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June 4, 2019

Legal Update

The ARRC's Final Fallback Language Recommendations for New LIBOR Syndicated Loans

In our Legal Update dated May 2, 2019,[1] we discussed the April 25, 2019, fallback language recommendations of the Alternative Reference Rates Committee ("ARRC") for new issuances of LIBOR floating rate notes ("FRN Recommendations"). On April 25, the ARRC also published its recommendations for syndicated loans, titled "ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans" ("Syndicated Loan Recommendations").[2] The Syndicated Loan Recommendations are largely consistent with the FRN Recommendations, which the ARRC has stated to be one of its goals, but differ in that the Syndicated Loan Recommendations offer two alternatives for LIBOR fallback language for syndicated loan products: the "Hardwired" approach and the "Amendment" approach. In this Legal Update we discuss how the Syndicated Loan Recommendations differ from the FRN Recommendations, in terms of proposed LIBOR cessation events, replacement rates, and spread adjustments.

LIBOR Cessation Definitions

As in the FRN Recommendations, the Syndicated Loan Recommendations set forth three mandatory "Benchmark Transition Events," the occurrence of any of which will trigger a move from LIBOR to the replacement rate. These Benchmark Transition Events are the same whether the Hardwired or the Amendment Approach is chosen.

The first two Benchmark Transition Events are triggered on a permanent cessation of LIBOR and align with the LIBOR cessation triggers in the International Swaps and Derivatives Association, Inc. ("ISDA") 2018 Consultation.[3] These two triggers require that the LIBOR administrator (currently ICE Benchmark Administration), the regulatory supervisor of the LIBOR administrator (currently the UK Financial Conduct Authority), the U.S. Federal Reserve System (as the central bank for the currency of USD LIBOR) or a bankruptcy/resolution official or court with jurisdiction over the LIBOR administrator publicly state or publish that the LIBOR administrator actually has ceased or is expected to cease providing LIBOR quotations. These Benchmark Transition Events will not trigger a change from LIBOR until the date that LIBOR ceases to be published, if that date is later than the date of the relevant announcement.

The third mandatory trigger is a pre-cessation trigger predicated on "a public statement or

publication of information by the regulatory supervisor for the administrator of the Benchmark announcing that the Benchmark is no longer representative."[4] The change from LIBOR upon the occurrence of this trigger event would begin on the date of the announcement or publication. As in its FRN Recommendations, the ARRC determined to eliminate two of the three pre-cessation triggers proposed in its September 24, 2018 Consultation,[5] and to retain this pre-cessation trigger as the only indicator of a decline in the quality of LIBOR. The ARRC is aware that ISDA is considering adding a pre-cessation trigger to its fallback language recommendations, including consideration of a regulatory statement about benchmark quality. The ARRC has made its recommendation with a goal of seeking as much consistency with ISDA as possible, in order to reduce mismatches between syndicated loans and derivatives instruments that hedge the related floating rate loan exposure.

Because of the "unique role of the administrative agent in a syndicated loan,"[6] the ARRC notes in the User's Guide portion of the Syndicated Loan Recommendations that administrative agents may choose to include a fourth mandatory trigger addressing "the highly unlikely event" that the administrative agent's regulator announces that LIBOR is no longer representative or no longer may be used by the administrative agent. The rationale is to avoid the additional disruption that would occur if the administrative agent were to resign under such circumstances. The ARRC notes that this fourth mandatory trigger was not included in its recommended language because the triggers "are intended to describe market-wide events and align as closely as possible with derivatives."[7]

In addition to the mandatory triggers, the Syndicated Loan Recommendations include a unique and optional "Early Opt-in Election," reflecting the fact that syndicated loans have a "natural flexibility to reduce risk"[8] because the syndicate members are known to the administrative agent and can take action prior to the occurrence of an actual LIBOR cessation event. In contrast, the beneficial holders of floating rate notes can be difficult to ascertain and solicit for any required consent to similar action.

