NOTE

Standard Chartered Plc v Guaranty Nominees Limited and Ors

1. On 15 October 2024, the English High Court handed down judgment in the case of Standard Chartered Plc v Guaranty Nominees Limited and Ors [2024] EWHC 2605 (Comm). This is the first case in which the High Court has had to determine the effect of the cessation of LIBOR on a transaction providing for payments to be made by reference to that rate.

2. The case was brought under the Financial Markets Test Case Scheme which applies to a claim brought in the Financial List "*which raises issues of general importance in relation to which immediately relevant authoritative English law guidance is needed*". In recognition of the general importance of the decision, it was (unusually for the Commercial Court) heard by a Divisional Court made up of two judges, including the Chancellor of the High Court (who is a Lord Justice of Appeal).

3. This note summarises and analyses the Court's reasoning and considers the extent to which this is a test case in the strict sense, with wider implications than the securities at hand.

The transaction and the parties

4. The proceedings concerned USD 750 million perpetual preference shares issued in December 2006 by Standard Chartered Plc (**SC**). Guaranty Nominees Limited (**GNL**) is the sole registered shareholder of the Preference Shares (as nominee for JPMorgan Chase Bank NA) and has in turn issued American Depository Shares (**ADSs**) to investors, who hold the economic interest in the Preference Shares. The ADSs are evidenced by American Depositary Receipts (**ADRs**) that are traded in the United States.

5. For the reasons explained below, it was significant to the High Court that the Preference Shares were issued by SC for the purpose of raising Tier 1 Capital to meet regulatory capital adequacy requirements set by the Basel Committee on Banking Supervision (the regulatory

classification of the Preference Shares was subsequently changed from Tier 1 to Tier 2 capital).

6. The Offering Circular set out the terms of the ADSs. It was common ground that those terms formed part of the contract between SC and the holders of the ADSs from time to time. Of most relevance to these proceedings were the following terms:

    6.1. The Preference Shares and ADS were perpetual (i.e. they had no maturity date).
    6.2. SC, but not the ADS holders, had the option to redeem the Preference Shares "*subject to the Articles, provisions of applicable law and to the prior consent of the FSA (if such consent is required)*" in whole or in part on 30 January 2017, and at 10-year intervals thereafter.
    6.3. Dividends were payable at a fixed rate of 6.409% per annum, semi-annually, until 30 January 2017, and thereafter at a floating rate of "*1.51% plus Three Month LIBOR*" ("*Three Month LIBOR*" was itself defined as described below).
    6.4. The Preference Shares were governed by the laws of England and Wales.

7. The definition of Three Month LIBOR in the Offering Circular was:

> "'*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…;*
> *provided that, if at such time, no such rate appears or the relevant Moneyline Telerate page is unavailable, it shall mean the rate calculated by the Company as the arithmetic mean of at least two offered quotations obtained by the Company after requesting the principal London offices of each of four major reference banks in the London interbank market, to provide the Company with its offered quotation for deposits for three months in US dollars commencing on the first day of the relevant Dividend Period to prime banks in the London interbank market at approximately 11:00 a.m., London time, on the second business day in London prior to the first day of the relevant Dividend Period and in a principal amount that is representative for a single transaction in US dollars in that market at that time;*
> *provided further that if fewer than two such offered quotations are provided as requested, it shall mean the rate calculated by the Company as the arithmetic mean of the rates quoted at approximately 11:00 a.m., New York time, on the second business day in New York prior to the first day of the relevant Dividend Period, by three major banks in New York selected by the Company for loans for three months in US dollars to leading European banks and in a principal amount that is representative for a single transaction in US dollars in that market at that time;*
> *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*."

8. Pausing there, the definition therefore provided for three express alternatives if LIBOR was not available.

9. The first two alternatives required quotations to be obtained by SC from four (alternatively at least two) major reference banks in the London interbank market for three month deposits in USD; or from three major banks in New York for three month USD loans to leading European banks. Critically, it was common ground between the parties that these express fallbacks were unworkable in that it was impossible to get the required bank quotations (or any of them).

10. The final fallback (if no such quotations could be obtained) was "*three month US dollar LIBOR in effect on the second business day in London prior to the first day of the relevant Dividend Period*" (**Final Fallback**). There was a dispute (described below) about the construction of the Final Fallback and whether it provided a replacement rate for LIBOR in the circumstances which prevailed.

