

Eurodollar Disaster Clause – LIBOR and Base Rate Loans

by

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Over the past two weeks, the LSTA has received a number of queries from members about a provision in a credit agreement which permits lenders to convert LIBOR loans to base rate loans. In response, the LSTA hosted an educational call on October 7th to discuss this provision, which is referred to as the “Eurodollar Disaster” clause. Rick Gray, Partner of Milbank Tweed Hadley & McCloy, led the discussion with more than 730 members participating.

Rick Gray provided historical background to the clause and highlighted general yield protection provisions found in credit agreements, before analyzing the clause and giving examples of when markets have focused on it in past downturns. During the Q&A that followed, he touched on another emerging issue, that of borrowers selecting base rate loans on their own because of the current disconnect between the Eurodollar rate and the base rate of most banks. Set forth below is a summary of the issues Rick Gray reviewed on the call. Rick Gray will be producing a more detailed memo on this subject in the near future. In addition, a brief description of the provision can also be found in the LSTA’s *Handbook of Loan Syndications & Trading* and a more detailed description is included in the LSTA’s *Credit Agreement Handbook* by Richard Wight, Warren Cooke and Rick Gray, which will be published in December.

Background

The Eurodollar provision, which gives lenders the right to suspend lending off Eurodollar rates, is typically found in section 2 of a credit agreement. An example of such provision is as follows:

If prior to the commencement of any Interest Period for a LIBOR Borrowing:

(a) the Administrative Agent determines (which determination shall be conclusive absent manifest error) that adequate and reasonable means do not exist for ascertaining LIBOR for such Interest Period; or

(b) the Administrative Agent is advised by the Required Lenders that LIBOR for such Interest Period will not adequately and fairly reflect the cost to the Lenders of making or maintaining the Loans for such Interest Period;

then the Administrative Agent shall give notice thereof to the Borrower and the Lenders as promptly as practicable thereafter and, until the

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Administrative Agent notifies the Borrower and the Lenders that the circumstances giving rise to such notice no longer exist, (i) any request to convert any Borrowing to, or continue any Borrowing as, a LIBOR Borrowing shall be ineffective and (ii) any requested LIBOR Borrowing shall be made as an ABR Borrowing.

The clause protects lenders against certain types of events or “disasters” in the LIBOR market which result in lenders not being able to obtain quotes adequately reflecting their cost of making the loan. Quotes not reflecting the lenders’ true cost could arise if there were “tiering” in the market – a practice where banks are tiered based upon their credit quality (with depositors demanding a better rate for placing funds with certain banks). Those lenders at the top tier might be able to obtain very good rates in comparison with those on the bottom tier. It might also occur if the quotes submitted to the relevant pricing services do not accurately reflect true market conditions.

Either the agent or the lenders can trigger the conversion to base rate. In clause (a) above, the administrative agent – not the lenders – determines whether rates are unavailable in the market in the amounts and for the relevant maturities needed. Alternatively, in clause (b), the Required Lenders can determine that the quoted LIBOR rates do not cover their cost of making the loans and they, in turn, advise the administrative agent of those increased costs.

Required Lenders is a defined term in a credit agreement and is typically a simple majority or two thirds majority. Sometimes agreements set a lower threshold. In the London market, less than a majority of lenders, or even a single lender, might be able to trigger the clause (of course, requiring that a majority of lenders must make the determination to invoke the clause gives greater protection to the borrower).

If the clause is invoked, and the credit agreement provides for both base rate and LIBOR pricing, then any loans priced according to LIBOR will be calculated according to US base rate. If the agreement does not include the right automatically to convert to base rate, it will require the administrative agent to negotiate an alternative interest rate with the lenders. Agreement on such substitute basis for pricing the loans must typically be reached within 30-45 days. In the event they cannot agree on such rate, the borrower will be required to prepay the loan or cover each individual syndicate member’s lending costs.

When has this provision been invoked

In the early 90s, many Japanese banks suffered higher funding costs than banks from other countries. However, rather than invoking this clause, efforts were often made to include Japanese banks among the reference banks used to determine LIBOR in order to have a rate that was more fair to the overall syndicate. (At that time, it was more common to determine LIBOR by averaging the quotes of Reference Banks, in contrast to today’s practice of using screen quotes.)

During the Asian financial crisis of the late 1990s, when the Asian banks paid a premium on their deposits, their cost of funding increased accordingly. At that time, although there was

discussion about parties invoking this clause, it seems that no one actually triggered a conversion, in many cases probably because the number of affected banks did not reach the Required Lenders threshold.

In today's market, more banks are being affected by the crisis than past downturns, so it might be easier for lenders to meet the threshold required to invoke the clause. Prior to the call, it seems that this clause has only been invoked in a club deal in the Americas with only European bank lenders, and newspaper reports speak of another recent case in Asia.

How to deal with today's situation

There are several different ways to tackle the issue. First, ensure accurate quotes. When rumors circulated earlier in the year about how inaccurate LIBOR was, the BBA was asked to address the issue and has considered expanding the panel of banks used to determine LIBOR and is looking to ensure that LIBOR is accurately quoted. Other ways that lenders are considering addressing the issue is by incorporating certain other provisions in their credit agreements, for example, including a LIBOR floor, increasing or supplementing the applicable margin, providing for the interest rate to be the higher of LIBOR and another market rate basis, or shortening the interest period.

Base Rate Loans Selected by Borrowers

Ironically, in the current environment, with LIBOR rates almost matching base rates, it may be less expensive for many borrowers to select base rate loans rather than borrow off Eurodollar rates. Most credit agreements do not contemplate the possibility that the base rate would not adequately cover their cost of funding and do not offer lenders the option to opt out of base rate loans. This outcome is exacerbated by the fact that the interest margin for base rate loans is generally about 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).