inc., 805 F.3d 18, 31 (2d Cir. 2015).

[9] Id.

[10] PERILLO at 124.

[11] Id. at 152.

[12] Law Debenture Trust Co. of New York v. Maverick Tube Corp., 595 F.3d 458, 466 (2d Cir. 2010).

[13] Toto Inc. v. Sony Music Entm't, 60 F. Supp. 3d 407, 414 (S.D.N.Y. 2014).

[14] Little v. Landsman Dev. Corp., 24 F. Supp. 3d 294, 298 (W.D.N.Y. 2014).

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