Background to SC's claim

11. The background to the cessation of LIBOR was not in issue between the parties. The following features of that background assumed significance in the proceedings:
    11.1. The Federal Reserve System of the United States and the Federal Bank of New York had convened the Alternative Reference Rates Committee (**ARRC**) to identify a set of alternative reference interest rates should it become necessary or desirable to replace LIBOR. The ARRC consisted of representatives from the financial services industry, including 15 large global investment rate derivative dealers, as well as *ex officio* members from the Federal Reserve, the SEC and the US Treasury.
    11.2. The ARRC undertook an extensive programme of market consultation. Following this, they recommended as an alternative to LIBOR the Secured Overnight Financing Rate (**SOFR**), which is a daily rate for overnight lending secured by US Treasuries. SOFR and SOFR-based rates behave differently than LIBOR.
    11.3. The International Swaps and Derivatives Association (**ISDA**) initiated a market-wide consultation to consider how to minimise value transfer that would occur in connection with transitioning LIBOR derivatives to so-called SOFR compounded in arrears. ISDA concluded that a spread adjustment based on a historical median over a five-year look-back period was appropriate. The ARRC eventually

endorsed the spread adjustment proposed by ISDA, and recommended that it be used in connection with transitioning financial instruments from LIBOR to all SOFR-based rates.

11.4. To provide forward term SOFR rates (**Term SOFR**) the ARRC eventually recommended using term rates published by the Chicago Mercantile Exchange Group Benchmark Administration (**CME Term SOFR**). While intended to be the forward-looking measurement of overnight SOFR for different tenors (*e.g.*, 1-month, 3-month, 6-month), CME Term SOFR is derived from the market for SOFR *futures*.

11.5. On 15 March 2022, the US Congress passed the Adjustable Interest Rate (LIBOR) Act which made provision for the Board of Governors of the Federal Reserve System (**FRB**) to select SOFR-based replacement rates for certain legacy contracts, including those that lacked any fallback provisions and those that resulted in benchmark replacements derived from LIBOR. On 26 January 2023, the FRB exercised the power granted by the Act and selected USD three month LIBOR of three months CME Term SOFR plus the ISDA Spread Adjustment as the so-called Board Selected Benchmark Replacement for various LIBOR Contracts, including most non-consumer cash products like preferred equity shares.

11.6. In the UK, while no similar legislation was passed, the Bank of England and the Financial Conduct Authority (**FCA**) announced their support for the use of Term SOFR as a benchmark replacement.

11.7. On 1 July 2023, the FCA exercised regulatory powers conferred on it to facilitate the LIBOR transition to require the IBA (ICE Benchmark Administration Limited, the administrator of LIBOR since 2014) to publish synthetic rates for 1, 3 and 6-month USD LIBOR based on the relevant CME Term SOFR Reference Rate plus the IDSA fixed spread adjustment. The FCA stated that it was satisfied that this was a "*fair and reasonable approximation of the value panel-bank LIBOR would have had*" (Synthetic USD LIBOR ceased to be published at the end of September 2024, being mid-way through the trial.)

12. In view of the then-pending cessation of LIBOR, on 8 November 2022, SC launched a "*consent solicitation process*" to replace, by special resolution, 3-month USD LIBOR as the dividend rate for the Preference Shares with three month Compound SOFR plus the

ISDA spread adjustment. However, SC failed to achieve the requisite 75% majority to replace the rate.

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13. Therefore, on 12 April 2024, SC issued a claim in the Financial List, with GNL as legal owner of the Preference Shares as the sole defendant, seeking declarations concerning the interest rate by reference to which the dividends payable on the Preference Shares should be calculated for the dividend periods after 30 October 2024.

14. The Second to Fifth Defendants (**Funds**) are holders of the ADSs who indicated that they wished to participate in the proceedings to oppose the relief sought by SC (GNL's role as depositary for the transaction meant that it was a nominal defendant, and took no active role in the proceedings).

SC's case on the Final Fallback

15. SC's case on the Final Fallback was that the phrase "*three month US dollar LIBOR in effect*" should be construed as "*a rate that effectively replicates or replaces three month USD LIBOR*". As the Court noted, "replicate or replace" would mean a rate which was the same as or which directly succeeded LIBOR. Yet what SC really meant was that Term SOFR was "*effectively*" LIBOR because it was the rate closest to LIBOR.

