

## Client Alert

### Financial Markets Developments

#### Market Disruption—Issues Arising Under APLMA/LMA and US Law Credit Agreements—A Global Perspective

##### Introduction

There have been a number of notes produced by law firms discussing the market disruption provisions contained in the APLMA<sup>1</sup>/LMA<sup>2</sup> standard forms and those contained in US law governed credit agreements.

This Financial Markets Alert discusses the practical operation of these provisions and issues which have arisen to date, comparing the differences in approach in Asia, Europe and the US. It also includes a number of suggestions for the lenders and agents as to how these provisions may be amended in the future in light of the current situation in the global credit markets.

One point worth making as a general observation in relation to these provisions is that until recently they have not been the subject of extensive negotiation and have seldom been utilised. Accordingly, much of the detail as regards implementation and construction of these provisions will depend upon the parties discussing and adopting a practical, common sense approach rather than seeking to find precise answers in current credit documentation.

In discussing “market disruption”, this note does not deal with provisions in APLMA/LMA/US law credit agreements which deal with inability to determine LIBOR due to absence of a “screen rate” and/or provision of a rate by “reference banks” but focuses on those provisions which relate to LIBOR failing to adequately cover lenders’ “cost of funds”. It should also be noted that there is no corresponding LSTA<sup>3</sup> “market disruption” provision equivalent to those in the APLMA/LMA standard forms and as such US law credit agreements are considerably less standardized than credit agreements in Asia and Europe. Accordingly, the observations on US law credit agreements are based on a review of deals closed by a variety of financial institutions since 2004.

#### Who can trigger a market disruption?

##### APLMA/LMA

The trigger point occurs when the agent has received notifications from a required threshold of lenders that the cost to such lenders of obtaining matching deposits in the relevant interbank market is in excess of LIBOR/HIBOR.



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If you have questions or comments regarding this Alert, please contact one of the lawyers listed below:

John Hartley  
Hong Kong  
Tel: + 852 2822 0409  
[jhartley@whitecase.com](mailto:jhartley@whitecase.com)

Alan Rockwell  
New York (English Law)  
Tel: + 212 819 7888  
[arockwell@whitecase.com](mailto:arockwell@whitecase.com)

David Koschik  
New York  
Tel: + 212 819 8241  
[dkoschik@whitecase.com](mailto:dkoschik@whitecase.com)

White & Case LLP  
1155 Avenue of the Americas  
New York, NY 10036  
+ 1 212 819 8200

[www.whitecase.com](http://www.whitecase.com)

<sup>1</sup> APLMA is the Asian Pacific Loan Market Association, based in Hong Kong

<sup>2</sup> LMA is the Loan Market Association based in London

<sup>3</sup> LSTA is the Loan Syndications and Trading Association based in New York

The required threshold typically ranges from 30 – 50 percent of participations in the loans although it can be as high as majority lenders (typically  $66\frac{2}{3}$  percent under APLMA/LMA) and even all lenders. Whilst the agent is not under a duty to proactively approach lenders to discuss triggering a market disruption, it would seem sensible for a lender seeking to trigger the clause to notify the agent and specifically request the agent to pass on a copy of its notification to the other lenders and seek their response. It is a matter for discussion between the notifying bank and the agent as to whether the identity of the notifying bank should be revealed at this stage; it probably does not need to be. Likewise, there is no need for the notifying lender to give details of its actual cost of funds at this stage; it simply needs to confirm that the cost of its obtaining matching deposits in the relevant interbank market exceeds LIBOR/HIBOR.

### US law

In US law credit agreements, the approach tends to be less consistent. Those that can make a claim varies from the administrative agent acting individually, the “Required Lenders” (typically 50.1 percent in US deals although you sometimes see a higher figure such as  $66\frac{2}{3}$  percent) or even an individual lender.

### Suggestions for change

- Amending the current way in which interest rate determination is provided for in credit agreements in a manner that avoids the need to trigger or invoke the “market disruption” provisions in the first place, e.g. a move to CDS market rate pricing as an alternative to LIBOR or Reference Bank rates.
- Lowering the current threshold levels, since this seems to be a significant factor in lenders being unable to trigger market disruption provisions. In the US, some credit agreements do include individual lender triggers, but typically inclusion of a single lender trigger has been resisted by borrowers and may be going too far even in light of current market conditions.

