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IN THIS ISSUE

LIBOR: An Endangered Species?

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The London interbank offered rate, commonly referred to as "LIBOR," has been under attack. LIBOR is a common reference rate for determining the interest rate to accrue on floating rate debt. Given LIBOR's widespread use in promissory notes and other financial instruments, is there reason for concern if the rate should disappear? Is it likely the rate will disappear? Will the rate be fundamentally changed?

What Is LIBOR?

Common reference rates for floating rate notes include the prime rate, keyed either to a particular U.S. bank rate, or a blended rate compiled and published by the *Wall Street Journal*, or LIBOR. The classic definition of "prime rate" is "the most favorable interest rates charged by a commercial bank on short-term loans to its best (i.e. most credit worthy) customers." *Black's Law Dictionary* (West 2009). According to Bankrate.com, "The *Journal* surveys the 30 largest banks, and when three-quarters of them (23) change, the *Journal* changes its rate, effective on the day the Journal publishes the new rate."

In contrast, LIBOR has historically been calculated by industry lobby group British Bankers' Association ("BBA") based on multiple averages of member banks' reports of rates at which the reporting bank represents it could arrange unsecured loans from peer banks. The LIBOR is actually calculated by BBA for multiple loan durations and multiple currencies, and given the permutations, the BBA published 150 rates in all. Need a reference rate keyed to the New Zealand dollar with an eleven week maturity? BBA can accomodate.

Why Was LIBOR Attacked By British Regulators?

In June of this year,[1] following an on-going investigation commenced in 2009, Britain's Financial Services Authority ("FSA") and the U.S. Commodities Futures Trading Commission accused Barclay's Bank traders of manipulating or attempting to manipulate LIBOR by reporting artificially low rates. Since then, dozens of international banks have come under investigation in the U.S. and abroad, including money center banks Bank of America and JP Morgan Chase Bank. The allegedly bogus rates could be employed in a number of contexts to the bank's financial benefit, most fundamentally, to profit in the derivatives market or misrepresent the financial standing of banks to counterparties. Barclay's ultimately settled U.K. and U.S. civil charges with aggregate penalties of £290,000,000 ($469,000,000).

One ripple effect of the proceedings, however, was to trigger a re-examination of the inner workings of the BBA in calculating LIBOR, culminating in the publication of the so-called "Wheatley Review."[2] Amid press accusations of lax regulation, the author of the report recognized that the elimination of LIBOR altogether might have profound commercial repercussions: "LIBOR is used in a vast number of financial transactions; it is estimated that contracts with an outstanding value of at least $300 trillion reference the benchmark. A move to replace LIBOR could only be justified by clear evidence that the benchmark is severely damaged, and that a transition to a new, suitable benchmark or benchmarks could be quickly managed to ensure limited disruption to financial markets.... A transition to a new benchmark or benchmarks would pose an unacceptably high risk of significant financial instability, and risk large-scale litigation between parties holding contracts that reference LIBOR" *Wheatley Review* at 7.

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Delaware Confidential Arbitration Proceedings Found Unconstitutional

In April 2009, the Delaware Legislature amended the Rules of the Court of Chancery to grant the Court the power to arbitrate certain business disputes when the amount in controversy was $1 million or greater. What drew particular attention to the rule changes was that the Chancery Court's arbitration proceedings would be "confidential and not of public record until such time, if any, as the proceedings are the subject of an appeal."

The confidential nature of these proceedings, in light of them involving sitting judges presiding

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The *Wheatley Review* instead recommended that the rate mechanism be cleansed and simplified by significantly reducing the number of durations and currencies in which the rate has historically been calculated, to instead be based transparently on "actual transactions." The rationale was that the markets for interbank lending in many of the historical currencies were either so thin, or non-existent, that reported rates did not and could not truly reflect arm's length, negotiated pricing of interbank credit. The author emphasizes that "[a] number of the [*Wheatley Review's*] recommendations are intended to establish strict and detailed processes for verifying submissions against transaction data and limiting the publication of LIBOR to those currencies and tenors that are supported by sufficient transaction data." *Wheatley Review* at 7. Mr. Wheatley additionally recommended that BBA be stripped of its sponsorship role. *Wheatley Review* at 22. The BBA directors have reportedly conceded defeat.[3]

Decisions from the modern era of bank failures in the late 1980s suggest that even the complete failure of an instrument to specify a replacement rate for a superseded reference rate would not result in applying a 0% interest rate under the instrument.

The FSA is currently engaged in wholesale implementation of the *Wheatley Review*, including governmental regulation of rate-setting.[4]

What Will A Modified LIBOR Mean?