16. The Court held, however, that "*in effect*" in the context in which it is used in the LIBOR Definition more naturally means "*in force*" or "*in operation*" at the relevant point in time. The Final Fallback therefore contemplates a situation in which LIBOR is temporarily unavailable and a LIBOR rate published on a prior date is treated as the effective LIBOR rate by the market.

17. The Court was emboldened in this conclusion by:

    17.1. The "*architecture*" of the definition of "Three Month LIBOR": The Third Fallback only comes into play if it is not possible to obtain quotations from banks (either in London or New York); it is therefore the express fallback of last resort. If it meant the rate which replicated or replaced LIBOR, there is no reason it would only apply after the other fallbacks have failed.

    17.2. The use of the phrase "in effect" in other places in the Offering Circular which shows that it means something which applies at a particular point in time, for

example, the provision that the Preference Shares "*will be subject to applicable UK tax laws and regulations in effect at the time of the exchange*".

18. SC's argument on the Final Fallback was therefore dismissed relatively swiftly. Far more of the judgment is devoted to what was described in the proceedings as the "*battle of implied terms*"; namely SC and the Funds' competing version of what should be implied into the contract if none of the express fallbacks worked.

SC and the Funds' rival implied terms

19. SC's alternative case was that a term should be implied that allows SC to use *"a reasonable alternative rate to three month USD LIBOR*" and SC contended that the rate produced by taking CME Term SOFR and adding the ISDA Spread Adjustment (**Proposed Rate**) meets the requirements for a reasonable alternative rate. The second part of SC's alternative case was smoothed by the fact that SC and the Funds' expert witnesses (although disagreeing on aspects of the Proposed Rate) agreed that it is currently the most reasonable alternative rate to LIBOR.

20. On the other hand, the Funds sought a declaration that a term should be implied that, if LIBOR ceases to be available, SC shall redeem the Preference Shares. It is not necessary to rehash the precise and detailed implied redemption term contended for by the Funds save to note that it involved a two-stage approach where if three month USD LIBOR ceases to be available then, "*subject to the Companies Act and all other laws and regulations applying to the Company, to the Articles and to the prior consent of the FSA (if such consent is required, in which case, the FSA may impose conditions on the redemption)"*, SC would redeem the Preference Shares, but if the Preference Shares could not be redeemed in accordance with that implied term (because for example, it was unlawful under the Companies Act), SC would pay to the Holders of the Preference Shares until redemption becomes lawful a sum "*as if it were a Dividend payable under the terms of the Preference Shares"* with the dividend rate being equal to the last published LIBOR, alternatively the fixed rate which applied for the first 10 years. The Funds were therefore arguing for an implied term with more than one in-built alternative.

21. There was no dispute between the parties as to the test which applies to implied terms under English law. 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 it is "*so obvious that it goes without saying*". Further, the term to be implied must be capable of clear expression, not contradict any express terms of the contract and be reasonable (the leading authority is *Marks & Spencer Plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] UKSC 72, [2016] AC 742).

22. The Court, however, put special emphasis on what it described as "*second order principles"* which apply to long term contracts (as stated above, unless SC exercises its ten year option to redeem the Preference Shares, the contract is a perpetual one). The Court noted that although "*there are no special rules of interpretation applicable to such contracts*"… "*That is not to say that in an appropriate case a court may not take into account that, by reason of the changing conditions affecting such a contract, a flexible approach may best match the reasonable expectations of the parties*." (citing Lord Steyn in *Total Gas Marketing Ltd v Arco British Ltd* [1998] 2 Lloyd's Rep 208, 218).

23. In particular, the Court highlighted (after a comprehensives analysis of the case law on long term contracts) that a failure to address a specific issue in a long-term contract may be less significant than in a short-term contract, and that when the parties are confronted during the life of a long term contract with an event which they did not foresee the Court should adopt an interpretation which is most consistent with the purpose of the contract in the changed circumstances. The Court viewed this approach as one which gives effect to an important policy of English contract law; namely a reluctance to contemplate the failure of partly executed contracts merely because the parties did not complete some eventuality.

24. The following matters were also foremost in the Court's mind:

    24.1. First, the reference to LIBOR itself was a reference to a "*potentially imprecise mechanism for measuring the costs of unsecured bank borrowing over time*". In this regard the Court described LIBOR as "*a means to an end, not Holy Writ in itself*" noting that LIBOR was based on subjective submissions by panel banks with scope for the manipulation of submissions, that the number of panel banks submitting to the BBA varied, the trimming exercise undertaken, and also that

LIBOR had become progressively less effective at measuring what it was intended to measure.