- Clarifying the agent’s role in implementing market disruption provisions and clarifying duties of confidentiality in relation to the agent when receiving notifications. One possible solution is to impose a clear framework requiring an agent to consult other lenders once it receives at least one notification from a lender that it wishes to invoke the market disruption provision in order to establish whether or not the required threshold for invoking the provision has been met (with clear guidance on what an agent may notify to a) the borrower and b) to other lenders). Based on discussions to date, we would suggest that an agent only be required to indicate to other lenders that another lender has delivered a notification without disclosing the identity of that lender. Also, once the market disruption is triggered the agent should notify the borrower and also all the lenders of this fact (but not the identity of the lenders triggering it). Prior to the end of an interest period each lender should notify its rate to the agent on a confidential basis who then delivers a composite list, again on a confidential basis, to the borrower identifying each bank and its cost of funds. The agent should also notify all lenders of the overall interest cost but without identifying each individual lender’s rates.
- Whilst costs incurred by the agent (including legal fees) in dealing with market disruption provisions would usually be covered by the borrower under a typical costs and expenses provision, it may be appropriate to consider providing for the agent to specifically recover management time in relation to market disruption provisions.

### When can it be invoked?

#### APLMA/LMA

Typically the agent has to have received notification from the required threshold of lenders by no later than close of business on the rate-fixing date for the relevant interest period. Note also that in order to give notice to the agent, a lender need only determine that its cost of obtaining matching deposits in the relevant interbank market exceeds LIBOR/HIBOR; it is not necessary at this stage to determine actual cost of funds.

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## US law

Language tends to vary but broadly it provides that the trigger point occurs when the agent/Required Lenders determine that LIBOR does not adequately and fairly reflect the cost to such lenders of funding such loan. Typically this provision tends to be tied into the rate fixing date as well. Note that this gives rise to a more subjective determination as to whether LIBOR still constitutes an adequate and fair basis in determining the interest rate under the loan agreement and can give rise to a discussion as to how wide the disparity between LIBOR and actual cost of funds needs to be before the provision can be triggered. Under APLMA/LMA, there is no such subjective consideration and the trigger is simply that matching deposits in the relevant interbank market are more expensive than the LIBOR/HIBOR rate determined under the loan agreement.

One further US provision which is sometimes seen is even stronger than the above and provides for the ability of an individual lender to make a claim under the “increased costs” provision on the basis that the lender incurs an increased cost with respect to any LIBOR loan because of circumstances affecting such lender, the interbank Eurodollar market or the position of such lender in such market. Typically, this claim can be made at any time. This formulation is obviously much broader than the APLMA/LMA language. Whilst this provision is included in some US credit agreements, it has not become standard and has been resisted by some borrowers in the US to date, so it is not clear that this option will gain widespread market acceptance.

## Suggested Changes

Evidence suggests that lenders are having difficulty because of the short time period between rate fixing under the standard LIBOR/HIBOR definition and the time by which they must then notify the agent/borrower that their cost of funds is higher than that rate/that the rate is not fair and reasonable. Lenders could consider requiring changes to give themselves until the actual start of the interest period or possibly longer to make such determination.

## What is the applicable fallback rate once market disruption is invoked?

### APLMA/LMA

Once the market disruption provision has been invoked, both APLMA/LMA provide that the applicable interest rate for each lender will be its cost of funding the loan for the relevant interest period from whatever source such lender may reasonably select. This applies to *all* lenders. The APLMA documentation goes on to provide a floor in the circumstances, such that the applicable rate is the higher of the cost of funds and the applicable LIBOR/HIBOR as originally determined so that a lender whose cost of funds is still at sub-LIBOR/HIBOR is protected. There is no specific provision requiring the agent to notify other lenders once the market disruption provision has been invoked but, similar to the agent generally notifying the lenders of determination of LIBOR, it would seem appropriate that the agent should notify all lenders as soon as practicable once the market disruption provisions have been triggered since they will all be required to confirm their costs of funds since this is now the interest basis for the loan during the relevant interest period. Those banks which can still fund at LIBOR/HIBOR should simply notify that rate as their cost of funds to the agent. Absent receiving a notification from a lender, the agent should treat such lender as still funding at LIBOR/HIBOR (this is clear from the APLMA “floor” language but would have to be implied into the LMA language).

There is no guidance in current form documentation as to how a bank should fund the loan, APLMA/LMA simply provide for recovery of each bank’s cost of funding its participation in that loan “from whatever source it may reasonably select.” This is one of the areas which seems to give rise to the most amount of uncertainty/desire for clarification.