Financial instruments like promissory notes or "swap" contracts may or may not spell out the consequences of the elimination or fundamental change of a designated reference rate. If the *Wheatley Review* is accurate, one may question whether LIBOR reference rates based on US bank reports of the most common interbank loan durations, denominated in U.S. Dollars, are radically changed under the *Wheatley Review* recommendations. Nevertheless, the failure of an instrument incorporating a LIBOR reference rate to specify a "plan of succession" (a replacement rate or institution to succeed the BBA) might conceivably provide some basis for a party to argue that interest ceases to accrue with abolition or succession, if LIBOR is supplanted by a new or materially modified reference rate. How would courts likely address a "zero accrual rate" argument?

Decisions from the modern era of bank failures in the late 1980s suggest that even the complete failure of an instrument to specify a replacement rate for a superseded reference rate would not result in applying a 0% interest rate under the instrument. In the aftermath of "bad bank" after "bad bank," "disappearing rate" issues were extensively litigated in collection actions brought by the Federal Deposit Insurance Corporation ("FDIC"), or successors to the FDIC, against borrowers of defunct banks. Where the note sued on incorporated the defunct lender's prime rate as the reference rate, the question presented in these cases was what evidence of interest accrual was sufficient to meet the plaintiff's burden of proof, given the defunct rate?

In *Bailey, Vaught, Robertson and Company v. Remington Investments, Inc.*[5] an FDIC successor acquired a note signed by Bailey, Vaught, Robertson ("BVR") which for its prematurity rate referred to "lender's prime rate." The "lender" was Forestwood National Bank, which failed in 1989, months before the note's maturity date. The note went into default at maturity and Remington ultimately bought the paper. In its collection action, Remington moved for summary judgment supported in part by an affidavit which included an aggregate dollar figure for pre- and post-maturity accrued interest, without specifying the basis for its prematurity interest calculation. Summary judgment was granted and the borrower appealed. After a discussion of potentially applicable replacement rates, the appellate court held: "in order to calculate the amount due on a promissory note where the prematurity interest rate is based on the no-longer-published prime rate of a defunct financial institution, the trier of fact should apply a 'reasonable' rate of interest, considering the facts of each case."[6] In arriving at this conclusion, the Court rejected a number of alternative rates proposed by both the plaintiff and defendant, including various statutory rates and one percent (as the prematurity rate was set at the Forestwood National Bank prime rate plus one percent).

The failed bank cases instruct us. It is unlikely that British regulatory authorities will abolish LIBOR without strenuous efforts to avoid market unease.[7] Even if LIBOR were to be phased out, or the *Wheatley* version of LIBOR recognized as a materially modified rate, a "reasonable rate" is still proveable through expert testimony, based on such factors as an explicitly identified replacement rate promulgated by FSA or a successor agency, or wholesale interest rates which mimic LIBOR, economically speaking. Checking your specific reference rates may nevertheless provide a measure of comfort to borrower and lender alike.

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1. An instructive timeline of scandal-related events may be found in British Broadcasting Corporation, *Timeline: LIBOR fixing scandal*, BBC (September 26, 2012), http://www.bbc.co.uk/news/business-18671255.

2. M. Wheatley, *The Wheatley Review of LIBOR: Final Report* (September 2012). Mr. Martin Wheatley ws appointed by the Chancellor of the Exchequer.

3. G. Finch and L.Vaughan, *BBA Poised to Give Up LIBOR Oversight on Rigging Scandal*, BLOOMBERG (September 25, 2012), http://www.bloomberg.com/news/2012-08-13/libor-failures-neuter-bba-as-lobby-may-lose-oversight-of-rate.html

4. G. Vina, *U.K. Will Implement Wheatley Plan for Libor Overhaul in Full*, BLOOMBERG (October 19, 2012), http://www.bloomberg.com/news/2012-10-17/u-k-will-implement-wheatley-plan-for-libor-overhaul-in-full-1-.html (hereafter cited as "Implementation of Wheatley").

5. 888 S.W.2d 860, 1994 Tex. App. LEXIS 3083 (Tex. App. – Dallas 1994), hereafter cited as "*Bailey Vaught*."

6. *Bailey Vaught* at 866, citing *FDIC v. Blanton*, 918 F.2d 524 (5th Cir.1990), the 5th Circuit is the Federal appellate circuit court to which Texas appeals are made.

7. Implementation of *Wheatley Review* recommendations is planned by British authorities to be executed over a one year period. See Implementation of Wheatley. Implementation is expected to require new legislation.

