SOFR Loan Documentation: 8 Things for Borrowers to Think About

A Lexis Practice Advisor® Article by David K. Duffee, Mayer Brown LLP

David K. Duffee
Mayer Brown LLP

Bankers, lawyers and others involved in the loan market's transition from LIBOR to another reference rate have spent much of the past two years thinking about and drafting fallback provisions—the section of a loan agreement that describes what happens if LIBOR is not available. Now that the likely disappearance of LIBOR is less than a year and a half away, and the Alternative Reference Rates Committee (ARRC) has identified the Secured Overnight Financing Rate (SOFR) as the likely successor to US dollar LIBOR, market participants are spending more time thinking about how to document loans that provide for interest accruing at a rate based on SOFR.

There are not many sources of guidance for developing SOFR loan documentation, but here are a few:

- There are a handful of precedent deals, including credit facilities for Royal Dutch Shell plc and British American Tobacco. Their utility in preparing documentation in the United States is limited since they are governed by English law; they are somewhat dateds (from December 2019 and March 2020, respectively); and, instead of providing for SOFR pricing at the outset, each has a so-called "switch mechanism" providing for a change in pricing from US dollar LIBOR to SOFR in the future. It is also possible that these financings were provided by relationship lenders and thus unlikely to be traded in the secondary market, making them less useful precedents for transactions in which such trading is anticipated. For more on these precedents, see "List of RFR referencing syndicated and bilateral loans," published by the Loan Market Association on July 21, 2020, available here. various draft "concept documents"—model credit agreements (governed by New York law) that provide for loans priced at a rate based on SOFR. The most recent of these forms includes provisions for loans bearing interest at daily simple SOFR (the "Draft Simple SOFR Credit Agreement"). Insofar as we know, these models have not yet been used for actual SOFR financings. Similarly, the LMA has prepared an exposure draft (governed by English law) of a compounded SOFR-based US dollar term and revolving facilities agreement (available here). The July 13, 2020, draft "Daily Simple SOFR or Daily Compounded SOFR (Compound the Balance) Concept Document" and other LSTA forms of SOFR credit agreements are available here.
- On June 30, 2020, the ARRC published revised recommendations for fallback language in syndicated credit agreements (the "Refreshed Hard-wired Recommendations"; see LIBOR Replacement Clause (Hardwired)). The revised recommendations provide solely for the "hard-wired" approach (and eliminate the "amendment" approach as an alternative). See "ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans," dated June 30, 2020,available here. Although this language provides for the automatic replacement of LIBOR with SOFR, it also acknowledges that "conforming changes" will need to be made to implement that

replacement. The ARRC has also published a note on "SOFR "In Arrears" Conventions for Syndicated Business Loans" (found here). This note discusses mechanical issues that must be addressed in documentation for SOFR loans (and, for many of the issues, the ARRC does not make a recommendation on how it should be resolved).

Although the borrower community has been actively involved in the negotiation of fallback provisions, borrowers in the United States have not had much of an opportunity to express their views on documentation for SOFR-priced loans. Here is a list of things that may be proposed by borrowers in the negotiation of a SOFR credit agreement and, in a syndicated financing, may be the subject of possible disagreement among lenders:

1. **Eliminate term SOFR from waterfall** –The first level of the waterfall in the Refreshed Hard-wired Recommendations is term SOFR. "Term SOFR" refers to a possible risk-free reference rate, based on SOFR, that is a forward-looking term rate (both attributes of LIBOR that some market participants would like to see in a reference rate). The ARRC has made it clear that there's no guarantee that it will be possible to develop term SOFR. Although there appears to be a strong preference by some banks for term SOFR (rather than daily SOFR), it is possible that some borrowers and lenders may prefer daily SOFR (the second level of the waterfall) since interest rate hedges (both for existing LIBOR hedges when they fall back and for new SOFR hedges) will likely be based on daily SOFR and not term SOFR. Those borrowers and lenders may fear potential basis risk and may want to eliminate the term SOFR level from the waterfall of possible fallback rates.8 The ARRC notes, in the "Refreshed Hard-wired Recommendations," that parties may wish to eliminate term SOFR from the waterfall for this reason. Other borrowers may well prefer to keep term SOFR as the first level of the waterfall (if term SOFR is in fact available) since its use will enable the parties to determine at the beginning of an interest period the exact amount of interest that will be payable at the end of the interest period—a determination that will not be possible for interest accruing at a rate based on daily SOFR in arrears (the second level of the waterfall in the "Refreshed Hard-wired Recommendations").