24.2. Second, the three fall-backs evidenced a common intention that issues relating to the publication of LIBOR should not prevent the continued operation of the contracts. Notably, the first and second Fallbacks were very different to LIBOR in that they did not involve a published rate, panel submissions etc

24.3. Third, the various fallbacks reflected a preference for a "real time" rate (with the only option reflecting the position at some earlier point in time being the Final Fallback).

25. In essence, the Court considered that the role of LIBOR in the Preference Shares was non-essential "machinery" and 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 also considered that the fact that the Preference Shares were issued by way of Tier 1 capital for a regulated financial institution made it particularly important for the dividend mechanism to continue to operate even if LIBOR ceased to be published, and that the parties would have required the qualification of "reasonableness" for any replacement rate as "*a sufficient protection of their interests*".

26. The Court was therefore primed to find in favour of some form of SC's implied term. The only argument against SC's implied term which appeared to concern the court was the spectre of rival arguments as to which rate to use. That concern was however diluted by two matters: the Court's own modified version of SC's term (explained below) and the fact that the experts were agreed in this case that ISDA-adjusted CME Term SOFR was a reasonable alternative rate despite it being different than LIBOR.

27. By contrast, the redemption term contended for by the Funds was rejected for a number of reasons, including that:

27.1. It was not necessary to give business efficacy to the contract. The purpose of the contract was for the long-term provision of capital to SC in return for a dividend calculated on a fixed-rate basis for 10 years, and at a floating rate after that. That purpose could be given effect by an implied term that an alternative reasonable rate be used.

27.2. It was not so obvious that it goes without saying. The term would have involved both parties signing up to a contract in which an event outside the control of SC or the Funds could bring the arrangement to an end at any time. That would have implications for SC's ability to make investment and acquisition plans which was one of the uses to which the capital raised could have been put (as the Court put it, "*the very antithesis of what Tier 1 regulatory capital is intended to permit*"). It would also have involved a risk to investors insofar as it required automatic redemption even if a significant majority of ADS holders wanted to hold onto the Preference Shares.

27.3. The proposed term is unclear. For example, it is not clear if the implied term would require SC (when the cessation of LIBOR was in contemplation or had occurred) to take reasonable steps to put itself in a position to redeem the shares.

27.4. It is inconsistent with the express terms of the contract which provide that SC has the option to redeem the Preference Shares in whole or in part of 30 January 2017 and at 10-year intervals thereafter. This was clearly a right exercisable only by SC which arose at specific times. Indeed, the Offering Circular stated that ADSs did "*not have a fixed final redemption date and investors will have no right to call for the redemption of the Preference Shares or ADSs*."

27.5. It was common ground that any share redemption would be subject to a number of restrictions in the Companies Act 2006 (**CA 2006**). These included that the terms, conditions and manner of redemption must be set out before the shares are allotted: ss.685(1) and (3) CA 2006, and that a public company would need to finance the redemption from distributable reserves or the proceeds of a fresh share issue: s.684(1) and 685(3) CA 2006.

27.6. Further, when the Preference Shares were issued in 2006, the Interim Prudential sourcebook: Banks issued within the FSA Handbook stated that for capital to qualify as Tier 1 capital, it must not "*be redeemable at the option of the holder*" or contain "*other provisions which require future redemption of the issue*."

The Court's decision

28. While the Court therefore had every reason in this case to favour the implication of a reasonable alternative rate to redemption of the Preference Shares, the Court modified the term contended for by SC in two respects:

28.1. ***First***, to make it clear that the identification of the reasonable rate is an objective question, rather than SC being permitted to reach its own decision as to an alternative rate.

28.2. **Second**, to allow for the fact that available alternative rates rates might change over the life of the Preference Shares (including if an interbank unsecured lending market akin to LIBOR were to be re-established).

29. The Court therefore held that there was an implied term 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 three month USD LIBOR at the date the dividend falls to be calculated*.

30. This meant that the area of expert agreement (viz. that the Preferred Rate is the current reasonable alternative rate) is all that is needed to set the rate for now, but there may be cause down the line to come back to Court if the rates environment changes and the parties cannot agree what the reasonable alternative is at a given dividend calculation date.