The mechanics of the Early Opt-in Election vary slightly depending whether the election is trigged under the Hardwired Approach or the Amendment Approach. Under the Hardwired Approach, the administrative agent—itself or at the request of the borrower—notifies all loan agreement parties that a specified number[9] of "currently outstanding U.S. dollar-denominated syndicated credit facilities" identify Term SOFR plus a Benchmark Replacement Adjustment as a benchmark interest rate, in lieu of LIBOR. After such notice is given, the administrative agent, the borrower, and the required lenders (most commonly, a majority) may elect by affirmative vote to replace LIBOR, and the change from LIBOR will take effect on the first business day the administrative agent provides written notice to all loan agreement parties that the Early Opt-in Election has been made.

Under the Amendment Approach, the early election option is triggered by a determination by either the administrative agent or the required lenders that U.S. dollar-denominated syndicated credit facilities are being executed or amended "to incorporate or adopt a new benchmark interest rate to replace LIBOR," and the related election and giving of notice by the administrative agent or required lenders, as applicable, to the other parties that it or they, as applicable, have declared that an Early Opt-in Election has occurred. Unlike the Hardwired Approach, no specific number of such transactions is suggested by the ARRC for the Amendment

Approach in the Syndicated Loan Recommendations.

The ARRC notes that the requirements under the Hardwired Approach for a specified number of reference transactions and for an affirmative vote of the syndicate provide an objective trigger that limits the administrative agent's discretion to initiate the automatic transition to a predetermined benchmark.

Benchmark Replacement

Unlike the FRN Recommendations, the Syndicated Loan Recommendations set forth two alternative approaches for benchmark replacement: the "Hardwired Approach," under which both the trigger events that would cause transition to a new benchmark rate, and the successor rate itself, are specified in the credit agreement, and the "Amendment Approach," under which the trigger events are specified but the successor rate is left to future negotiation. As with floating rate notes, both approaches acknowledge and specify that a spread adjustment is likely to be required upon transition. A Benchmark Replacement cannot be less than zero.

In recommending these two approaches, the ARRC sought to balance the goals of clarity, consistency, and the avoidance of gamesmanship, on the one hand, with flexibility in an uncertain future market, on the other hand. The Hardwired Approach, similar to the FRN Recommendations, proposes fallback language that is based on clear and observable triggers and includes a waterfall of identified successor rates, eliminating the ability of any party "to take advantage of the then-current market environment to capture economic value."[10] The Amendment Approach uses almost identical trigger events and creates a simple, streamlined amendment process, but does not reference rates or spread adjustment methodologies that do not yet exist. The ARRC notes that responses to the 2018 Consultation suggest that it may be more appropriate to follow the Amendment Approach until "the market has further visibility" into successor rates, spreads, and related mechanics and parties can "ensure alignment with derivatives at the time of transition." However, the operational risk of simultaneously negotiating amendments to, and transitioning, thousands of loans indicate that "eventually some version of a hardwired approach will be more appropriate."[11] The ARRC encourages that this happen well in advance, including through use of the Early pt-in Election.

HARDWIRED APPROACH

The Hardwired Approach sets forth an order of replacement rates for LIBOR syndicated loans that is similar to the Benchmark Replacement waterfall for floating rate notes:

- Step 1a: Term SOFR + Adjustment
- Step 1b: Next Available Term SOFR + Adjustment
- Step 2: Compounded SOFR + Adjustment
- Step 3: Administrative Agent and Borrower Selected Rate + Adjustment

A key difference, however, is the process for resolving the unavailability of a specific interest rate tenor. The FRN Recommendations provide that an issuer first will interpolate the next shortest and next longest tenors of LIBOR, and proceed to the waterfall only if interpolation cannot be determined. Respondents to the 2018 Consultation expressed concern that not all administrative agents would be prepared operationally to interpolate LIBOR.[12] As a result, the Hardwired Approach moves directly to the waterfall, looking first to SOFR for the requested tenor, and moving to the Next Available Term SOFR, which is the longest tenor that is shorter than the applicable requested tenor, if the requested tenor is not available. A second protection built into the

Hardwired Approach is the ability of the administrative agent to remove, and subsequently reinstate, specified tenors as borrowing options when those tenors are not available as screen rates. The goal of these provisions is to "ensure that parties stay in the first step of the benchmark replacement waterfall as long as possible," and avoid a situation where different loans under the same credit facility use different benchmark rates.[13]

In addition, the Hardwired Approach eliminates two interim waterfall steps that were included in the FRN Recommendations to address the typically longer maturities of floating rate notes.