2. **Permit movement from daily SOFR to term SOFR** – It is possible that term SOFR (the first level of the waterfall) will not exist at the time a SOFR-priced loan agreement is entered into, and the loans will thus be priced at a rate based on daily SOFR (the second level of the waterfall). The parties to a credit agreement may want to provide that, if term SOFR is subsequently available, the daily SOFR interest rate will be automatically replaced with an interest rate based on term SOFR. That might require a significant amount of additional drafting, including (a) the possibility of different interest margins that would apply to loans priced at term SOFR (which may be difficult to agree on in advance if the calculation of term SOFR is not yet determined) and (b) provisions for the mechanics of pricing loans at term SOFR (such as day count and business day conventions, holiday and weekend conventions and the payment of broken funding compensation)—see "Refreshed Hard-wired Recommendations" at note 23. Such a transfer from daily SOFR to term SOFR might also require modification of hedging arrangements to avoid or minimize basis risk. The ARRC, in the Refreshed Hard-wired Recommendations, rejected the inclusion of a mechanic to change the pricing from daily SOFR to term SOFR, citing, among other things, "potential operational challenges"(see "Refreshed Hard-wired Recommendations" at note 23). As noted above, many lenders have expressed a preference for term SOFR, and borrowers may also prefer a term interest rate. The Draft Simple SOFR Credit Agreement does provide language for the possible replacement of daily SOFR with term SOFR but notes that an objective trigger may be required and that term SOFR may have limited availability for syndicated loans. See the Draft Simple SOFR Credit Agreement at note 34. The minutes of the ARRC's October 22, 2019, meeting state: "Federal Reserve staff delivered a presentation … showing that while SOFR futures volumes have grown significantly since inception, current market depth and trading volumes significantly lag fed funds futures and do not yet appear sufficient to create a robust IOSCO compliant SOFR term rate."

3. **Compound daily SOFR** – The waterfall in the "Refreshed Hard-wired Recommendations" provides that the second level of the waterfall is simple SOFR rather than compounded SOFR. The use of simple SOFR may facilitate sales of loans in the secondary market. It is possible that some lenders and some borrowers may prefer compounded SOFR so that the calculation of the interest rate on the loans is consistent with the way SOFR is calculated in any related interest rate hedges.

4. **Reduce or eliminate interest rate floors** – Many recent credit agreements have a floor on LIBOR (i.e., if LIBOR is actually less than a specified rate, LIBOR will be deemed to equal the specified rate for purposes of calculating interest). These floors generally range between zero and 1 percent and protect lenders in the event that LIBOR falls below the floor. The "Refreshed Hard-wired Recommendations" provide that, for purposes of a SOFR-based fallback rate, the sum of SOFR plus the spread adjustment cannot be less than the floor. That is appropriate because the sum of SOFR plus the spread adjustment is the replacement for LIBOR. In negotiating new SOFR credit agreements, borrowers may take the view that whatever floor was agreed to in the context of a LIBOR-priced loan should be reduced (or eliminated) in determining a floor for a SOFR loan since SOFR will almost always be a lower rate than LIBOR. See generally "SOFR "In Arrears" Conventions for Syndicated Business Loans" at pages 4 and 5.

5. **Eliminate breakage cost compensation** –Credit agreements currently provide that if a borrower repays a LIBOR-priced loan on a day other than the last day of an interest period, or if it fails to borrow a LIBOR loan that it requested, it must pay to the lenders any applicable broken funding cost. Note that generally, an amount equal to the difference (if any) between the amount of interest that would have accrued during the unelapsed portion of such interest period had there been no prepayment and the amount of interest that would accrue on the prepaid principal for that unelapsed portion of the interest period at a rate equal to LIBOR in effect on the date of the prepayment. The obligation to pay breakage for LIBOR-priced loans arose out of the structure of the London interbank market, in which banks made loans by buying certificates of deposit that did not permit prepayments. If a loan made by a bank that had funded itself in the LIBOR market were prepaid, that bank would not be able to prepay its funding source and would run the risk that interest rates in the interim had declined and interest that the bank could obtain on the amount of the prepayment would be less than the bank would owe on the certificate of deposit at maturity. Of course, lenders do not now fund themselves in the London interbank market, and borrowers nevertheless agree to pay broken funding compensation as if they did. That notwithstanding, borrowers may well balk at agreeing to breakage provisions when the historical explanation for breakage payments does not exist for a loan priced at a rate based on SOFR. The Draft Simple SOFR Credit Agreement notes that "[i]nclusion of breakage indemnities for SOFR-based loans is an ongoing discussion point in the market"(see Draft Simple SOFR Credit Agreement at note 43). The "Refreshed Hard-wired Recommendations" provide that modifications to the broken funding provision are one of the "Benchmark Conforming Changes" that can be made unilaterally by the Administrative Agent. Note that the modifications could be to terminate the breakage provision or to modify it so that it works in the context of a SOFR-priced loan.