Margin Taxes and Leases: Who Should Pay?

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What Is The Margin Tax?

In May 2006, the Texas Legislature significantly changed the Texas Franchise Tax. Prior to the change, the tax was largely optional for most landlords, as it did not apply to limited partnerships and most landlords chose that form of ownership. But in 2006, Texas was struggling with equitable funding for local school districts and the Legislature did two things to generate tax income. First, it broadened the state's tax base by expanding the franchise tax to cover virtually all types of entities that enjoyed some form of liability protection, including limited partnerships. Second, the Legislature changed the formula for the tax from one based solely on the income of the entity paying it, to one based on gross receipts, or margin, allowing for certain deductions. As a result, some entities could owe tax even if they did not earn any income. At the same time these two changes to the franchise tax were made, Texas mandated a reduction in local school property taxes so that more school funding would come from the state. For many real property leases in Texas which provided that tenant would be responsible for taxes on the leased property, the changes created considerable uncertainty.

Who Should Pay The Margin Tax?

Many commercial real property leases provide for the tenant to pay certain property expenses including property, or ad valorem, taxes. Landlords have argued that the new margin tax was a replacement for local property taxes and should also be passed on to their tenants. Existing leases do not clearly allow that result, and many tenants have pushed back at landlord attempts to incorporate a margin tax pass-through in new or renewal leases because tenants historically did not pay landlord franchise taxes or income taxes. Tenants argue that margin taxes are clearly franchise taxes, not property taxes, and are treated as income taxes for accounting purposes because they are based on revenue and not on the value of the underlying property.

As in most landlord/tenant lease issues, margin taxes are a negotiated provision of the lease, and while there is no right answer the margin tax issue should be clearly addressed in the lease. Tenants will not be responsible for the landlord's margin taxes absent a provision in the lease providing for the pass-through of taxes, so if the landlord intends for the tenant to pay the tax it must add such a provision. Some landlords have specifically added language to their form leases explicitly allowing the landlord to pass-through margin taxes to tenants. Other landlords have tried to disguise the pass-through by providing that the landlord can pass through ad valorem taxes and taxes that replace ad valorem taxes. I do not recommend the latter approach as many arguments can be made that margin taxes are not a replacement for ad valorem taxes. Because the margin tax is now a known cost, the best practice, and the one least likely to result in a later dispute, is to explicitly allocate it between the landlord and the tenant just like any other cost addressed in the lease.

What Other Issues Apply?

If the landlord and tenant do agree to pass through the margin tax to the tenant there are several issues to consider when drafting the lease provision, especially from the tenant's perspective. First of all, the margin tax is a unitary tax applying to all similar businesses in the same ownership group as landlord. If the property contains multiple units, or the landlord owns multiple properties, the landlord may have to allocate exemptions and expenses in calculating the tax applicable to tenant. One approach may be for the lease to provide that the margin tax be calculated as though the leased property is the only property owned by landlord. Second, if the landlord were to sell the property during the term of the lease the proceeds from the sale of the property could be included in the calculation of margin tax for landlord. A tenant would expect these gross receipts to be excluded from the margin tax passed through to it. Third, the Texas legislature could amend or terminate the law mandating a reduction in local school taxes, thereby increasing those taxes to what they were before the 2006 changes. The tenant may want to provide for a limit on passing through the margin tax if ad valorem taxes are raised past a certain level. Fourth, margin taxes are deductible by the landlord and the tenant may want to take the benefit of such deduction into account when determining the pass-through. Clearly, drafting and administering a margin tax pass-through to a tenant is complex.

Is There A Standard Approach?

Even though the margin tax has been with us for a number of years, the above issues linger in negotiations between landlords and tenants and there is not yet a commercial standard for addressing them. Knowledgeable landlords and tenants, however, can negotiate lease provisions that specifically address the above issues and result in what the parties believe to be a fair allocation of landlord's costs. In any lease where some taxes are to be passed through to the tenant, landlord and tenant should carefully consider relevant issues and clearly draft the lease to resolve those issues. ■

