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LIBOR CESSATION: ENGLISH COURT IMPLIES "REASONABLE RATE" TERM INTO PERPETUAL PREFERENCE SHARES

Where contracts do not contemplate LIBOR cessation, the market has been transitioning LIBOR-referenced contracts to newer risk-free rates by agreeing amendments to the documentation. But what if a counterparty will not transition? Should a term be implied or should the product be redeemed?

That was the choice for the English Court in *Standard Chartered PLC v Guaranty Nominees Limited and Ors* [2024] EWHC 265, in an eagerly-awaited "test case".

The Court implied a term - a decision that has been largely welcomed by the financial markets. But, as ever there is nuance. In this briefing we consider implications for other products, and how the facts of the case may have impacted the Court's decision in this instance.

The case: facts in brief

First, a short summary of the scenario on which the Court was asked to rule. Standard Chartered PLC (the "**Issuer**") had issued US$750,000,000 6.409% Non-Cumulative Redeemable Preference Shares which provided that the rate of dividends was calculated by reference to 3-month USD LIBOR ("**3M USD LIBOR**") – long-term 'perpetual' securities, with no maturity date. In anticipation of the cessation and non-representativeness of LIBOR, the Issuer launched a consent solicitation process, proposing that LIBOR be replaced with SOFR compounded in arrear plus the ISDA Spread Adjustment. Although 67% of the votes cast were in favour, the 75% threshold required was not met.

Synthetic USD LIBOR, which the FCA had required to be published on an interim basis, provided a temporary fix for the dividend calculation – aided by UK interpretative legislation - but only whilst it remained available (until 30 September 2024). But what next?

The Issuer sought guidance from the English Court, seeking a binding declaration as to the use of an alternative rate to 3M USD LIBOR.

There were two conflicting approaches: the Issuer's expert proposed CME Term SOFR plus the ISDA Spread Adjustment (i.e. the same rate as Synthetic USD LIBOR); this was challenged by certain holders of the economic interest

in the Preference Shares, via American Depository Shares (the "**Funds**"). The Funds argued that, upon the cessation of LIBOR, the Preference Shares should be redeemed by the Issuer.

The Court was prepared to imply a term that the reasonable alternative to three-month USD LIBOR is to be used where the definition of three-month LIBOR is no longer operative.

It accepted expert evidence that the reasonable alternative rate was a rate based on SOFR with a Spread Adjustment.

LIBOR background

The London Interbank Offered Rate has been the reference rate in an estimated USD 400 trillion of contracts. Over the years, LIBOR's administrator, the screen of publication, and its methodology have all been modified. Against that backdrop, the contractual definition of LIBOR in contracts has been framed using different language over time.

Many financial contracts made provision for the calculation of a so-called "fallback" rate should LIBOR be unavailable. Common fallback rates include the last published rate, the rate used for the last interest period, the lenders' costs of funds (in loans) and reference bank quotations (in bonds, derivatives and other instruments).

Over time, reference bank quotations became increasingly difficult to obtain. As the FCA acknowledged in 2021 about reference bank quotes (sometimes called dealer polls): "*we are not aware […] of any Issuer that has confirmed a willingness to provide rates in response to such a poll after the relevant LIBOR setting is no longer published, other than where they have a contractual commitment to do so.*"

This raised the spectre of the contractual fallbacks failing to produce an interest rate after LIBOR ceased to be published. That scenario was at risk of materialising with the Preference Shares.

LIBOR and the Three Fallbacks in the Preference Shares

The Preference Shares were issued by the Issuer in 2006. LIBOR was defined as:

"*the three month London interbank offered rate for deposits in US dollars which appears on page 3750 of Moneyline Telerate as of 11:00 a.m., London time, on the second business day in London prior to the first day of the relevant Dividend Period*".

Should the rate on the Telerate page be "*unavailable*", the First and Second Fallback provided for the Issuer to seek reference bank quotations from firstly, London Banks three-month deposits in USD and if fewer than two offered quotations were provided as requested, New York banks, for loans for three months in USD.

