

LIBOR Phase-Out: Questions of Interest to Arbitrators

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Introduction

The London Interbank Offered Rate (“LIBOR”) is an estimate of the interest rate at which London-based major banks borrow unsecured funding from one another. It is administered by the Intercontinental Exchange (“ICE”) under the supervision of the Financial Conduct Authority (“FCA”). Based on the entries supplied by a panel of banks, ICE currently estimates and publishes LIBOR on a daily basis in five currencies, for seven maturity periods.[fn] US Dollar, Euro, Pound Sterling, Japanese Yen and Swiss Franc; overnight, one week, one month, two months, three months, six months, and one year.[/fn]

LIBOR has been a fixture of international commercial transactions for over 30 years. Financial contracts (such as derivatives, syndicated loans, bonds, and retail mortgages) commonly use it as the benchmark interest rate. It is also used in a variety of commercial contracts to define the interest rate applicable in price adjustment mechanisms or for late payments.

Notwithstanding its importance, reliance on LIBOR must soon end. In the wake of what is generally referred to as the “LIBOR Scandal”, after it emerged that some banks had manipulated the system by submitting artificially high or low interest rates, on 27 July 2017, the FCA’s CEO announced that, as from 1 January 2022, the FCA would no longer require participating banks to file LIBOR estimates. Although the FCA did not directly call for the discontinuation of LIBOR, it is now widely understood that LIBOR is unlikely to be published as from 2022.

The end of LIBOR raises several questions for arbitral tribunals dealing with issues of interest. In this blog we attempt to address two such questions.

First, how should a tribunal apply a LIBOR-benchmarked contract once LIBOR has ceased to exist? Can the tribunal apply a replacement rate,[fn] The financial industry has been seeking to come up with viable replacements for LIBOR. However, given some unique characteristics and the global nature of LIBOR, finding sustainable alternatives has proven difficult. Among the alternatives proposed so far, there are overnight index rates for different currencies, such as the Sterling Overnight Index Average (“SONIA”) and the Swiss Average Rate Overnight (“SARON”), as well as various repurchase agreement rates and the secured overnight financing rate for the US dollar (“SOFR”); see here for more details.[/fn] or has the relevant clause become frustrated or impossible to perform?

Second, what will happen to awards of interest by reference to LIBOR that have not been fully paid on

the date of LIBOR's discontinuance? Can they be corrected or revised, and if not, are they still enforceable?

A. LIBOR-Benchmarked Contracts

We first address the situation where an arbitral tribunal is faced with a contract that refers to LIBOR as a benchmark. Although parties are expected to replace or amend their contracts in the phase-out period or resort to contractual fallback mechanisms, it is likely that disputes will nevertheless arise in respect of outstanding LIBOR-benchmarked contracts after the phase-out.

Where the contract provides for a fallback mechanism or an alternative benchmark for calculating interest (as is the case with many financial contracts^[fn] The International Swaps and Derivatives Association ("ISDA"), for instance, recommends that fallback mechanisms be included in transactions precisely to avoid difficulties when the default reference rate is not (or no longer) available. See ISDA, "Development of Fallbacks for LIBOR and other Key IBORs", 28 November 2017, see: <https://www.isda.org/2017/11/28/development-fallbacks-libor-key-ibors-faqs/>, last accessed on 18 May 2019. The US-based Alternative Reference Rates Committee ("ARRC") has recently released recommended contractual fallback language for US dollar LIBOR denominated floating rate notes and syndicated loans. See <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-Apr-25-2019-announcement.pdf> last accessed on 21 May 2019.^[fn], the tribunal should apply that mechanism. Any disputes are thus likely to relate to the interpretation or operation of that mechanism. While the tribunal's task should be relatively straightforward, difficulties may arise in the interpretation of the "trigger provisions" which determine when the mechanism is activated.

Where the contract contains no fallback mechanism, the tribunal will need to resort to a more complex analysis under the applicable substantive law. Below we offer an overview of legal concepts that might guide the tribunal in common and civil law jurisdictions, using English and Swiss law as examples. Our analysis focuses on contracts concluded before the LIBOR phase-out became public knowledge.^[fn] If parties concluded a LIBOR-benchmarked contract after that date, neglecting the consequences of the phase-out, different considerations may apply, possibly calling for the application of rules such as those on "initial impossibility" or "mistake", among others, depending on the type of contract and parties involved.^[fn]

1. English law

The following principles might be potentially relevant for LIBOR-benchmarked contracts governed by English law:^[fn] For a more in-depth discussion, see in particular W. Bristow, R. Huntsman, "A post-LIBOR world: how will the English courts address legacy contracts after 31 December 2021", *International Banking and Financial Law Review* 3, 1 January 2018.^[fn]