6. **Eliminate yield protection** – Credit agreements will usually have provisions requiring the borrower to pay additional amounts to a lender to compensate the lender for additional costs it incurs as a result of changes in applicable law (and certain other circumstances). These provisions were originally included in credit agreements because of the loan pricing theory that a lender should be paid its cost of funds (i.e., LIBOR) plus the agreed-upon margin (the "cost-plus" loan pricing theory). Although these provisions now customarily apply to both base rate loans and LIBOR loans, borrowers may object to them being applied to SOFR loans, arguing that since SOFR is not a cost-of-funds rate, the cost-plus pricing theory does not apply to SOFR-priced loans (and that it would be anomalous to ask a borrower to reimburse a lender for an increase in the lender's funding cost when the SOFR-based pricing of the loan is not related to the lender's funding cost).

7. **Eliminate illegality provision** – Although they are becoming less common (as noted, for example, in The LSTA's Complete Credit Agreement Guide), some credit agreements still provide that a lender is released from its obligation to lend LIBOR-priced loans if it becomes illegal for the lender to make loans at an interest rate based on LIBOR (see Yield Protection Clauses in Credit Agreements). Those provisions arose out of fears that the US government might prohibit LIBOR loans as an attempt by banks to avoid US regulation by funding themselves outside of the United States. Although the Draft Simple SOFR Credit Agreement includes an illegality provision tied to SOFR loans, it is likely that borrowers will object to an illegality provision for loans priced at an interest rate published by the US government. See Draft Simple SOFR Credit Agreement, § 2.18

8. **Eliminate SOFR prong to "base rate"** – Credit facilities typically provide that borrowers are able to borrow either at a rate based on LIBOR or a rate based on the "base rate" or "adjusted base rate." That is typically defined as the greatest of (a) the US prime rate, (b) the federal funds rate plus 50 basis points and (c) some variant of LIBOR (usually one-month LIBOR as determined on any day) plus 100 basis points. The LIBOR prong of this definition is a recent addition that reflects the anomalous circumstance during the 2008 financial crises in which there was a risk that a LIBOR-priced loan would have a lower interest rate than a loan priced at the base rate (for which the spread would typically be 100 basis points less than the spread for LIBOR-priced loans). The Draft Simple SOFR Credit Agreement contemplates a SOFR prong (in lieu of the LIBOR prong) but does not express a view on whether the additional spread should be 100 basis points or something else. It may be that borrowers will push back on the inclusion of a SOFR prong since the circumstances that led to the increase of LIBOR in 2008 are unlikely to happen with respect to SOFR (since it is a risk-free rate).

Related Content

For more guidance on this topic, see:

- LIBOR Transition to SOFR in Credit Agreements
- The Client Asks: What Happens When LIBOR Ends?
- Market Trends 2019/20: LIBOR Succession Clauses
- Market Trends 2020: Yield Protection and Increased Costs
- LIBOR Replacement Clause (Amendment)
- LIBOR Replacement Clause (Hardwired)
- Interest Rate Provisions in Credit Agreements
- Yield Protection Clauses in Credit Agreements

David K. Duffee, Partner, Mayer Brown LLP

David Duffee is a finance partner in Mayer Brown's New York office, and is the leader of the firm's New York Banking & Finance practice. He advises financial institutions and borrowers in lending transactions – both for US-based borrowers and in cross-border financings. A significant part of David's practice focuses on Latin American lending. According to *Chambers Latin America* 2015, David is "[a] popular choice for syndicated bank financing."

Acquisition financings comprise a large part of David's practice. He also works on lending transactions with insurance company borrowers. He has extensive experience with work-outs, debtor-in-possession financings and other distressed situations.