Under APLMA/LMA all lenders switch to cost of funds once market disruption has been triggered, even those lenders that did not give a market disruption notification to the agent. The issue is whether those banks which did not give a notification can then claim to have costs of funds which are in excess of LIBOR? We would argue that failure to notify a market disruption

does not of itself preclude lenders from subsequently claiming a higher cost of funding once the market disruption provision has been triggered. For example, they may have had commercial reasons for not triggering the market disruption provision themselves or they may have been considering triggering it but find themselves in cost of funds anyway because other banks did give notice before they did. It is suggested that once market disruption has been triggered, it is appropriate that the agent notify the borrower of this fact but it is probably not appropriate to reveal the identities of those lenders who triggered the market disruption, but simply to confirm that it has been invoked and that all lenders are now charging interest at cost of funds rather than LIBOR/HIBOR.

The only subjective element is that a bank must be “reasonable” in selecting the source of funding. It will obviously be prudent for a bank to make sure that it is in a position to justify the rate which it notifies to the borrower as its cost of funds, preferably by reference to readily identifiable external quotation(s). There is no duty on the bank to obtain the best rate in the market but simply to act reasonably. On the current language, it is not even strictly necessary for the lenders to be “match funding”; cost of funds is simply a determination of the overall cost to the lender (expressed as a percentage rate per annum) of maintaining the outstanding loan for the duration of the interest period.

### US law

There is a significant diversion between US law and APLMA/LMA provisions since US law credit agreements do not typically default into an actual cost of funds rate. Typically LIBOR loans will default into a Base Rate loan if market disruption is triggered (although not all US credit agreements contain even this protection). If the trigger right is given to an individual lender, only that lender will benefit from this provision; otherwise it will apply to all lenders.

“Base Rate” is typically determined by reference to the higher of (1) the agent’s own “Prime” rate, i.e. its publicly announced benchmark rate for lending to customers (which in theory it determines according to what it is charged externally by third parties to borrow in order to fund such loans, whether through the interbank market or otherwise, its desired return, general

economic conditions at the time and other factors) and (2) the latest published Federal Funds rate plus 50 basis points. Although in theory banks can change their “Prime” rate at any time, for economic and political reasons, banks have generally been reluctant to change this published rate to reflect short term increases in “cost of funding” and there has also been some external market pressure from regulators, industry bodies and government to avoid this and so the Federal Funds rate, as adjusted, was historically included as a fallback to reflect this possibility. This alternative in the US additionally also reflected the ability of banks in the US to fund themselves in other ways, such as in the certificate of deposit market or from the federal reserve banks.

However, in the current environment, a bank’s “Prime” rate may equally not reflect an individual lender’s costs of funds. Most credit agreements do not contemplate the possibility that the Base Rate would not adequately cover a lender’s actual “cost of funding” and do not therefore offer lenders the option to opt out of Base Rate loans. This outcome is exacerbated by the fact that currently LIBOR rates almost match Base Rates, making it less expensive for many borrowers to select Base Rate loans rather than borrow at LIBOR rates because the interest margin for Base Rate loans is generally at least 100 basis points less than the interest margin for LIBOR Loans. Lenders will need to consider incorporating provisions in their credit agreements that better address the current relationship between LIBOR and the Base Rate and provide for the option to select the higher of the two (or an alternative rate which more closely reflects their “actual cost of funding” in a similar way to LMA/APLMA, although see discussion of this point further below).

As mentioned above, the strongest provisions under US law credit agreements provide for individual lender claims under the increased costs provision and pursuant to these provisions the borrower is obliged to pay the relevant lender additional amounts (in the form of an increased rate or different method of calculating interest or otherwise, as such lender in its reasonable discretion may determine) to compensate such lender for such increased cost. There is therefore greater flexibility under this provision as to how the claim is made and the increased amount is communicated to the borrower.

