



Outside Counsel

Legislative Solutions To the LIBOR Replacement Dilemma

Our previous article on this topic outlined the challenging issue of LIBOR transition—that is, moving from LIBOR to another benchmark rate—for asset-backed securities such as residential mortgage-backed securities (RMBS), and particularly, the complication created by there being two levels of transition: LIBOR-indexed mortgage notes that are assets of an RMBS securitization trust, and LIBOR-indexed interest rates paid on the securities issued by the securitization trust. See John M. Lundin, *The Special Challenges of LIBOR Transition for Residential Mortgage-Backed Securities and Other LIBOR Indexed Securitizations*, NYLJ (May 25, 2021). Here, we discuss legislative solutions—both one that already has been enacted and another that has been proposed—to the problem of LIBOR transition in securitization trusts. These solutions address some



By
**John M.
Lundin**



And
**Hannah
Zelcer**

of the LIBOR transition challenges, but uncertainty—and hence substantial litigation risk—remains on their ultimate scope or effectiveness.

The ARRC and the Development of A LIBOR Replacement Rate

On April 6, 2021, Gov. Andrew Cuomo signed Senate Bill 297B, which created a new Article 18-C to New York's General Obligations Law creating a framework for LIBOR transition for contracts governed by New York law where the rate to use once LIBOR is permanently unavailable is not set by the contract.

Senate Bill 297B was initially drafted by the Alternative Reference Rates Committee (ARRC), a working group created in 2014 by the Federal Reserve Board and the Federal Reserve Bank of New York to address LIBOR transition. The ARRC

is composed of a diverse group of private financial market participants. Working with financial regulators, it has proposed the Secured Overnight Financing Rate (SOFR) as the LIBOR replacement for U.S. Dollar transactions and developed a LIBOR transition plan and related publications.

SOFR is published by the Federal Reserve Bank of New York and is derived from overnight repurchase agreement contracts where the collateral posted is U.S. Treasury securities. Since SOFR was first published in April 2018, daily transaction volume in the markets underlying SOFR has averaged more than \$980 billion. *The End of LIBOR: Transitioning to an Alternative Interest Rate Calculation for Mortgages, Student Loans, Business Borrowing, and Other Financial Products*: Hearing Before the House Financial Services Subcomm. on Investor Protection, Entrepreneurship, and Capital Markets, 117th Cong. 3-4 (2021) (statement by Dan Coates, Senior Associate Director, Federal Housing Finance Agency). Unlike LIBOR, SOFR is a transparent reference rate because it is based on actual market transactions and

published by an unbiased administrator subject to regular audits. *Id.*

New York's LIBOR Transition Legislation

Senate Bill 297B lays out a framework for LIBOR transition for LIBOR-indexed agreements governed by New York law. In general, it provides that where a contract provides a clear replacement to LIBOR, the contract governs, but where the LIBOR replacement is unclear, it allows—but does not require—the parties to use SOFR as the LIBOR replacement.

First, if an agreement has a LIBOR replacement provision that is not based on LIBOR, then the replacement provision in the agreement, not the statute, governs. N.Y. Gen. Oblig. Law §18-401 (Consol., Lexis Advance through 2021 released Chapters 1-112).

Second, if an agreement does not provide for a LIBOR replacement, then LIBOR will be replaced by SOFR. *Id.* ¶ 1.

Third, when an agreement's LIBOR replacement is “based on or otherwise involving a poll, survey or inquiries for quotes or information concerning” a rate “based on LIBOR,” then that LIBOR replacement must be “disregarded” and will be “null and void and without any force or effect.” *Id.* ¶ 2. In this case, again, LIBOR will be replaced by SOFR. *Id.* ¶ 1.

Fourth, for contracts where someone—typically one of the parties—gets to choose the LIBOR replacement, that person may—but is not required to—choose SOFR as the LIBOR replacement. *Id.* ¶ 3. Where a person with discretion to choose a LIBOR replacement

chooses SOFR, they get the benefit of the safe harbor provisions of N.Y. Gen. Oblig. Law. §18-402, which, broadly speaking, prevent any liability from arising from choosing SOFR as a LIBOR replacement. N.Y. Gen. Oblig. Law §18-402 (Consol., Lexis Advance through 2021 released Chapters 1-112).

Senate Bill 297B is designed to solve many of the problems LIBOR-based asset-backed securities will face. For example, mortgage loans using the older version of the FannieMae/FreddieMac standard note form provide that if LIBOR no longer is available, “the Note Holder will

On April 6, 2021, Gov. Andrew Cuomo signed Senate Bill 297B, which created a new Article 18-C to New York's General Obligations Law creating a framework for LIBOR transition for contracts governed by New York law where the rate to use once LIBOR is permanently unavailable is not set by the contract.

choose a new index that is based upon comparable information.” Now, a securitization trustee can choose SOFR as the LIBOR replacement and take comfort in the safe harbor provisions protecting that choice.