Each step in the waterfall is described below with clarifying commentary.

Term SOFR + Adjustment: Term SOFR would be a forward-looking term rate, published by a third party, with a tenor matching the LIBOR tenor selected or recommended by the "Relevant Governmental Body" (the ARRC for USD LIBOR). As the ARRC has previously noted, it is not expected that a term Secured Overnight Financing Rate ("SOFR") that is IOSCO-compliant and based on a broad derivatives market will be available prior to the expected LIBOR cessation.[14] Also, because ISDA is not expected to reference a forward-looking term rate, the use of this rate for loans with related hedges may cause a hedging mismatch. Consequently, the ARRC confirms that credit agreement parties may wish to delete Term SOFR from the Benchmark Replacement waterfall, fall back to Compounded SOFR, which is expected to be ISDA's fallback for derivatives, and adjust other terms accordingly.

Next Available Term SOFR + Adjustment: As explained above, an interim step before proceeding to Compounded SOFR (and possibly creating a permanent split of loans subject to different benchmarks) is to fall back to the longest available tenor that is shorter than the requested tenor. In such a case, the Benchmark Replacement Adjustment used would correspond to the tenor of the rate actually used.

Compounded SOFR + Adjustment: Compounded SOFR, which was discussed extensively in the ARRC's "A User's Guide to SOFR," is a method to create an interest rate for a period by using a compounded average of the daily published SOFR rates during the interest period. The interest calculation may be done "in arrears," i.e., at the end of the interest period, by compounding the overnight SOFRs for the current relevant period, or "in advance," at the beginning of the interest period, by compounding the overnight SOFRs for the previous relevant period. The definition of Compounded SOFR specifically allows for a lookback or suspension period for calculations in arrears, and flexibility for change in the future due to direction from the ARRC or market-accepted conventions. The Syndicated Loan Recommendations also allow credit agreement parties to use a simple average of SOFR, rather than compounded SOFR, plus an adjustment, if desired.

In contrast to the FRN Recommendations, each of these alternatives—compound average and simple average SOFR—provides that if the administrative agent determines that the rate, methodology or convention for average SOFR is not "administratively feasible" for the agent, then Compounded SOFR will be deemed unable to be determined for purposes of the definition of "Benchmark Replacement." This provision acknowledges that no Compounded SOFR syndicated loans have been originated to date, so no standard methodology or convention exists currently, and lenders have not had to address whether their operational capabilities can accommodate a daily compounded SOFR.

Administrative Agent and Borrower Selected Rate + Adjustment: This final step

allows the administrative agent and the borrower to choose a replacement rate for a tenor corresponding to the requested tenor, giving due consideration to any recommendation of the Relevant Governmental Body (the ARRC) or any evolving or then-prevailing market convention for syndicated credit facilities at such time, if the prior waterfall steps do not produce a usable rate. Once selected, the administrative agent will give notice of the chosen rate to the syndicate members, who will have five days to object by following the streamlined amendment process set forth in the Amendment Approach described below. Lenders representing the required lenders must affirmatively object in order for the chosen rate to fail.

AMENDMENT APPROACH

Under the Amendment Approach, neither the successor benchmark rate nor the related spread adjustment are prescribed. Rather, this approach sets forth a streamlined amendment process for negotiating those provisions in the future. The ARRC notes that its recommendation is similar to the LIBOR fallback language being included in credit agreements currently, but builds in more specificity with respect to triggers, spread adjustment, and approval process.