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## Proposed changes

- Consider using LIBOR/Base Rate floors. Whilst typically these would be a protection against falling market interest rates, one possible solution might be for an alternative floor to apply upon “market disruption” being triggered or invoked by lenders, although so far lenders have not agreed on what basis such an alternative floor would be set.
- In US deals, to deal with i) the situation where the Base Rate is lower than LIBOR (or does not exceed LIBOR by expected differential), and ii) to address the margin discrepancy between Base Rate loans and LIBOR loans, the Base Rate definition should be amended to equal the highest of a) “Prime” rate, b) Federal Funds Rate plus 50 basis points and c) 1-month LIBOR plus 100 basis points (or the actual margin discrepancy, if higher).
- In US deals, consideration could perhaps be given to including an APLMA/LMA- style market disruption switch to cost of funds provisions where Base Rate did not adequately reflect cost of funds, but it should be noted that in discussions on some recent transactions, lenders remain **very** uncomfortable about notifying their “actual” cost of funds to either an agent or borrower.

An alternative to that approach currently under discussion involves redefining Base Rate to mean the highest of (a) “Prime” rate, (b) Federal Funds Rate plus 50 basis points and (c) a new objective non-cost of funds based adjustment. This adjustment would be in addition to the adjustment suggested to address the discrepancy between Base Rate and LIBOR as described in paragraph (2) above (i.e. if appropriate, these adjustments should be cumulative (not in the alternative)). One approach for this new objective non-cost of funds adjustment would be simply to add a flat additional amount e.g. 1% (note that this flat additional amount is what we have seen proposed in recent transactions but is obviously subject to negotiation depending on what the market may

“require” for syndication of that particular transaction). Another approach for this new objective non-cost of funds adjustment would be to apply a graduated amount, stepping up by reference to a grid based on the spread e.g. between 3-month LIBOR and 3-month US Treasury Bill rates (note that the spread could equally be measured by reference to other government-issued debt instruments with different tenors depending on the market and the currency of the loan) – as the spread widens the graduated amount would increase.

- Consider specifying “cost of funds” determinations for non-bank financial institutions (which traditionally do not obtain “matched funding” in the interbank markets) and reviewing funded participation and Credit Default Swap language for pass-through of funding costs where market disruption provisions are not currently covered in existing documentation.

## Handling of rate notifications when market disruption is triggered

There is a considerable sensitivity at present when it comes to lenders disclosing their actual cost of funds.

### APLMA/LMA

Under the current market disruption provisions, the rate applicable to each lender’s share of the loan for the applicable interest period is the rate notified to the agent by that lender as soon as practicable and in any event before interest is due to be paid in respect of that interest period to be that lender’s cost of funding. There has been much discussion about whether the agent can notify a blended rate to the borrower and whether the agent is under an obligation to calculate the blended rate.

Under the current wording, most lawyers agree that a blended rate is not an option unless it is separately negotiated with the borrower. The interest rate applicable to the loan is the cost to *each* lender of funding the loan and it is therefore reasonable for the borrower to expect to see a notification of interest from the agent identifying each lender’s cost of funds (which rate may

still be LIBOR/HIBOR if that lender is still able to fund at that rate or if the APLMA floor applies). The borrower would only be able to challenge these rates on the basis that they believe that the lender has not acted reasonably in selecting its source of funds. Obviously the timing for notification under APLMA/LMA can give considerable concern for borrowers since it means a borrower may not find out what the precise rate to be utilised is until immediately prior to the end of the interest period.

### US law

As mentioned above, under most US law credit agreements, the remedy when market disruption is triggered is for affected loans to default to Base Rate giving rise to less uncertainty. However, to the extent that US lenders seek to include APLMA/LMA-style cost of funds provisions these issues will also arise (as indeed they already do where the individual lender “increased costs” claim provision exists).

### Suggestions for change

Considering implying express duties of confidentiality on the agent when passing on rates from lenders to the borrower so that no other lenders see a lender’s rate. However note that, at some stage, the all-in interest cost to the borrower may become a matter of credit concern for lenders so it may be appropriate for the agent, when notifying interest cost to the borrower, to also notify the total interest amount payable to all lenders.

### How long does market disruption apply?

#### APLMA/LMA

“Market disruption” is specific to a Loan and the Interest Period applicable to that Loan. Accordingly, it will cease to apply to a Loan at the end of the Interest Period for which it was triggered unless the required threshold of lenders trigger it again for the succeeding Interest Period.

#### US law

Market disruption provisions tend to continue to apply until the agent/Required Lenders determine that the circumstances giving rise to the market disruption no longer exist.

### Suggested changes

- Under APLMA/LMA, it seems unduly burdensome to have to go through the market disruption triggering provisions for each interest period and each loan. It may be better to have a formulation that once it triggers, it applies until a specified fall-away trigger is reached, for example, where the cost of funds rates as notified to the agent by a specified majority do reflect LIBOR/HIBOR.
- In US law credit agreements, it may be better to have more specific triggers for disapplying “market disruption” rather than leaving these to determination by the agent/lenders as a group.