Contextual interpretation – As recalled by the UK Supreme Court in *Wood v. Capita Insurance Services Ltd*, interpreting contractual provisions under English law involves ascertaining the objective meaning of the language chosen by the parties to express their mutual intention. For this purpose, besides the ordinary meaning of the contractual terms, English courts may also consider the context, including the contract as a whole, the circumstances known to the parties while entering into the contract, and commercial common sense. Applying these principles, a tribunal might consider it appropriate to ascertain if the parties intended for interest to apply per se, and were flexible as to its calculation.^[fn]

Notably, a court or tribunal might forego contractual interpretation altogether, since the analysis to be conducted in respect of the LIBOR phase-out is not necessarily interpretative. [fn] If this is so, and if a proposed alternative to LIBOR makes commercial sense (because it ensures a comparable result in terms of allocation of the floating interest rate risks between the parties for a given transaction), a court or tribunal could resort to that alternative as a reflection of the parties' likely mutual intention. That being said, in Arnold v. Britton & Others, the Supreme Court has also emphasized that the analysis should be made from a standpoint contemporaneous to the conclusion of the contract. Thus, if the parties have not inserted a fallback mechanism in their contract, it might be difficult to prove – without specific contemporaneous evidence of intention – that the parties intended to calculate the applicable interest rate based on an alternative benchmark.

Implying Contractual Terms – A tribunal may imply a term to form part of the contract if the term is reasonable, equitable, not contradicted by other terms of the contract, and either necessary for preserving the business purpose of the contract or so obvious that “it goes without saying”. Marks & Spencer v. BNP Paribas Securities Services & another shows that the courts apply the test strictly and are not willing to imply a contractual term simply because the outcome may be otherwise harsh for one of the parties.[fn] Equally, English courts seek to avoid implying terms based on hindsight bias. [fn] If the LIBOR clause plays a peripheral role in the contract, it may be difficult to argue that implying an alternative mechanism is crucial for the preservation of the parties' contractual deal. Conversely, where the LIBOR clause is a central term, a tribunal is more likely to imply a fallback mechanism to preserve the contract's business efficacy.

Alternative Valuation Mechanism – In Sudbrook Trading Estate v. Eggleton, an English court substituted a contractual valuation mechanism in a lease when that mechanism became inoperable.[fn] Sudbrook Trading Estate v. Eggleton, [1983] 1 AC 444. [fn] However, this was only possible because the valuation mechanism was not itself an essential term of the contract. Tribunals applying English law might thus consider applying the rationale in Sudbrook by analogy when the reference to LIBOR is considered non-essential. This will depend on the type of contract, the tribunal's understanding of the parties' intent and whether an existing alternative can fulfill a substantially equivalent function in terms of risk allocation and general reliability.

Frustration – If the above approaches fail, then, depending on the role of the LIBOR clause for the contract, either the entire contract or the LIBOR clause may be deemed frustrated, i.e. commercially impossible to perform. In that case, the parties may be able to recover sums paid before the frustration. Tribunals taking this route should bear in mind commercial realities and the wider detrimental effects that such an outcome may have on the relevant financial market.[fn] Albeit, given that arbitral awards are often confidential and without precedential value, the implications are not comparable with those of court judgments.[fn]

2. *Swiss law*

The following rules may become relevant when a tribunal is faced with a LIBOR-benchmarked contract governed by Swiss law:[fn] For this section, see, eg, B. Winiger, in L. Thévenoz/F. Werro (Eds), Commentaire romand – Code des obligations I, 2nd ed. 2012, Article 18 SCO, paras 14-53 and 193-215 ; W. Wiegand, in H. Honsell/N. Vogt/W. Wiegand (Eds), Basler Kommentar – Obligationenrecht I, 6th ed. 2015, Article 18 SCO, paras 18-40 and paras 95-125a, with further references.[fn]

Article 18(1) Swiss Code of Obligations – Pursuant to this provision, when interpreting a contract,[fn] As noted in footnote 6 above, it will be for the tribunal to determine whether the question is one of contract interpretation in the first place. [fn] a tribunal should seek to establish the parties' “true and

common intention” (“subjective” interpretation). Beyond the text of the contract, the parties’ “true and common intention” may be evinced by reference to other elements, including their negotiations and subsequent conduct. If the parties’ true and common intention cannot be established, the tribunal will interpret the agreement as it would have been understood by a reasonable person, acting in good faith, in light of the circumstances at the time of its conclusion (“objective” interpretation). Under both a subjective and an objective interpretation, in case of doubt, the tribunal should be guided, *inter alia*, by the principle in *favorem negotii*, and thus opt for a solution that best preserves the parties’ contractual bargain. The tribunal may also refer to relevant trade customs and industry practice. These rules might enable the tribunal to preserve the parties’ contractual deal by substituting a defunct reference to LIBOR with another benchmark that would best reflect the prevailing industry practice and the contractual risk allocation.

