High Court considers first LIBOR cessation test case: key implications for financial institutions

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The High Court has implied a term providing for the use of a "reasonable alternative" rate in a series of LIBOR-linked instruments following the benchmark's cessation

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The High Court has determined the appropriate rate which should apply to a series of LIBOR-linked instruments following the benchmark's cessation: *Standard Chartered plc v Guaranty Nominees Limited & Ors* [2024] EWHC 2605 (Comm). The court implied a term providing for the use of a "reasonable alternative" rate in the absence of LIBOR, which the court determined as term Secured Overnight Funds Rate (**SOFR**) published by the Chicago Mercantile Exchange Group Benchmark Administration (**CME**) plus a fixed spread adjustment (to address the difference between SOFR and LIBOR) published by the International Swaps and Derivatives Association (**ISDA**).

The judgment should provide comfort for financial institutions dealing with a rump of "tough legacy" LIBOR contracts. It provides some welcome guidance as to how the court is likely to approach the exercise of contractual interpretation in this context, highlighting the potential for implied terms to fill the gaps left by LIBOR cessation and providing a potential model for alternative rates. However, it is important to bear in mind that the contract at the heart of the present dispute was a very long-term one, which steered the court towards taking a more flexible approach to interpretation (including the implication of terms), on the basis that circumstances could have changed during the period of the contract. Accordingly, there remains a risk of future cases being decided differently, particularly in respect of shorter-length contracts.

In summary, the court considered a term governing the defendant bank's preference shares, providing for dividends to be paid by reference to "Three Month LIBOR", which was defined by reference to a screen rate for 3-Month USD LIBOR in the relevant dividend period. The court agreed with the bank that an implied term was necessary to give business efficacy to the contract, and that such a term was obvious, capable of clear expression and not inconsistent with the contract's express terms, applying the well-known test for the implication of terms set down in

Marks & Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd [2015] UKSC 72 (see our blog post).

The term implied by the court provides that, if the express definition of "Three Month LIBOR" ceases to be capable of operation, dividends should be calculated using a "reasonable alternative" rate to 3-month USD LIBOR. The court emphasised that the identification of a reasonable alternative was a question for the court to resolve; it was not the case that the bank could simply itself select an alternative rate which could only be challenged on *Braganza* grounds, ie whether the bank's exercise of its contractual discretion was reasonable and not irrational, arbitrary or capricious (see our blog posts considering this duty). An alternative contractual interpretation argument was unsuccessful, but this did not affect the outcome given the court's findings on the implied term argument (which is likely to be more applicable to other cases).

Financial institutions may also be interested in the court's reflections on the contractual fallbacks to the LIBOR provision in the present case, as these generated a significant amount of discussion in the process of transition. The waterfall of fallbacks in this case are typical of legacy LIBOR-linked financial instruments (eg reverting to the last available published screen rate for LIBOR in the relevant currency and tenor). The court suggested that fallbacks of this nature were intended only to be used where there had been a temporary operational problem with the publication of LIBOR, rather than as a permanent replacement (as noted in the Wheatley Review in 2012).

As a High Court judgment, the decision is not binding as a precedent, but it will be highly persuasive for other first instance judges considering similar issues (particularly as the judgment was delivered by Sir Julian Flaux, the Chancellor of the High Court, and Mr Justice Foxton). The court also took the opportunity to make a general observation in respect of debt instruments, which will no doubt be appreciated by the market:

> "…the arguments which have led us to find the 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."

We consider the decision in more detail below.

We have followed the potential litigation risks of LIBOR transition closely and you can find our previous blog posts and articles on this topic here.

Background

In 2006, the claimant bank (the **Bank**) issued USD 750 million perpetual preference shares to the first defendant, Guaranty Nominees Limited (**GNL**), in order to raise what at the time was classified as "Tier 1" regulatory capital. GNL held the shares as a nominee for an American bank, which in turn issued American Depository Shares (**ADSs**) to holders who in fact hold the economic interest in the preference shares. The second to fifth defendants are hedge funds who hold some of the ADSs (the **Funds**), amounting to just over 10% of the ADSs by value.

The shares provide for dividends to be paid at a fixed rate until 30 January 2017, and thereafter at a floating rate of "1.51% plus Three Month LIBOR". Three Month LIBOR is defined as:

> "'Three Month LIBOR' means 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…;"

In addition to this primary means of ascertaining LIBOR, there are three alternatives (if the primary method cannot be operated), which are considered in the main body of our analysis, below.

With knowledge of the impending cessation of LIBOR, in November 2022, the Bank initiated a consent solicitation process to amend the dividend rate for the preference shares by special resolution. This would have replaced 3-month USD LIBOR with a rate very similar (but not identical) to the rate proposed as part of the present proceedings. Although 67% of votes cast by ADS-holders were in favour of the proposed amendment, the proposed change failed to achieve the requisite 75% majority.

