



May 2019

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ARRC Releases Recommended Fallback Language for Floating Rate Notes and Syndicated Loans

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"It's no longer a question of if—but when—LIBOR will become unusable, yet most contracts referencing it don't adequately account for this eventuality."

The above statement by Tom Wipf, chair of the Alternative Reference Rates Committee (the "ARRC"), summarizes the driving force behind the ARRC's release of its final recommended contractual fallback language for U.S. dollar LIBOR denominated floating rate notes ("FRN")¹ and syndicated business loans ("syndicated loans")² in anticipation of the phasing-out of LIBOR and the transition to a benchmark rate based on the Secured Overnight Financing Rate ("SOFR").

In making this recommendation, the ARRC intends to set forth robust fallback provisions that provide clarity and specificity upon a LIBOR cessation while also preserving the flexibility needed for any unforeseen circumstances. As this recommendation follows the publication by the International Swaps and Derivatives Association ("ISDA") for different types of derivatives contracts, the ARRC noted that it strived to align its fallback provisions with the ISDA approach as much as possible.

The recommended fallback language generally addresses the following key terms:

1. **Benchmark Transition Events:** trigger events that represent a significant shift away from LIBOR;
2. **Benchmark Replacement:** successor adjusted rate that replaces LIBOR; and
3. **Benchmark Replacement Adjustment:** the spread adjustment applied to the successor rate to preserve the economic terms of the relevant contract.

Floating Rate Notes

The ARRC's recommended FRN fallback language can be used in a variety of floating rate securities issued in the capital markets, such as municipal bonds, convertible debt, and other debt issuances in connection with a cessation of LIBOR. It is meant to provide a more robust waterfall for a conversion to SOFR-based rates than the historic waterfall provisions included in FRN documentation. In general, the recommended FRN fallback language provides specificity on the triggers, successor rates, and



spread adjustments in an effort to eliminate ambiguity and limit the exercise of discretion by any party. The ARRC's language includes the following key terms:

- **Triggers:** Two permanent cessation triggers cover public statements from the benchmark administrator or the administrator's regulator or the central bank for the relevant currency announcing that the benchmark administrator has ceased or will cease to provide the benchmark and one pre-cessation trigger covers when the benchmark administrator's regulatory supervisor announces that the benchmark is no longer representative.
- **Benchmark Replacement:** Once a trigger event occurs, if only some tenors of LIBOR have been affected, then the interpolated value based on the nearest available benchmark tenor will be the benchmark replacement. If it is not possible to determine such an interpolated benchmark, the fallback language establishes a waterfall to determine the successor rate to be used. The waterfall for FRNs has several additional steps as compared to some of the other cash products, to account for long maturities and difficulty in amending the applicable contracts. In order to maintain consistency across asset classes, each step in the waterfall is assessed when a trigger event first occurs, without reversion back to an earlier step. The waterfall runs as follows:
 - Step 1: Term SOFR + Adjustment
 - Step 2: Compounded SOFR (compounded average for tenor in arrears) + Adjustment
 - Alternative Step 2: Simple Average SOFR (uncompounded simpler calculation) + Adjustment
 - Step 3: Relevant Governmental Body Selected Rate + Adjustment (if SOFR-based rate is discontinued)
 - Step 4: ISDA Fallback Rate (the fallback rate embedded in the ISDA standard definitions) + Adjustment
 - Step 5: Issuer or its Designee Selected Rate + Adjustment

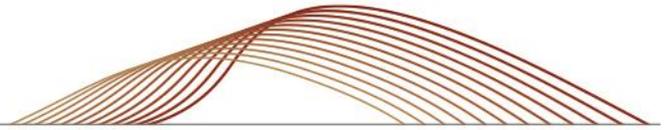
"Term SOFR" will be a forward-looking term SOFR rate with various tenors, which currently does not exist.

- **Benchmark Replacement Adjustment:** To account for the difference between LIBOR, which is an unsecured term rate, and SOFR, which is a secured overnight rate, the fallback language provides for an adjustment to be included in the determination of any benchmark replacement. Correlating to the benchmark replacement waterfall outlined above, the benchmark replacement adjustment waterfall runs as follows:

Step 1: ARRC Selected Adjustment (as selected or recommended by the ARRC or other Relevant Government Body)

Step 2: ISDA Fallback Adjustment (to be used with the ISDA Fallback Rate)