Upon the occurrence of a specified trigger event—either mandatory or optional—the administrative agent and borrower may select a successor rate (which may, but need not, be Term SOFR) and spread adjustment, giving due consideration to any recommendation by the Federal Reserve Board or the ARRC, as well as any evolving or then-prevailing market conventions. Once chosen, the administrative agent must notify all lenders of the Benchmark Replacement. If selected pursuant to a mandatory trigger, the Benchmark Replacement becomes effective on the fifth business day after such notice, unless the required lenders object. In contrast, if selected pursuant to the optional Early Opt-in Election, the Benchmark Replacement becomes effective on the date that the administrative agent receives affirmative approval from the required lenders. During the time after the giving of notice and prior to effectiveness, outstanding loans will bear interest at the Alternative Base Rate.

A final aspect of note about the Amendment Approach is the recognition that it is operationally challenging to amend thousands of loans simultaneously. As a result, the Amendment Approach includes a "Benchmark Transition Start Date," which permits the transition to occur at any time within a specified window of time (the ARRC suggests up to 90 days) but not later than an announced cessation date.

Benchmark Replacement Adjustments

Because SOFR, unlike forward-looking LIBOR, is an overnight rate that is backward-looking, secured, and does not reflect credit risk, there will have to be an adjustment to the Benchmark Replacement to compensate for the differences and make the rates comparable. These adjustments may be positive, negative or zero.

HARDWIRED APPROACH

There are three steps in the Benchmark Replacement Adjustment waterfall under the Hardwired Approach:

- ARRC Selected Adjustment
- ISDA Fallback Adjustment
- Administrative Agent and Borrower Selected Adjustment

The first two options apply if the Benchmark Replacement is determined to be Term SOFR or Compounded SOFR. The third option applies if the Benchmark Replacement is determined by the administrative agent and

borrower pursuant to the streamlined amendment process. The method of calculation of the first two Benchmark Replacement Adjustments has yet to be determined.

ARRC Selected Adjustment: This adjustment is designed to be used with Term SOFR to correlate with the related LIBOR tenor. Because the ARRC acknowledges that some market participants may want to skip Term SOFR as a Benchmark Replacement, going straight to Compounded SOFR to achieve greater alignment with derivatives, these market participants should also remove the ARRC Selected Adjustment from their documentation.

ISDA Fallback Adjustment: This adjustment is designed to be used if there is no ARRC Selected Adjustment, and can be used with Term SOFR or Compounded SOFR. The Syndicated Loan Recommendations note that it is expected that the fallback rate selected by ISDA will be Compounded SOFR in arrears for derivatives; however, ISDA has not analyzed, and will not analyze, whether its fallbacks, including any spread adjustments, are appropriate in a non-derivative context.

Administrative Agent and Borrower Selected Adjustment: Much like the Administrative Agent and Borrower Selected Benchmark Replacement, this Adjustment allows the administrative agent and the borrower to choose an adjustment, or method for calculating an adjustment, that gives due consideration to any recommendation of the Relevant Governmental Body (the ARRC) or any evolving or then-prevailing market convention for syndicated credit facilities at such time.

AMENDMENT APPROACH

The Benchmark Replacement Adjustment under the Amendment Approach is virtually identical to the Administrative Agent and Borrower Selected Adjustment provided for in the third step of the Hardwired Approach, allowing the administrative agent and borrower to agree on an adjustment or calculation method that reflects any governmental recommendation and then-current market practice. The ARRC notes that the flexibility of this process "means that future developments with respect to spread adjustments are more easily captured,"[15] unlike the more rigid predetermined ARRC Selected and ISDA Fallback Adjustments under the Hardwired Approach.