Wider implications of the decision

31. While the Court's reasoning was very much focused on the particular terms of the Preference Shares as set out in the Offering Circular, their perpetual nature, the English company law prohibitions on redemption and factors such as the Tier 1 capital requirements, the Court went on to say that its reasoning is "*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 when the publication of LIBOR ceases.

32. The reason for this "likelihood" given by the Court is twofold:

32.1. The use of a floating LIBOR rate as a reference rate in debt instruments is equally "likely" to be a non-essential term, such that the inoperability of the mechanism should not defeat the continuation of the contract.

32.2. Further, an implied term by which the cessation of LIBOR would give rise to an automatic redemption would be at least as, if not more, unworkable in debt instruments, where it would trigger immediate payment of the full amount of the outstanding principal sum despite the fact that events of default in loan contracts are generally carefully defined and clearly set out because of the dramatic consequences they have.

33. As explained above, this was the decision of an unusually-constituted Divisional Court. In practical terms, this means that this judgment will have the status of a Court of Appeal decision. It is very likely that despite the case-specific elements of the reasoning, any High Court (or lower court) in the UK would be heavily influenced by the Court's reasoning, and in particular by the general policy of saving contracts despite the occurrence of events which neither party anticipated. An argument based on frustration of the contract in similar circumstances is likely to receive short shrift where an implied term that the reasonable alternative rate be used would make the contract workable.

34. However, there are a number of reasons which emerge from the judgment itself as to why there may be a different outcome in another case:

34.1. The decision will not apply where there are effective fallback provisions or where there is otherwise an express term covering what the replacement rate should be absent LIBOR. In this regard, the decision underscores the importance of the particular wording of the contract in question. In this case, even though the express fallbacks were not workable (either as a matter of common ground or in the case of the Final Fallback by the Court's determination of SC's construction argument), the Court still considered the express fallbacks carefully (including the order in which they appeared) and what those fallbacks said about the parties' common intentions.

34.2. It remains open to parties to agree to an alternative fix; it is simply that the consent solicitation process failed in this case because SC did not achieve the requisite 75% majority to replace the rate. As such, even where a similar term could be implied, it is likely that an agreement on another solution may (depending on the

wording of the contract and of that agreement) be regarded as having varied the implied term.

34.3. This is a case where the Court was faced with a decision between two rival implied terms, one of which was very convoluted and unworkable under English company law and regulatory capital requirements. It does not mean that in another case there will be no workable rival implied term.

34.4. The specific focus in this case on the perpetual nature of the Preference Shares and the company law aspects which made redemption an unworkable solution (and the Court's comment about the forced acceleration of loans) mean that it may well be possible to distinguish, for example, a short term loan agreement which affords a borrower a wide discretion to repay the loan early without penalties (which would not cause any regulatory or company law issues). In such a case an implied term of optional redemption where the reference rate fails may be in accordance with the parties' common intentions.

34.5. There was no evidence in this case to counter the Court's view that LIBOR had not been chosen for some specific reason – i.e. that the particular agreed reference rate was a non-essential term. There may well be a good basis is another case for arguing that the parties' common intention was for a particular kind of floating rate (for example, one linked to unsecured bank borrowing or a proxy for a party's cost of funds) to apply such that the non-availability of any such rate defeats the purpose of the contract.

34.6. It was common ground at this hearing that the issues before the Court were to be determined by reference to the law of England and Wales. Another governing law may produce a different solution.

35. It is also very important to note that the outcome on the alternative replacement rate was heavily influenced by the expert agreement on that alternative rate being (currently) the "best alternative" (and the rate which has received market acceptance, even if by means of statutory imposition). The experts did not present evidence regarding every alternative reference rate that exists, including so-called credit sensitive rates that are intended to behave more like LIBOR than SOFR-based rates.

36. There was nonetheless considerable disagreement between the experts as to how closely the output of the Proposed Rate (**Adjusted Term SOFR**) would match LIBOR over time and in different economic conditions, and the Court accepted that there are likely to be economic conditions in which Adjusted Term SOFR could be materially less than LIBOR, and vice versa. While the Court observed that the ultimate net effect of using Adjusted Term SOFR rather than LIBOR over what will be the life of the Preference Shares could only be a matter of speculation, there may well be a case where it could be shown that objectively the investors / borrowers in question valued LIBOR's tendency to "spike" in times of crisis and selected it for that reason, in which case Adjusted Term SOFR would not be a reasonable alternative.

37. It is therefore important to be careful not to overstate the “test case” aspect of this (though undoubtedly very important) decision.