Step 3: Issuer or its Designee Selected Adjustment



Syndicated Business Loans

The ARRC recommended two sets of fallback language for new originations of LIBOR-referenced U.S. dollar-denominated syndicated loans: the “hardwired approach” and the “amendment approach,” further described below. Whereas the hardwired approach provides more clarity and certainty upfront as the specific fallbacks are built into the contract, the amendment approach, by providing a framework for negotiating a replacement rate in the future, maximizes flexibility and does not reference any rates or adjustment methodologies not yet existent. Although market participants initially may favor the amendment approach for its flexibility during the transition phase, they eventually may move to the hardwired approach to overcome operational difficulties in amending contracts in volume and the possibility of being subject to manipulation depending on the economic environment at the time of transition, as also noted by the LSTA.³

- **Triggers:** The same two permanent cessation triggers and the pre-cessation trigger applicable to FRNs apply to syndicated loans, but syndicated loans also have an additional “early opt-in election” trigger, which takes advantage of a syndicated loan’s flexibility for parties to agree to switch to an alternative rate before LIBOR is discontinued or becomes unrepresentative.
- **Hardwired Approach:** As with FRNs, the fallback language for syndicated loans is included in the original contract so that upon a trigger event, the waterfalls for the benchmark replacements and the benchmark replacement adjustments will apply.

Benchmark Replacements:

- Step 1a: Term SOFR + Adjustment
- Step 1b: Next Available Term SOFR (SOFR for longest tenor that can be determined that is shorter than the applicable tenor) + Adjustment
- Step 2: Compounded SOFR + Adjustment
- Alternative Step 2: Simple Average SOFR + Adjustment
- Step 3: Borrower and Administrative Agent Selected Rate + Adjustment

Benchmark Replacement Adjustments:

- Step 1: ARRC Selected Adjustment
 - Step 2: ISDA Fallback Adjustment
 - Step 3: Borrower and Administrative Agent Selected Adjustment
- **Amendment Approach:** Instead of the predetermined waterfalls, the amendment approach provides the process and procedures for parties to agree on a benchmark replacement for LIBOR and the adjustments that should apply. Upon a trigger event, the borrower and the administrative agent may agree to select a successor rate and a spread adjustment, in each case giving due consideration to any selection or recommendation by the Federal Reserve Board, the ARRC, or any evolving or then-prevailing market convention for determining such successor rate or spread adjustment. Similar to the “early opt-in election” trigger,



the amendment approach is a specific feature for loans due to the relative ease in modifying applicable agreements.

Differences from ISDA Fallback Language

While the two permanent cessation triggers included in the ARRC fallback language align with the fallback triggers included in ISDA's 2018 consultation,⁴ the pre-cessation trigger (which permits market participants to transition to an alternative rate when the quality of the benchmark has deteriorated such that it no longer is representative of the underlying market or economic reality) does not align and could create a potential area where the ARRC's language and ISDA's language may diverge. On May 16, 2019, ISDA published a consultation⁵ on the pre-cessation issue for LIBOR and certain other IBORs seeking market feedback on this pre-cessation trigger and other related issues, but it remains to be seen whether ISDA ultimately will include a similar pre-cessation trigger with the FRN and syndicated loan fallback.

Another area where the ARRC fallback diverges from the proposed ISDA fallback is the primary fallback rate. Whereas the ARRC recommended fallback language references a forward-looking term SOFR rate (which currently does not exist) as the primary fallback rate, the primary fallback rate proposed by the ISDA 2018 consultation is based on the average of SOFRs for the relevant term and compounded in arrears. Market participants should be on the lookout for ISDA's final fallback language, and to the extent it diverges from the ARRC's fallback language, market participants should consider whether to adjust the ARRC's fallback language to eliminate mismatch with any interest rate derivatives they have entered into in order to offset or hedge the floating rate exposure of the FRN or syndicated loan.

Conclusion and Next Steps

The ARRC recommendations offer a helpful framework for market participants to consider adopting into their agreements with appropriate modifications catered to their specific needs. Regardless of what fallback regime is followed, it is critical that market participants inventory existing agreements that could be affected by the cessation of LIBOR, understand their LIBOR exposure across relevant contracts, and develop a timeframe for amendments. Also, determining a robust fallback regime that will be used going forward will help ensure a smooth transition away from LIBOR.

As the next step, the ARRC will be releasing recommended fallback language for bilateral business loans and securitizations soon. The ARRC also expects to consult with a broad range of stakeholders on proposals for fallback language in consumer products in the future.

Paul Hastings lawyers are actively counseling our clients on the cessation of LIBOR as well as the benefits and consequences of each fallback regime for the various products.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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 - ⁵ International Swaps and Derivatives Association, Inc., Consultation on Pre-Cessation Issues for LIBOR and Certain Other Interbank Offered Rates (IBORs) (2019), <https://www.isda.org/a/t6tME/Pre-cessation-issues-Consultation.pdf>.

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