Conforming Changes

The Syndicated Loan Recommendations allow the administrative agent to make technical, administrative and operational changes to terms, such as day-count conventions and frequency of determining rates. The definition of "Benchmark Replacement Conforming Changes" under both the Hardwired Approach and the Amendment Approach is substantially similar to the definition in the FRN Recommendations and reads:

> [w]ith respect to any Benchmark Replacement, any technical, administrative or operational changes (including changes to the definition of "ABR," the definition of "Interest Period," timing and frequency of determining rates and making payments of interest and other administrative matters) that the Administrative Agent decides may be appropriate to reflect the adoption and implementation of such Benchmark Replacement and to permit the administration thereof by the Administrative Agent in a manner substantially consistent with market practice (or, if the Administrative Agent decides that adoption of any portion of such market practice is not administratively feasible or if the Administrative Agent determines that no market practice for the administration of the Benchmark Replacement exists, in such other manner

of administration as the Administrative Agent decides is reasonably necessary in connection with the administration of this Agreement).

The administrative agent's ability to implement conforming changes is available both at the time of transition and from time to time thereafter, and is conclusive and binding absent manifest error. These conforming changes generally become effective without any further action or consent of any other party to the credit agreement, except as expressly required (for example, the affirmative consent right of the lenders with respect to an Early Opt-in Election). However, the administrative agent does have an obligation to promptly notify the borrower and lenders of any of the following events: the occurrence of a trigger event and its related replacement or start date, the implementation of a Benchmark Replacement, the effectiveness of any Benchmark Replacement Conforming Changes, the removal or reinstatement of any tenor of Term SOFR, and the commencement or conclusion of any period during which an announced cessation date has occurred but a Benchmark Replacement for LIBOR has not been determined (a "Benchmark Unavailability Period").

Other Considerations

Although the ARRC considers both the Hardwired Approach and the Amendment Approach recommendations to provide "a complete fallback solution," it also acknowledges that it is not possible to address every credit agreement provision that might be affected by a transition to a new interest rate benchmark. Some examples of provisions that lenders and borrowers should analyze further include:

- the level of lender consent (presumably unanimous) required to amend the chosen fallback language;
- break-funding, increased costs, and other provisions that address the effect of a lender's internal funding costs on margin preservation; and
- the effect of an "in arrears" interest rate on calculations of interest due on loan prepayments.

The ARRC states that it intends that "future changes such as these would be … implemented through … 'Benchmark Replacement Conforming Changes.'"[16]

Finally, the Syndicated Loan Recommendations also note that, given the determinations empowered to the administrative agent, the inclusion of general disclaimer language with respect to LIBOR or any successor rate would not be inconsistent with the ARRC's principles.

Effect on New Originations of Syndicated Loans

Although syndicated loan facilities can adjust more readily to changed market conditions than, for example, floating rate note issuances, administrative agents and loan syndicates are encouraged to begin using SOFR as an interest rate benchmark, even if a forward-looking Term SOFR may not be available for some time.

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Endnotes

[1] https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/05/arrcs-final-recommendations-for-new-fallbacks-for-libor-floating-rate-notesconverted.pdf.

[2] The FRN Recommendations are available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/FRN_Fallback_Language.pdf, and the Syndicated Loan Recommendations are available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Syndicated_Loan_Fallback_Language.pdf.

[3] *See* "Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW" at http://assets.isda.org/media/f253b540-193/42c13663-pdf/.

[4] Syndicated Loan Recommendations at 7 and 11.

[5] The ARRC Consultation Regarding More Robust LIBOR Contract Fallback Language for New Originations of LIBOR Syndicated Business Loans (Sept. 24, 2018) (the "2018 Consultation") is available at: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Syndicated-Business-Loans-Consultation.pdf.

[6] Syndicated Loan Recommendations at 16.

[7] *Id.*

[8] *Id.*

[9] The ARRC has suggested reference to five such agreements, but leaves the precise number to the negotiation of the parties. *See* Syndicated Loan Recommendations at 17.

[10] Syndicated Loan Recommendations at 36.

[11] Syndicated Loan Recommendations at 13-14.

[12] Syndicated Loan Recommendations at 21.

[13] Syndicated Loan Recommendations at 19.

[14] *See* "A User's Guide to SOFR" at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Users_Guide_to_SOFR.pdf.

[15] Syndicated Loan Recommendations at 29.

[16] Syndicated Loan Recommendations at 32.

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