The Third Fallback stated that "*if the banks selected by the Company, are not quoting as mentioned above*" LIBOR shall mean "*3M USD LIBOR* ***in effect on*** *the second business day in London prior to the first day of the relevant Dividend Period.*" (our bold emphasis)

What did the Third Fallback require?

The Court was asked to construe the Third Fallback, before considering the competing implied terms put forward by the Issuer and the Funds (discussed below). As the Court noted, neither party had suggested that the absence of an express term addressing LIBOR cessation meant "nothing was to happen"

or that that the Preference Shares would have commercial or practical coherence without a term to address LIBOR.

The Issuer's position was that the Third Fallback meant a rate that effectively replicates or replaces 3M USD LIBOR, which in its submission was CME Term SOFR plus the ISDA Spread Adjustment. That required "*in effect*" to mean "effectively" or "in fact" or "in practice".

The Court was not persuaded. It found that "*in effect*" was used in the sense of meaning "in force" or "in operation", i.e. the LIBOR rate first published on a prior date is treated at the effective LIBOR rate by the market. After Synthetic LIBOR ceased to be published, no such LIBOR rate was "in effect", meaning that the Third Fallback did not produce a rate. That mirrored the Funds' position, which was that the Third Fallback could not be operated.

The Competing Implied Terms

The Issuer's alternative case was that a term should be implied such that "where the express definition fails, SC should use a reasonable alternative rate to three month USD LIBOR".

It proposed CME Term SOFR plus the ISDA Spread Adjustment. (Side note - this was different to Compound SOFR rate proposed in the Issuer's consent solicitation, but the consent solicitation had pre-dated the FCA's proposals on publishing Synthetic USD LIBOR on an interim basis.)

The Funds initially sought an implied term that if 3M USD LIBOR ceased to be available, the Issuer will redeem the preference shares. The consequences of this proposed formulation were stark, with the Issuer thereby being forced to redeem.

The Funds' proposed term evolved into a more complex formulation, given the requirement to comply with law and regulation, that was "subject to the Companies Act and all other regulations applying to the Company, to the Articles and to the prior consent of the FSA". To the extent that the Preference Shares could not be redeemed lawfully in accordance with that implied term, the Funds advanced a "second stage" implied term to be paid "as if it was a dividend", proposing alternatives of "the last published LIBOR rate … plus 1.51%" (i.e. using a "frozen historic LIBOR rate") or the rate which applied during the fixed dividend period, or (after being pressed at the trial), the Proposed Rate.

Both parties accepted that the test for implying terms set out in Marks & Spencer Plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd [2015] UKSC 72, [2016] AC 742 applied, namely that made clear that any implied term must either be necessary to give business efficacy to the contract, or be so obvious that it goes without saying. Further, the term to be applied must be capable of clear expression. not contradict any express terms of the contract and be reasonable and equitable.

The Funds' proposed implied term failed

Given the complex formulation, it is perhaps unsurprising that the Court agreed that the Funds' proposed implied term could not be said to be so obvious that it goes without saying. Nor was it clear, nor needed to give business efficacy to the contract.

The Court observed that the Funds' proposed term would mean that an event outside the control of the Issuer or the holders of the economic interest in the Preference Shares could have brought the contract to an end at any time – which had implications for the Issuer's capital planning, the Funds' stable

income stream, and the marketability of the instrument whilst LIBOR's future was uncertain.

The proposed term did not align with the purpose of the Preference Shares, which was for long-term (indeed, possibly perpetual) provision of capital in return for the dividend. Nor did the proposed term take into account what would happen if the FCA or PRA imposed conditions on redemption of the Preference Shares or how the Issuer should prepare to redeem - meaning it was unclear.

The Funds' implied term providing for automatic termination was also inconsistent with the express terms, which provided for redemption on 30 January 2017 and on ten-year intervals thereafter.

As we discuss further below, in other financial instruments, any existing express terms will impact the ability to imply terms, and their form.

