New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 265—NO. 51
THURSDAY, MARCH 18, 2021

Outside Counsel

The Governor's LIBOR Legislation: Its Promise and Its Limitations

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As widely reported, LIBOR—a benchmark interest rate used worldwide in trillions of dollars worth of investment contracts and other financial instruments—is being phased out and will cease publication in its current form entirely by mid-2023. With some LIBOR tenors terminating as soon as the end of this year, Governor Cuomo's FY 2022 budget proposal includes provisions that address LIBOR's retirement. See FY 2022 New York State Executive Budget, Transportation, Economic Development and Environmental Conservation Article VII Legislation, "Part PP: Discontinuance of LIBOR", at pp. 233-42 (hereinafter Proposed LIBOR Legislation). Similar legislation has been drafted and is being considered by congressional lawmakers at the federal level.

Governor Cuomo's proposed LIBOR legislation was initially drafted by the Alternative Reference Rates Committee (ARRC), a body convened by the Federal Reserve Board and the New York Fed to address the end of LIBOR. In proposing the legislation, ARRC warned that New York courts could soon face "a flood of litigation" arising from LIBOR's discontinuation, given the significant number of LIBOR-based contracts and other financial instruments that are governed by New York law. Alternative Reference Rates Committee, "Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition" (March 6, 2020), p. 7.

> The uncertainty of when the exemption may be reduced makes flexibility in planning techniques very attractive.

Accordingly, ARRC and other major stakeholders welcomed the Governor's proposed legislation.

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See Keshia Clukey and William Shaw, "Libor Overhaul Gets Boost in Cuomo Bid to Avert Transition Chaos," *Bloomberg Law* (Jan. 21, 2021). Tom Wipf, Vice Chairman of Institutional Securities at Morgan Stanley and Chairman of the ARRC, touted the legislation as "essential in order to provide legal certainty and minimize the adverse economic impacts for legacy Libor contracts," calling the Governor's decision to include the proposed legislation in his budget plan "notable progress." Id.

The proposed legislation, as Mr. Wipf noted, aims to provide legal certainty and curb litigation. One of the prominent features of the proposal is to substitute by operation of law the Secured Overnight Financing Rate (SOFR) for LIBOR in contracts that do not already include a designated fallback benchmark interest rate. See Proposed LIBOR Legislation at §18-401. The legislation further prescribes that the use of SOFR shall not discharge or excuse performance of a financial instrument or contract in which SOFR is used as a substitute for LIBOR and that the use of SOFR shall not constitute a breach of any contract, security or other financial instrument (id. at §18-402(2)(ii)); and declares the use of SOFR to be "a commercially reasonable substitute for and a commercially substantial equivalent to LIBOR." Id. at §18-402(1)(a). Furthermore, it prohibits "any liability for damages [or] any claim or request for equitable relief arising out of or related to the use of a recommended benchmark replacement … ." Id. at §18-402(3).

Even with these safeguards, however, the proposed legislation will not eliminate adverse economic impacts for all parties to LIBOR-based financial contracts. Nor will it necessarily curb all litigation. Given the economic differences between these two benchmark interest rates—including that, because the lending reflected in SOFR is secured by U.S. treasuries, SOFR is considered a risk-free interest rate, whereas LIBOR is not—there will almost certainly be economic winners and losers if a substitution of these rates is made by operation of law without other adjustments.

> Given the various challenges that could be brought even if the proposed legislation is adopted, any party to a significant number of LIBOR-based contracts would be wise to start planning now.

Thus, even with all that the proposed legislation does to curb litigation and provide legal certainty for the parties to LIBOR-based contracts, economically aggrieved parties may still be financially motivated to sue—sometimes for very large sums of money—and will have legitimate arguments to bring.

Contract Clause Of the U.S. Constitution

Parties economically disadvantaged by a rate substitution may facially challenge the proposed legislation claiming that it violates the Contract Clause of the United States Constitution. The Contract Clause prohibits states from passing any law "impairing the Obligation of Contracts." U.S. Const. Art. I, §10, Cl. 1. The Supreme Court applies a two-step test in analyzing challenges brought under the Contract Clause: first, the Court considers whether the state law substantially impairs the contract; if it finds that it does, then the Court asks whether the law is a reasonable way to advance a significant and legitimate public purpose. See *Sveen v. Melin*, 138 S. Ct. 1815, 1821-22 (2018).