### Negotiation Rights

#### APLMA/LMA

These documents specifically provide for a 30-day period of negotiation to be invoked by either the agent or the borrower to try and determine an acceptable alternative interest rate for funding. The alternative basis has to be agreed by all lenders before it can take effect. In disclosing and discussing proposed interest rates, there is obviously commercial sensitivity as between lenders and also legal sensitivity in relation to anti-competitive behaviour and banking secrecy in those jurisdictions with specific legislation. However, practically speaking, it is unlikely that an agent under an APLMA/LMA document is going to unilaterally initiate such a discussion or is going to be able to have any meaningful negotiation with the borrower absent specific input from the lender group.

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## US law

US law credit agreements do not typically contain any specific provision for amending the interest rate outside the operation of the market disruption provisions and so this matter would be handled in much the same way as any other proposed amendments to the agreement would be and would likely require consent of all lenders (see below).

Typically under US law credit agreements, the borrower also has a right to “yank” a lender (i.e. prepay or require it to transfer its loans at par) if such lender invokes the increased cost provision, although in the current market, with many loans trading below their par value, the practical effect of this protection for borrowers has been eroded and is less effective than hoped for. The borrower may also have the right to convert the relevant loans to Base Rate loans.

To the extent that US law credit agreements adopt, going forward, APLMA/LMA-style market disruption provisions where affected lenders notify their “individual” cost of funds and as a result also incorporate provisions for negotiating an alternative interest rate, the same considerations discussed above for APLMA/LMA will apply,

## General

Applicable to both APLMA/LMA and US law credit agreements is a discussion whereby the borrower agrees to simply increase the margin on the loan to try to deal with the current situation. Whilst an increase in the margin would generally only require consent from the majority lenders/ Required Lenders, one would assume that the borrower would only be agreeing to the increase on the basis that the “market disruption” provisions would then not be triggered. Since this could still theoretically result in a lender receiving a lower rate of return than that to which it would otherwise be entitled, a prudent view on this would be that such an amendment disapplying the market disruption provision would still require consent of all lenders in order to effectively bind all lenders and operate to prevent one or more individual lenders from subsequently attempting to trigger or invoke market disruption with respect to the amended rate.

## Suggestions for change

In agreeing to a substitute basis, in addition to agreeing what the substitute basis was, the borrower and the lenders would have to agree to, the following:

- (a) When the new rate would take effect, from the date agreed or retrospective to the date when disruption was invoked?
- (b) How long the new rate would apply and to which loans, otherwise it would only be valid for a particular interest period?
- (c) Fall-away provisions, i.e. when (if at all) would the loan revert to a LIBOR/HIBOR basis?
- (d) What would be the “Interest Periods” applicable to the new rate going forward?

\* A modified version of this alert has been posted on the [APLMA website](#).

If you have questions or comments regarding this Alert, please contact one of the following lawyers:

## Asia

### John Hartley

Hong Kong  
Tel: + 852 2822 0409  
jhartley@whitecase.com

### John Shum

Hong Kong  
Tel: + 852 2822 0748  
jshum@whitecase.com

### Brian Conway

Singapore  
Tel: + 65 6347 1322  
bconway@whitecase.com

### Jamie Thomas

Singapore  
Tel: + 65 6225 6000  
jamiethomas@whitecase.com

## Frankfurt

### Annica Lindegren

Tel: + 69 29994 1210  
alindegren@whitecase.com

## London

### Magdalene Bayim-Adomako

Tel: + 44 20 7532 1202  
bayimma@whitecase.com

### Christopher Kandel

Tel: + 44 20 7532 1260  
ckandel@whitecase.com

## Paris

### Gilles Peigney

Tel: + 33 1 55 04 15 42  
gpeigney@whitecase.com

### Clare Calver

Tel: + 33 1 55 04 58 44  
ccalver@whitecase.com

## New York

### Eric Berg

Tel: + 212 819 8253  
eberg@whitecase.com

### David Koschik

Tel: + 212 819 8241  
dkoschik@whitecase.com

### Eric Leicht

Tel: + 212 819 8796  
eleicht@whitecase.com

### Alan Rockwell

Tel: + 212 819 7888  
arockwell@whitecase.com

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