THE RULING

The Court accepted a modified version of the Issuer's implied term

Instead, the Court was prepared to imply a term that "if the express definition of Three Month LIBOR ceases to be capable of operation, dividends should be calculated using **the reasonable alternative rate** to three month USD LIBOR at the date the dividend falls to be calculated." (our bold emphasis)

The two modifications to the Issuer's proposed terms were to: (1) make clear that the identification of the reasonable rate was an objective question, and not one where the Issuer alone could decide, with the Court being the "ultimate arbiter"; and (2) allow for the fact that the universe of available alternative reference rates might change over the life of the Preference Shares.

In doing so, the Court was particularly cognisant of the very long-term contract embodied by the Preference Shares. It noted that, unless the Issuer exercises its decennial option to redeem the Preference Shares, it would be a perpetual contract. That meant that a "flexible approach to its construction" was required, and as discussed further below, the Court cited with approval, and labelled as "second order principles" for the implication of terms, the cases embodying the Court's approach to such long term contracts. Indeed, the Court considered that the parties did not intend issues with the availability of LIBOR to prevent continued performance of the contract. The fact the Preference Shares were issued as Tier 1 capital for a regulated financial institution made it particularly important for the dividend mechanism to continue to operate even if LIBOR ceased to be published.

The Court took an overarching view as to the role of LIBOR within the Preference Shares' terms, characterising it as "an essentially judgmental and potentially imprecise mechanism for measuring the costs of bank borrowing over time" and as a "measure" (rather than "a value in its own right").

It considered that the role of LIBOR in the Preference Shares (and the way in which the three existing fallbacks were framed) provided "a measure which will link the amount of the dividend to the changing costs of borrowing over time, with the result that the provision is properly to be characterised as non-essential "machinery" for the purpose of determining what happens when LIBOR ceases to be published". The Court felt that was clear from "the nature of LIBOR itself" and "from its treatment in the relevant contractual terms".

That meant that the Court was willing to give business efficacy to the arrangements, to imply an obligation by references to what is reasonable to enable the contract to be carried out.

The characterisation of LIBOR as "non-essential machinery" meant that the Court drew support from, and applied the principle in the House of Lords authority of Sudbrook Trading v Eggleton [1983] AC 444 (the "**Sudbrook Principle**") (and the series of cases which have applied it). The Sudbrook Principle provides that where a quantification method in a contract has failed, the Court can step in and perform the necessary exercise of quantification itself, but only where the relevant provision of the contract is "machinery" or "subsidiary and non-essential question", as opposed to a substantive entitlement, or essential term of the agreement – as clarified in Didymi Corporation v Atlantic Lines and Navigation Co Inc (The Didymi) [1988] 2 Lloyd's Rep 108, 115).

What rate was to apply?

Using expert evidence, the Court had to determine the "reasonable alternative rate" in its implied term.

On this issue, the Court was assisted by the large measure of agreement between the Issuer's and the Funds' experts, including their acceptance that of the available reference rates, the Proposed Rate is the closest to 3M USD LIBOR. The experts did, however, disagree on how closely the output of CME Term SOFR plus ISDA Spread Adjustment would match the output of 3M USD LIBOR under different economic conditions or challenge the fixed adjustment.

What does this mean for other contracts continuing to reference LIBOR?

This case, which was heard under the Financial Markets Test case scheme, is a helpful piece of guidance for the financial markets, and for unamended legacy contracts referencing LIBOR in any calculation mechanism.