Texas Supreme Court Upholds Constitutionality of Margin Tax

On October 19, 2012, the Texas Supreme Court in a 6-2 decision upheld the Texas franchise tax, or margin tax, that was adopted in 2006. Nestle USA filed the case challenging the tax, saying that it violated the Equal and Uniform clause of the Texas Constitution, as well as several provisions of the US Constitution. Nestle argued that the margin tax did not relate to the value of the privilege of doing business in Texas, is not uniform and applies differently to companies doing business outside the state of Texas. Nestle pays over $8 million in franchise or margin taxes to the State of Texas for both the wholesale and the retail business it undertakes here. The Texas tax charges a lower rate for businesses engaged primarily in the wholesale trade (0.5%) as opposed to the retail trade (1%). Nestle is charged at the 1% retail rate because it has affiliated manufacturing operations in other states and the Texas tax is a unitary tax that applies to all operations of the taxpayer and its affiliates. The Court upheld the tax and the unitary feature of it, and held that it did not violate the Equal and Uniform clause of the Texas Constitution, nor did it violate the Equal Protection, Due Process or Commerce Clauses of the United States Constitution. The Court found that the tax only needed to be uniform among similar classifications of taxpayers; different classifications of taxpayers are permitted and they can be treated differently. *By Mike Peterson*

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over complex, large dollar arbitration proceedings without having those proceedings open to the public, resulted in a constitutional challenge to the law based on the First Amendment. The statue was also criticized because of its potential to keep shareholders from learning information about these disputes and, in theory, preventing shareholders from discovering claims that could be asserted as part of a shareholder class action suit.

On August 30, 2012, U.S. District Judge Mary A. McLaughlin issued an opinion in *Delaware Coalition for Open Government v. Honorable Leo E. Strine, Jr., et al.*, that held the Delaware statue violated the First Amendment's qualified right of public access to trials. The Court held that the arbitration proceedings were equivalent to civil trials, and therefore could not be conducted in secret without violating the First Amendment. An appeal challenging the District Court's ruling has been filed with the United States Court of Appeals for the Third Circuit.

Construction Lien Waivers in Texas are likely unenforceable unless they match the new lien waiver forms set forth in the Texas Property Code.

Statutory Form Now Required for Construction Mechanic's Lien Releases

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Owners and general contractors can have a difficult time obtaining the appropriate mechanic's lien releases during and after a construction project. Often a construction contract calls for both a conditional lien release for the progress payment being requested, which states that the lien is released if the subcontractor is paid the requested amount, and an unconditional lien release for the immediately preceding progress payment that has since been paid in full. This same pattern will often be followed for the final payment as well. Obtaining each and every conditional and unconditional release before making a payment to the general or subcontractor is certainly the best practice, but practically it can be very difficult. In the last legislative session the Texas legislature passed a new law that will add another layer of complexity to the lien release process.

As of August 31, 2012, construction lien waivers in Texas are likely unenforceable unless they match the new lien waiver forms set forth in the Texas Property Code. Chapter 53 of the Texas Property Code generally governs mechanic's liens, and the Texas legislature added Subchapter L to it in 2011. The new Subchapter L specifically governs waivers and releases of mechanic's lien and payment bond claims and became effective on January 1, 2012. It includes four different lien waiver forms that contractors and owners must use in order to effectively waive or release a mechanic's lien. Section 53.285, titled "Attempted Compliance" and now expired, provided that a waiver or release is enforceable if it attempts to comply with Subchapter L; this section, however, expired on August 31, 2012. Without section 53.285, Subchapter L appears to require compliance with the forms provided.

There are four different waiver and release forms to be used in different circumstances:

1. *Conditional Waiver and Release on Progress Payment* – to be used when a contractor/subcontractor is required to execute a waiver and release before receiving a progress payment, or the progress payment is made by check.

2. *Unconditional Waiver and Release of Progress Payment* – to be used when a contractor/subcontractor is required to execute a waiver and release to prove the receipt of a progress payment.

3. *Conditional Waiver and Release on Final Payment* – to be used when a contractor/subcontractor is required to execute a waiver and release before receiving a final payment, or the final payment is made by check.

4. *Unconditional Waiver and Release on Final Payment* – to be used when a contractor/subcontractor is required to execute a waiver and release to prove the receipt of a final payment.

After August 31, 2012, national, standardized forms such as the AIA G706A Contractor's Affidavit of Release of Liens may no longer be enforceable against contractors, subcontractors or suppliers.

Finally, it is unclear whether an owner could enforce a lien release that includes every part of the statutory form but also includes additional language, for example releasing the owner or general contractor from liability related to the construction project. Would the court enforce the entire document, only the lien release but not the extra language, or possibly reject the entire document? It's difficult to anticipate, and the safest course will be to include additional language on a separate document that is also required prior to payment by the contract documents.

While the new statute does create an additional hurdle when relying on or enforcing a mechanic's lien release, it also simplifies the payment process by creating a standardized form. Owners and general contractors previously may have had to handle many different forms used by various sub-contractors on the project. Now, at least, each lien release form should look the same resulting in a quicker evaluation of whether or not the release is adequate. ■

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