Clausula rebus sic stantibus (théorie de l’imprévision) – Under this principle, a tribunal may intervene to adapt a contract to changed circumstances. However, as the Supreme Court’s case law makes clear (eg, ATF 192 III 97), the threshold for obtaining relief under this theory is very high. In particular, the principle applies only where the change of circumstances was not reasonably foreseeable and its impact is such as to render the transaction grossly disproportionate (and therefore abusive). Arguably, if a debtor uses the extinguishment of LIBOR in order to free itself from the obligation to pay interest or fundamentally alter the contractual risk allocation, a tribunal might have a ground to intervene to reestablish the contractual equilibrium. This could be done by resorting to an alternative benchmark that makes commercial sense in the given circumstances.

Impossibility – Article 119(1) SCO provides that an obligation, LIBOR clause or entire contract as the case may be, “is deemed extinguished where its performance is made impossible by circumstances not attributable to the obligor.” The obligor might then be liable “for the consideration already received”. Given its detrimental economic effects, this solution would appear to be best considered as a last resort if other mechanisms do not allow the preservation of the contractual deal.

B. LIBOR-Based Interest Awards

Arbitral tribunals enjoy a degree of discretion in determining damages, including interest, subject to the usual requirements of due process and equality of arms.^[fn] In specific cases, the contract or applicable investment treaty contains guidance as to the interest rate to be applied on the compensation amount.^[fn] Tribunals often use LIBOR as a benchmark for calculating pre- and post-award interest, even when LIBOR is not specifically mentioned in the relevant contract or investment treaty. A review of the publicly available awards issued after the announcement of the LIBOR phase-out shows that tribunals continue to use LIBOR, without apparently considering the risk that, if the award is not paid out until 2022, the winning party may be left with an unenforceable interest award.^[fn] *Gavrilovic and Gavrilovic d.o.o. v. Republic of Croatia*, ICSID Case No. ARB/12/39, Award, 26 July 2018, para. 1324.d; *Unión Fenosa Gas, S.A. v. Arab Republic of Egypt*, ICSID Case No. ARB/14/4, Award, 31 August 2018, para. 10.138; *Greentech Energy Systems A/S (now Athena Investments A/S), NovEnergia II Energy & Environment (SCA) SICAR and NovEnergia II Italian Portfolio SA v. Italian Republic*, SCC Case No. V (2015/095), Final Award, 23 December 2018, para. 594(e).^[fn] Tribunals should consider the following when dealing with matters of interest:

First, in currently pending proceedings, if a party requests an award of interest by reference to LIBOR and none of the parties raises the issue of the LIBOR phase-out, tribunals should arguably bring the issue to the parties’ attention. This derives from the tribunal’s duty to render an enforceable award, which is sometimes explicitly set out in applicable arbitration rules.^[fn] E.g, Article 42 of the 2017 ICC Rules.^[fn]

Second, if the tribunal has already rendered an award containing LIBOR as a benchmark, the available options are limited. Although arbitration rules often provide for a possibility for correction or interpretation of an award, this mechanism is reserved for typographical errors and genuine ambiguities in the language of the award, as opposed to substantive issues that the parties have neglected or that have arisen after the award has been rendered. An application for revision may be a more suitable mechanism. However, only some arbitration laws and rules provide for such a possibility, and even when they do, the applicable time limits are stringent. For instance, under Article 51 of the ICSID Convention, a party may make an application for revision of the award within 90 days from the discovery of a new material fact. Given that the LIBOR phase-out has been in the public domain since July 2017, it might be difficult to argue that this fact was unknown to a diligent party 90 days prior to lodging the revision application.

In these circumstances, an award creditor will likely need to argue before the enforcing courts that LIBOR should be substituted by another benchmark, with the uncertainty that that entails.^[fn] Since this issue does not appear to fall under the 1958 New York Convention, the outcome will depend on the legislation of the jurisdiction in which enforcement is sought. In particular, domestic jurisprudence concerning the enforcement of ambiguous or disputed terms of arbitral awards is likely to be relevant.^[/fn]

Conclusion

The LIBOR phase-out from 2022 creates a considerable risk of contractual disputes. As things stand, the absence of a commonly agreed substitute for LIBOR makes the outcome of such disputes uncertain. While the solution will depend on the law applicable to the contract, tribunals are in principle equipped with sufficient tools to preserve the contractual deal by reference to the parties' common intentions and commercial common sense. In some cases, however, a tribunal may be left with the unattractive solution of declaring LIBOR-benchmarked obligations frustrated or impossible to perform.

As for arbitral awards that use LIBOR as a benchmark for interest, tribunals should be vigilant of the risk that the interest portion of the award may become unenforceable if it remains unpaid beyond 2022. As the available remedies after the award has been rendered are scarce, tribunals are encouraged to uphold their duty to render an enforceable award, including by raising the consequences of the LIBOR phase-out with the parties whenever they have neglected to address these issues.