Similarly, if an RMBS trust's LIBOR replacements are all LIBOR-based (for example: If LIBOR no longer is available, then the interest rate shall be the last available LIBOR), then the LIBOR-based replacement rules are void and SOFR becomes the new benchmark.

Senate Bill 297B accomplishes many things, but it is not without drawbacks, including:

- It only applies to agreements covered by New York law. While agreements governing securitization structures such as RMBS pooling and servicing agreements often are governed by New York law, some are governed by other law, particularly Delaware law. And there many securitized assets, such as mortgage loans, where New York law likely applies only to a minority of the agreements.
- As we discuss below, there is proposed federal LIBOR transition legislation what may preempt some or all of the provisions of Senate Bill 297B, or worse, create ambiguity regarding the law's coverage.
- It is possible that Senate Bill 297B will face constitutional challenges. It changes the terms of existing contracts, implicating the Contracts Clause of the U.S. Constitution. Less likely, but possible are challenges under the federal and New York state Due Process and Takings Clauses and an argument that the law violates New York's nondelegation doctrine, because the law imposes a LIBOR replacement that the state legislature had no role in setting and over which it has no control.

Federal LIBOR Replacement Legislation

New York (with the ARRC's help) has taken significant steps in implementing legislative solutions to the

LIBOR transition challenge. However, other legislative fixes are on the horizon.

On April 15, 2021, the U.S. House of Representatives held a hearing on proposed federal LIBOR legislation, H.R. __, the Adjustable Interest Rate (LIBOR) Act of 2021, which is largely modeled after Senate Bill 297B, and addresses three key issues implicated by the transition from LIBOR.

First, §4(f) would give contracts that contain a clearly defined benchmark rate as a fallback, such as the Effective Federal Funds Rate, full legal force and effect. Adjustable Interest Rate (LIBOR) Act of 2021, H.R. __, 117th Cong. §4(f) (2021). The goal of this section is to allow for the original terms of applicable contracts to operate as negotiated by the participants where a viable benchmark is referenced. Id.

Second, in order to achieve a uniform process for contracts that currently reference LIBOR, §4(a) uses very similar language to Senate Bill 297B, and provides that contracts that either contain no fallback provision or contain a fallback provision that is based in any way on LIBOR will be replaced by a SOFR-based rate following the cessation of LIBOR. Id. at §4(a)

Third, the language of §5(a)(1) defines the selection of SOFR as a “commercially reasonable replacement for and a commercially substantial equivalent to LIBOR.” Id. §5(a). Further, §5(b) (3)(A)-(B) goes on to state that the selection or implementation of a SOFR-based benchmark rate shall not, “effect or discharge performance under the contract, (ii)

give any person under the contract the right to unilaterally terminate, (iii) constitute a breach of contract, or (iv) render the contract null and void.” Id. at §5(b).

Fourth, the federal legislation offers a similar safe harbor as Senate Bill 297B to contract participants who choose SOFR as an alternative. Section 5(c) states that, “[n]o person shall be subject to any claim or cause of action in law or equity or have liability for damages, arising out of or related to the selection or use of a Board-Selected Benchmark Replacement . . .” Id. §5(c).

The Trust Indenture Act

A more unique issue is posed by financial instruments governed by the Trust Indenture Act of 1939 because §316(b) of the TIA states that, “the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder.” 15 U.S.C.S. §77ppp (LexisNexis, Lexis Advance through Public Law 116-344, approved Jan. 13, 2021, with a gap of Title 10 provisions affected by Public Law 116-283). Thus, any indenture that references LIBOR cannot be unilaterally changed by the participants. Section 8(2) of the proposed legislation addresses the issue by stating that §316 is amended by the proposed legislation, by

inserting “and except 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 deemed to be impaired or affected by any change occurring by the application of section 4 of the Adjustable Interest Rate (LIBOR) Act of 2021 to any indenture security” Adjustable Interest Rate (LIBOR) Act of 2021, H.R. __, 117th Cong. §8(2) (2021).

Federal legislation would provide a nationwide solution to the issues that inevitably will arise when LIBOR no longer is published. Still, it is subject to the same potential constitutional challenges as Senate Bill 297B. And, to the extent the final legislation differs from Senate Bill 297B, it will create ambiguity regarding which law controls.

Conclusion

The current and proposed legislative solutions to the LIBOR transition challenge accomplish much, but uncertainty remains regarding some aspects of implementing the LIBOR transition for asset-back securities. We hope to address how investors—and their counsel—can address these uncertainties in a future article.