Mindful of this, the Court made some general observations (strictly obiter) on the likely success of arguments that there is an implied term requiring redemption in "*debt instruments*", signalling that an implied term may be a suitable approach:

- "… [t]he arguments which have led us to find the implied term […] above, and to reject the Funds' implied term, are likely to be similarly persuasive when considering the effect of the cessation of LIBOR on debt instruments which use LIBOR as a reference rate **but do not expressly provide for what is to happen if publication of LIBOR ceases**. Once again, the use of a floating LIBOR rate as a reference rate in instruments of that kind is essentially a measure of the wholesale cost of borrowing over time. The specific reference to LIBOR is likely, therefore, to be a non-essential term, and the inoperability of the mechanism should not defeat the continuation of the contract." (our bold emphasis); and
- An implied obligation to redeem the loan instrument on the cessation of LIBOR would be "unworkable" as it would have the same accelerating effect as a stipulated event of default, but would be out of the control of the parties and without any of the protective cure or notice provisions typically drafted in by loan parties.

Whilst the decision demonstrates the flexible approach of the English Court with respect to the implication of terms (and the formulation of such terms), the judgment does not disturb the general principle that each contract's express terms will need to be construed on their face. Differences in the words chosen

(e.g. for the fallbacks), and the nature of the contract or product, will likely impact how LIBOR should be determined, ascertaining the parties intentions, whether a similar term requiring a reasonable rate can be identified, and what that reasonable rate should be.

- This was a case where both parties argued that a term should be implied. Neither party suggested that the contract could operate without the implication of a term to address the cessation of LIBOR, nor that the contract was frustrated. The Court was therefore left with a choice between two competing implied terms.
- In their work to transition financial contracts, financial market participants, industry organisations and working groups have laid the groundwork to enable the Court and the parties' experts in this claim to identify the likely replacement rates. The reasonable rate identified for use in the Preference Shares is the same rate chosen by the FCA for Synthetic 3M USD LIBOR.
- The Court expressly acknowledged that the Reasonable Rate for use in the Preference Shares' dividend calculation might change over time, as the universe of available alternative reference rates might change. It is not the case that 3M USD LIBOR means Term SOFR plus the ISDA Adjustment Spread for evermore. Parties will need to consider and objectively determine what is the "Reasonable Rate". If challenged, in any claim they will need to support that choice with expert evidence.
- When determining any "Reasonable Rate", parties should be aware that financial regulators have varying approaches to the suitability of otherwise of the use of term rates (such as Term SOFR or Term SONIA) - with some prescribing limited use cases - especially for new issuances (see, for example, the ARRC 21 April 2023 revised Term SOFR scope of use (link) and the 1 October 2024 joint statement FCA, Bank of England and RFR Sterling Working Group (link)). One such use case suggested by ARRC for Term SOFR, however, is as a fallback rate for legacy LIBOR cash products.
- Parties will need to continue to operate the express contractual language. Put simply, parties cannot simply read LIBOR references as CME Term SOFR plus the ISDA Adjustment Spread – and ignore the express fallback language they agreed.
- For the Preference Shares, the Court found that no rate could be established using the Third Fallback. The judgment does not address the fact pattern where the fallback is to a historic rate which can be established, requiring an assessment of whether the parties intended that historic rate to apply as a 'frozen rate' for the remainder of the product term.
- In other contracts, there may remain questions as to whether the waterfall of fallbacks has to each be operated before getting to the final fallback. The Issuer's proposed term contained a pre-requisite that it applied "*where the express definition fails*". Obiter, the Court said: " *it is very difficult to understand why the Third Fallback should become available only after the First and Second Fallbacks have failed. On SC's approach, the First and Second Fallbacks are simply more restricted means of undertaking the same task which* [the Issuer's] *construction of the Third Fallback contemplates*."
- The Court was rightly concerned with the long-term nature of the Preference Shares, such that the parties could be said (at the point of contract) to have wanted them to work or continue on a long-term basis.

The Court observed that "*a failure* [i.e. of the drafters] *to address a specific issue in a long-term contract may be less significant than in a short term contract*" and endorsed various authorities addressing long-term contracts, including the comments of Rix LJ in *Mamidoil-Jetoil Greek Petroleum Co SA v Okta Crude Oil Refinery AD (No 1*) [2001] EWCA Civ 406:

"Particularly in the case of contracts for future performance over a period, where the parties may desire or need to leave matters to be adjusted in the working out of their contract, the courts will assist the parties to do so, so as to preserve rather than destroy bargains, on the basis that what can be made certain is itself certain […]

This is particularly the case where one party has either already had the advantage of some performance which reflects the parties' agreement on a long-term relationship, or has had to make an investment premised on that agreement."