The USD LIBOR bank panel ceased to exist on 30 June 2023, but the FCA exercised regulatory powers to require the publication of "synthetic" rates for 1, 3 and 6-month USD LIBOR to support transition away from LIBOR (see our blog post). Accordingly, from June 2023, the Bank calculated dividends by reference the synthetic rate, but with the knowledge that this would cease to be published entirely at the end of September 2024.

On 12 April 2024, the Bank commenced proceedings asking the court to make declarations as to the rate applicable to the preference shares, according to which the dividends would be calculated following cessation of synthetic 3-month USD LIBOR. The court proposed that the claim be transferred to the Financial Markets Test Case Scheme (established by CPR Practice Direction 63AA). This is a scheme which enables a claim raising issues of general importance to financial markets to be determined in a test case without the need for a specific dispute between the parties where immediately relevant and authoritative English law guidance is needed.

The application was supported by an expert report, expressing the view that the appropriate rate to use is CME Term SOFR plus the ISDA Spread Adjustment (the **Proposed Rate**). The Bank submitted that the Proposed Rate is the reasonable alternative rate, either on the basis of contractual construction, or because a term should be implied into the terms governing the preference shares.

The sole defendant was initially GNL as depositary, which did not take an active role in the proceedings. The Funds intervened in order to oppose the relief sought by the Bank, arguing instead that the preference shares should be redeemed upon the cessation of synthetic 3-month USD LIBOR. However, at trial, the relief sought by the Funds changed, and they argued for the implication of an alternative term.

Decision

The High Court agreed with the Bank that the Proposed Rate is the reasonable alternative rate on the basis of an implied term, but rejected the Bank's contractual interpretation argument. Each of the Bank's principal arguments are explored further below.

Implied term argument

Both parties accepted that the relevant test for the implication of a term is that set out in *Marks & Spencer*, as follows:

1. An implied term must either be necessary to give business efficacy to the contract, meaning that the contract would lack commercial or practical coherence without the term or be so obvious that it goes without saying.
2. The term to be applied must be capable of clear expression, not contradict any express terms of the contract; and be reasonable and equitable, although a term which meets the previous requirements will almost certainly be reasonable and equitable.

Both parties also agreed that a term had to be implied into the terms of the preference shares, as they would otherwise lack commercial or practical coherence following the cessation of LIBOR. The contentious issue was what this term should be. The implied term proposed by the Bank was as follows:

> "A term should be implied in the definition of Three Month LIBOR in the Offering Circular that, where the express definition fails, [the Bank] should use a reasonable alternative rate to three month USD LIBOR."

The court found in favour of the Bank's argument for an implied term (although it changed the precise formulation, as discussed in more detail below). The Funds articulated an alternative implied term, but in the court's assessment, this failed to satisfy each of the criteria for the implication of a term (and is not considered in further detail in this blog post). In reaching this conclusion, the court made the following key observations and findings:

1. **Long-term contract considerations:** The court noted that the contract was a very long-term one, potentially perpetual, and therefore it was important to take a flexible approach to interpretation because circumstances could have changed during the period of the contract (see *Total Gas Marketing Ltd v Arco British Ltd* [1998] 2 Lloyd’s Rep 208). In the court's view, this flexible approach included interpretation of a contract's express terms and the ascertainment of any implied terms.
2. **Non-essential "machinery":** The court noted that the role of LIBOR in the preference shares was essentially to provide a measure which would link the amount of the dividend to

the changing costs of borrowing over time. As such, the provision was properly to be characterised as non-essential "machinery" for the purpose of determining what happens when LIBOR ceases to be published. In reaching this view, the court reflected on the decision in *Sudbrook Trading v Eggleton* [1983] AC 444, in which the House of Lords drew a distinction between provisions of a contract which are intended to define the substantive entitlement of the parties, and provisions which are “machinery” intended to quantify that substantive entitlement. Where the machinery is a non-essential part of the contract, and is incapable of operation, the House of Lords held that the court can step in and itself perform the necessary exercise of quantification itself. In the court's view, the present case was one in which the inoperability of the mechanism should not defeat the continuation of the contract, and where the court should imply an obligation by reference to what is reasonable to enable the contract to be carried out.

