# PUBLICATION

## What Recently Finalized Regulation ZZ Means for LIBOR-Based Commercial Financing Contracts When LIBOR Sunsets

**Authors: Walter R. Kirkman**
**March 06, 2023**

**The well-publicized sunset of the London Interbank Offered Rate (LIBOR), the adjustable interest rate benchmark referenced in trillions of dollars' worth of contracts, is happening this summer. After June 30, 2023, U.S. dollar LIBOR will cease to be published as representative of the markets it was intended to measure.**

Over the last decade, market participants and regulators have lost confidence in LIBOR as a benchmark after a decrease in the number of short-term unsecured wholesale borrowing transactions on which LIBOR is based and because of certain high-profile alleged manipulation scandals. As a result, the United Kingdom's Financial Conduct Authority, which regulates LIBOR's administrator, announced a timetable for phasing out the various tenor and currency pairs of LIBOR in 2017.

In the United States, a group of private-sector firms convened by the Federal Reserve Bank of New York, known as the Alternative Reference Rates Committee (ARRC), has led efforts to transition financial contracts away from LIBOR to its recommended replacement benchmark, the Secured Overnight Financing Rate (SOFR), which is a measure of the cost to borrow cash overnight that is secured by U.S. Treasury securities.

Despite efforts to encourage market participants to prepare for the sunset of LIBOR, a significant number of financial contracts remain that reference LIBOR and mature after June 30, 2023, but do not have adequate fallback provisions for a replacement benchmark when LIBOR sunsets (known as "tough legacy contracts").

So, what happens on the next banking day after the cessation of USD LIBOR if you or your organization are a party to a tough legacy contract?

To provide a uniform, nationwide solution for replacing LIBOR references in tough legacy contracts and reduce disruptive litigation, Congress enacted the Adjustable Interest Rate (LIBOR) Act (the LIBOR Act), which was signed into law by President Biden on March 15, 2022. Final regulations implementing the LIBOR Act (Regulation ZZ) adopted by the Federal Reserve Board of Governors (the Board) became effective February 27, 2023.

Among other things, the LIBOR Act provides that, on the first London banking day after June 30, 2023, references in a tough legacy contract to USD LIBOR shall, by operation of law, be replaced by a Board-selected benchmark replacement. The LIBOR Act further contemplates the need for conforming changes to implement the replacement benchmark. These changes may be determined by the Board or, in the case of a commercial financial contract, by the person responsible for calculating payments based on a benchmark (the calculating person).

To achieve its purpose of reducing litigation, the LIBOR Act provides statutory protections for implementing a Board-selected benchmark replacement and benchmark replacement conforming changes. The statute provides for continuity of the contract after such implementation and precludes claims and causes of action arising out of the implementation. Moreover, state law on benchmark replacement and related changes is expressly preempted and superseded by the LIBOR Act.

The recently finalized Regulation ZZ implements the LIBOR Act. It provides Board-selected benchmark replacements for derivative transactions, commercial and consumer loans, and other transactions. It also specifies tenor spread adjustments to be applied to those benchmark replacements. The Board-selected benchmark replacements for a commercial financial contract are:

in place of overnight LIBOR, SOFR (published by the Federal Reserve Bank of New York or a successor administrator), plus the designated tenor spread adjustment; and

in place of one-, three-, six-, or 12-month LIBOR, the corresponding one-, three-, six-, or 12-month Term SOFR (published by the CME Group Benchmark Administration, Ltd. or a successor administrator), plus the designated tenor spread adjustment.

Regulation ZZ also specifies various benchmark replacement conforming changes to the provisions of a contract that become effective when a Board-selected benchmark replacement becomes the benchmark replacement for that contract. An example of a benchmark-replacement–conforming change specified by Regulation ZZ is replacement, by operation of law, of a reference in a contract to a specific source for LIBOR with a reference to the publication of the applicable Board-selected benchmark replacement.

For other than consumer transactions, Regulation ZZ authorizes a calculating person to make additional technical, administrative, or operational changes to implement the Board-selected benchmark replacement. Such changes fall within the statutory safe harbor protections of the LIBOR Act, which are incorporated by reference in Regulation ZZ.

Parties to tough legacy contracts should carefully consider the unique terms of their agreements and the anticipated impact of Congress's legislative solution on those terms. If the statutory solution will not provide sufficient certainty or otherwise effectuate the parties' intent in the context of a particular contract, there is still time before June 30, 2023, for amendments incorporating preferred terms.

For questions about the application of Regulation ZZ or help with a LIBOR-based contract, please contact Walter R. Kirkman, or any member of Baker Donelson's Financial Services Transactions Group.