Because the proposed legislation mandates a substitute benchmark replacement rate and seeks to preclude the availability of a damages remedy, it seems at least likely that an economically aggrieved party could satisfy the first prong of the Supreme Court's test. See *Donohue v. Cuomo*, 980 F.3d 53, 76 (2d Cir.), certified question accepted, 36 N.Y.3d 935(2020) ("If a state passes a law … preclud[ing] a damage remedy, … the law has impaired the obligation of the contract.") (internal quotation omitted)).

However, any challenger to the proposed legislation will face a higher hurdle in trying to satisfy the second prong of the test. The sheer scale of economic activity tied to LIBOR makes its termination a widespread problem, and legislation designed to eliminate the ensuing legal uncertainty seems likely to be deemed in service of a significant and legitimate public purpose. While the question of whether the Governor's proposed approach is a "reasonable way" to advance that purpose may be subject to some doubt and litigation, "courts usually defer to a legislature's determination as to whether a particular law was reasonable and necessary."

Donohue, 980 F.3d at 82 (2d Cir.) (internal quotation omitted).

Non-Delegation

Separately, the New York Constitution prohibits the state legislature from delegating its law-making responsibilities to other entities. See, e.g., *Levine v. Whalen*, 39 N.Y.2d 510, 515 (1976); *Fink v. Cole*, 302 N.Y. 216, 225 (1951). The proposed legislation defines the "recommended benchmark replacement" to mean "a benchmark replacement based on SOFR … that shall have been selected or recommended by" "the Federal Reserve Board, the Federal Reserve Bank of New York, or the Alternative Reference Rates Committee, or any successor of them." Proposed LIBOR Legislation §§18-400(7), 18-400(11). A litigant wishing to challenge the proposed legislation on this ground could argue that it is improper for the Legislature to impose on contracting parties a replacement rate selected by the Federal Reserve, the New York Fed, or ARRC. An opponent would counter that the proposed legislation does not actually delegate legislative responsibilities to any of these entities, but rather only incorporates a recommended rate developed by them, given their appropriate technical expertise.

Trust Indenture Act

Bondholders with interests subject to the Trust Indenture Act (TIA) would have an additional argument against the proposed legislation. Section 316(b) of the TIA provides that "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security … shall not be impaired or affected without the consent of such holder." 15 U.S.C. §77ppp(b). A 2017 Second Circuit decision held that §316(b) is violated, and the right to payment is "impaired or affected," only if there are "formal indenture amendments to core payment rights." *Marblegate Asset Mgmt. v. Educ. Mgmt. Fin.*, 846 F.3d 1, 16 (2d Cir. 2017). No court has ever held that government action can constitute a formal amendment to a bondholder's rights for purposes of the TIA. Moreover, in *Marblegate*, the Second Circuit expressly rejected the theory that §316(b) is violated when a bondholder's "practical ability to collect payments" has been impaired, but not eliminated—suggesting that a party challenging the proposed legislation would have to show that its right to payments is somehow invalidated by the use of SOFR, not just that its payments would be reduced. *Marblegate*, 846 F.3d at 9; accord *CNH Diversified Opportunities Master Account, L.P. v. Cleveland Unlimited*, 36 N.Y.3d 1, 16 (2020) (holding that a strict foreclosure sale that cancelled notes and thereby "terminat[ed] the Minority Noteholders' *legal* right to receive payment of principal and interest" violated the language of §316(b)). Furthermore, the legislation itself seems to anticipate this argument by declaring that "the recommended benchmark replacement" does not constitute "an amendment or modification of any contract, security or instrument" and does "not prejudice, impair or affect any person's rights or obligations under or in respect of any contract, security or instrument." Proposed LIBOR Legislation at §18-401(1). However, none of these headwinds to litigation might be enough to stop a disadvantaged bondholder from making a claim if the bondholder was sufficiently harmed by the substitution of SOFR.

Conclusion

Given the various challenges that could be brought even if the proposed legislation is adopted, any party to a significant number of LIBOR-based contracts would be wise to start planning now. The draft legislation provides parties with the option to mutually opt out of the proposed scheme for substituting SOFR. Proposed LIBOR Legislation at §§18-400(6), (11), and 401(5). Reaching agreement with counterparties to LIBOR-based financial contracts is another way to achieve the same certainty—without the litigation risk—that the proposed legislation is designed to achieve.

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