3. **Cessation of LIBOR not foreseen:** The court noted that it was clear from the terms on which the preference shares were issued that the parties did not intend issues with the availability of LIBOR to prevent the continued performance of the contract. The court reflected on a number of authorities which specifically address how the task of interpretation is to be approached when the parties are confronted during the life of their contract with an event leading to contractual implications which they did not foresee (see *Debenham Retail Plc v Sun Alliance and London Assurance Co Ltd* [2005] EWCA Civ 868). Concluding that these cases support an approach which is reluctant to contemplate the failure of the contract, the court said its task was to ascertain the purpose/structure of the bargain and adopt an interpretation which best serves that purpose in the changed circumstances.
4. **Necessity for business efficacy:** The court found that the implied term was necessary to give business efficacy to the contract. The purpose of the contract is for the long-term provision of capital to the Bank in return for a dividend calculated on a fixed-rate basis for 10 years, and at a floating rate thereafter. This purpose could be given effect by the following implied term established by the court: 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 3-month USD LIBOR at the date the dividend falls to be calculated. This formulation modified the Bank's proposed implied term in two respects:
   - Firstly, the court concluded that the identification of a reasonable alternative was a question for the court to resolve; it was not the case that the Bank could simply itself select an alternative rate which could only be challenged on *Braganza* grounds; and
   - Secondly, the need to imply a term which would survive LIBOR in turn implied a need for that term to survive the possible cessation or inapplicability of any replacement rate. Given that the universe of available alternative rates might change over the life of the preference shares, the court left open the possibility that – in the future – a different reference rate might be more appropriate.
5. **Obviousness:** The court found that the implied term was so obvious that it goes without saying. It was clear in the present case that the parties did not anticipate issues with the availability of LIBOR in the future to prevent continued performance when entering into the contractual arrangements. On the other hand, they did in fact agree to a dividend-calculation

mechanism which allowed some scope for changes in the make-up of the rate over time. Each party would have required the qualification of "reasonableness" as a sufficient protection of their interests in calculating an alternative rate.

6. **Clear, consistent with express terms, reasonable and equitable:** The court found that the implied term did not contradict any express terms of the contract. It also found that the implied term was capable of clear expression, was reasonable and equitable. In the court's view, it was appropriate to imply a term requiring the use of a reasonable alternative rate when an index used to measure payments under a contract ceases to be published.

Appropriate rate

The court concluded that the appropriate alternative rate should be CME Term SOFR plus the ISDA Spread Adjustment (as proposed by the Bank).

The court noted that, following many years' work by regulators, analysts and market participants, this is the rate that has been arrived at as the best available alternative to LIBOR, and it has received the endorsement of financial regulators in the US and UK. Insofar as it is the closest surviving alternative to LIBOR, it offers continuity and predictability.

While it is possible that, in the future, a better alternative rate might present itself, in the court's view these factors provided a robust justification for using the Bank's proposed term now.

Contractual interpretation argument

The court applied well-known principles of contractual interpretation, most recently summarised by the Supreme Court in *Sara & Hossein Asset Holdings Ltd v Blacks Outdoor Retail Ltd* [2023] UKSC 2. It noted that the contract must be interpreted objectively, by asking what a reasonable person (with all the background knowledge reasonably available to the parties at the time they entered into it) would have understood the contract to mean. Elements of the wider context can be considered, depending on the nature, formality and quality of the drafting. Interpretation is a unitary exercise, which involves an iterative process by which each suggested interpretation is checked against the contract and consequences are investigated.

The Bank's primary case centred on the third fallback in the definition of "Three Month LIBOR" in the terms of the preference shares (it was accepted by both parties that it was no longer possible to operate either of the first two fallbacks). The third fallback states as follows:

> "...provided however that if the banks selected by the Company, are not quoting as mentioned above, it shall mean **three month US dollar LIBOR in effect** on the second business day in London prior to the first day of the relevant Dividend Period."
> (Emphasis added)

The Bank submitted that the phrase "three month US dollar LIBOR in effect" in this fallback, should be construed as "a rate that effectively replicates or replaces three month USD LIBOR". This interpretation is based on the understanding that "in effect" could mean "in fact" or "in practice", effectively allowing for a substitute rate when LIBOR ceased to be published.

However, the court rejected this interpretation for several reasons:

- **Natural meaning:** The court found that in the specific context of an identified point in time ("in effect on the second business day in London prior to the first day of the relevant Dividend Period"), the natural meaning of "in effect" is "in force" or "in operation".
- **Contractual architecture:** The court noted that the contract provides for three fallbacks if the primary means of ascertaining LIBOR cannot not be operated. The third fallback, which refers to "LIBOR in effect", is the rate of last resort in the definition because it is not a "current" rate. If the Bank's interpretation was accepted, it would be difficult to understand why the third fallback should become available only after the first and second fallbacks have failed, as all three would essentially be undertaking the same task.
- **Usage in the contract:** The phrase "in effect" is used in the terms of the shares on several occasions in the sense of "in force" or "in operation", which supported the court's interpretation.

Accordingly, the Bank's contractual interpretation argument failed.