The Court assessed the three existing fallbacks as providing a measure, rather than replicating aspects of the LIBOR calculation methodology (such as requiring panel banks to quote, or trimming to remove outliers)." It felt the fallbacks (with the exception of the Third Fallback) contemplated a floating, "real time" rate, which reflected a desire to "future proof" and index the dividend to a rate that provided a measure of movements in the cost of borrowing over time. It remains to be seen to what extent that might be read across to other products or contracts, including those with shorter terms.

- LIBOR's role in such products or contracts will need to meet the requirements of the Sudbrook Principle, and to be properly characterised as "non-essential "machinery" for the purposes of determining what happens when LIBOR ceases to be published".

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

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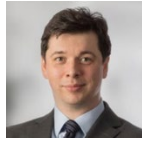
CONTACTS

Kate Scott
Partner, London

T +44 2070064442
E kate.scott
@cliffordchance.com



Michael Brown
Partner, London

T +44 207006 8359
E michael.brown
@cliffordchance.com

Caroline Dawson
Partner, London

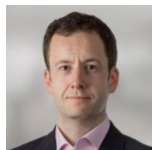
T +44 207006 4355
E caroline.dawson
@cliffordchance.com

Paget Dare Bryan
Partner, London

T +44 207006 2461
E paget.darebryan
@cliffordchance.com

Anne Drakeford
Partner, London

T +44 207006 8568
E anne.drakeford
@cliffordchance.com

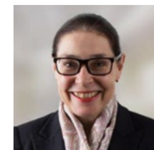


Paul Deakins
Partner, London

T +44 207006 2099
E paul.deakins
@cliffordchance.com

Matt Fairclough
Partner, London

T +44 207006 1717
E matt.fairclough
@cliffordchance.com

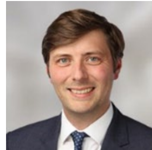


Kate Gibbons
Partner, London

T +44 207006 2544
E kate.gibbons
@cliffordchance.com

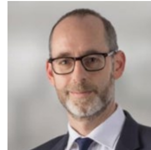
Paul Landless
Partner, London

T +44 207006 2368
E paul.landless
@cliffordchance.com



Matteo Sbraga
Partner, London

T +44 207006 3083
E matteo.sbraga
@cliffordchance.com



Simon Sinclair
Partner, London

T +44 207006 2977
E simon.sinclair
@cliffordchance.com

Kate Vyvyan
Partner, London

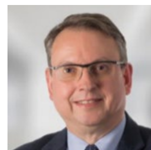
T +44 207006 1940
E kate.vyvyan
@cliffordchance.com

Jeremy Walter
Partner, London

T +44 207006 8892
E jeremy.walter
@cliffordchance.com

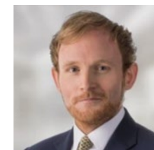
William Winterton
Partner, London

T +44 207006 4386
E will.winterton
@cliffordchance.com



Chris Bates
Special Counsel, London

T +44 207006 1041
E chris.bates
@cliffordchance.com

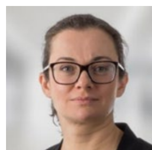


Guy Burkitt
Senior Associate, London

T +44 207006 1872
E guy.burkitt
@cliffordchance.com

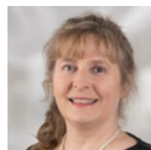
Michael Gorrie
Senior Associate, London

T +44 207006 4113
E michael.gorrie
@cliffordchance.com



Katie Hoyle
Knowledge Director, London

T +44 207006 4528
E katie.hoyle
@cliffordchance.com



Julia Machin
Knowledge Director, London

T +44 207006 2370
E julia.machin
@cliffordchance.com