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FIRST ENGLISH JUDGMENT CLARIFYING THE REASONABLE ALTERNATIVE TO LIBOR

In a recent judgment that will have been welcomed by financial institutions dealing with legacy LIBOR contracts and parties seeking to rely on relevant interest clauses, the English High Court clarified how to deal with assessing a reasonable alternative to LIBOR, and the role of implied contractual terms in overcoming unforeseen events.

Introduction

For years contracts referenced the London Interbank Offered Rate (**LIBOR**) as a benchmark for interest rates calculations in commercial agreements. *Standard Chartered Plc v Guaranty Nominees Limited* [2024] EWHC 2605 (Comm) is the first English judgment dealing with the consequences of the ending of LIBOR, and only the second test case brought under the Financial Markets Test Case Scheme.

In 2006, Standard Chartered PLC (**SC**) issued USD 750 million perpetual preference shares which paid a fixed rate dividend for an initial period (**fixed rate**) and thereafter paid a variable dividend of 1.51% plus Three-Month USD LIBOR. On 30th September 2024 (by which time the LIBOR based dividend was payable) the publication of LIBOR had ceased, and SC could not calculate the dividend payments due under the terms of the preference shares.

The question before the court was what should happen in the absence of LIBOR

1. SC argued that the court should imply a term that when LIBOR is unavailable *'SC should use a reasonable alternative rate'*.
2. The counterargument (by certain preference shareholders) was also that the court should imply a term, but that the term should be that when LIBOR ceased there was no alternative, and the preference shares should be redeemed when legally possible to do so and that pending redemption a dividend at the fixed rate or at the last published LIBOR rate plus a margin should be payable.

Judgment

Implied Contractual Terms

The parties agreed that in looking at implied terms, the test was as set out in the UK Supreme Court judgment of *Marks & Spencer Plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] UKSC 72, in which it was held that to succeed an implied term must:

1. either be necessary to give business efficacy to the contract, or be *"so obvious that it goes without saying"*;
2. be capable of clear expression and not contradict any express terms of the contract; and
3. be reasonable.

The court noted that these first order principles were supplemented by certain second order principles as follows:

1. whilst long-term contracts do not have special rules, flexibility was needed as they are more likely to encounter unforeseen circumstances, which may need resolving;
2. a distinction can be drawn between provisions that define the substantive entitlement of the parties and those which are 'machinery' designed to qualify or quantify the substantive rights and where terms are machinery and are a non-essential part of the contract and cannot operate, the court can step in and perform the quantification exercise;
3. if an unforeseen event arises during the contract, the court must decide what the parties intended in relation to that event; and
4. when a contract must be performed in unforeseen circumstances (as was the case with the cessation of LIBOR), the court will review the purpose of the parties' agreement and adopt an interpretation consistent with that purpose.

The court agreed with SC and implied a term that in absence of LIBOR dividends should be calculated using a reasonable alternative. The reasons for this decision included:

1. other contractual terms showed that the parties did not intend the contract to end if LIBOR was unavailable, thereby meeting the obvious test;
2. this term was capable of clear expression and did not contradict any express terms;
3. the perpetual preference shares were a long-term contract and thus flexibility was needed;
4. the role of LIBOR was to provide a measure which would link the amount of the dividend to the changing costs of borrowing over time and should, as such, be classified as "non-essential machinery" for purposes of what happens if it ceased to be published.

Appropriate Rate

The court determined that the reasonable alternative rate to apply was CME Term SOFR plus ISDA Spread Adjustment, on the basis that:

1. of the available rates, this rate was closest to Three Month USD LIBOR.
2. expert analysis agreed this was the most reasonable alternative rate for Three Month USD LIBOR.

Comment

The English courts differ to the US system where legacy LIBOR terms are dealt with by legislation.

This judgment does suggest that in seeking an alternative rate, the English courts' approach will be linked to the currency to which LIBOR was referenced, in the case of sterling, this will likely mean that the Bank of England's Sterling Overnight Index Average (**SONIA**) rate will be applied.

However, each case will be considered on its own facts and may therefore be decided differently.

Clients may wish to revisit contracts referencing LIBOR and agree a substitute to avoid the courts, including the English courts, imposing one.

Whether or not the replacement of Three Month USD LIBOR by CME Term SOFR plus ISDA Spread Adjustment is beneficial, clients will wish to revisit contracts referencing LIBOR.

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