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LIBOR, an Extinct Species, and What Comes Next

Effective June 30, 2023, the London Interbank Offered Rate (LIBOR) joins the Brontosaurus, the dodo and the Edsel—all relics of the past that are done, finished, extinct species.

On that June 30 date, the Intercontinental Exchange (ICE) Benchmark Administrator will cease publication of the interest rate index that for the past four decades has been the standard reference index for variable rate commercial loans, interest rate swap agreements and variable rate tax-exempt bonds.^[1] What will replace LIBOR as the new standard? By all accounts, it is the Secured Overnight Financing Rate, or SOFR.

There are many forms of SOFR that can be used as an index rate.^[2] By an emerging consensus, the most common replacement for One-Month LIBOR seems to be the One-Month CME Term SOFR.^[3]

Unlike compounded SOFR, which is backward-looking based on overnight rates of repurchase agreements collateralized with U.S. Treasuries, the CME Term SOFR is an indicative, forward-looking measurement based on market expectations for interest rates derived from surveys of the derivatives markets. The CME Group Benchmark Administration Limited currently publishes 1-month, 3-month, 6-month and 12-month Term SOFR Reference Rates on each business day.

Historically, variable rate tax-exempt bonds have borne interest at a rate equal to (i) One-Month LIBOR multiplied by a fraction (79% to take account of the federal corporate tax rate of 21% that would otherwise apply to interest received on bonds if they were taxable), ^[4] plus (ii) a margin based on the credit quality of the borrower. Borrowers and issuers of variable rate tax-exempt bonds that bear interest with reference to LIBOR are modifying their tax-exempt bonds to address the fact that LIBOR will not be quoted or available after June 30, 2023.

In these situations, tax-exempt debt instruments which reference LIBOR are being amended to strike LIBOR and LIBOR-related terms

and to insert references to SOFR and SOFR-related terms, while making certain other changes. The goal in making these changes is to express a tax-exempt rate based on SOFR that is roughly equivalent to the old LIBOR-based rate.

Much care needs to be given to the drafting of the amending documents. This is because the amendment of a tax-exempt bond may be treated as a “significant modification” that results in a “reissuance” of the bond under Treasury Regulation 1.1001-3. Reissuance of a tax-exempt bond, without proper steps being taken, can result in the loss of tax exemption of interest on the bond. Accordingly, the goal in all cases is to avoid a “significant modification” whenever possible.

Treasury Regulation Section 1.1001-6 was promulgated to permit parties to amend documents to provide for the necessary transition from LIBOR to SOFR. If the amendments satisfy the regulation’s safe harbors, then they will not trigger a reissuance. Modifications of LIBOR-based debt instruments made prior to June 30, 2024 that are “covered modifications”^[5] will satisfy the safe harbor under Treasury Regulation Section 1.1001-6 and will not result in a reissuance of the debt instrument so long as the modifications are not made for an impermissible purpose.

The key to achieving “covered modification” status is that the new index rate must be to a “qualified floating rate” under Treasury Regulation Section 1.1275-5(b), and any additional modifications of the debt instrument’s technical, administrative, or operational terms must be reasonably necessary to adopt or implement the new index rate. SOFR is listed as a type of “qualified floating rate.”^[6] Modifications are not covered modifications if made to (1) induce one or more parties to perform any act necessary to consent to the transition from LIBOR to the new index; (2) compensate one or more parties for the transition from LIBOR to the new index; (3) grant or obtain a concession to or from one or more parties that are experiencing financial difficulties; or (4) compensate one or more parties for a change in rights or obligations that are not derived from the debt instruments being amended.

Treasury Regulation Section 1.1001-6 also allows “qualified one-time payments” to be made to compensate the lender/bondholder for all

or part of the basis difference between the discontinued index (e.g., LIBOR) and the new index benchmark.

We have assisted many clients in transitioning from LIBOR to SOFR as the June 30, 2023 deadline approaches. Most clients amend the debt instrument to provide that the new interest rate will be expressed as the One-Month Term SOFR, plus a spread adjustment of 9 to 10 basis points (+ or -). The spread adjustment is negotiated by the lender/bondholder and the borrower to account for the slightly higher risk premium associated with LIBOR since it was based on unsecured transactions, as compared to SOFR, which is based on transactions secured by U.S. Treasuries. Lenders and bondholders are requiring the spread adjustment as a condition to their willingness to modify the debt documents.^[7]

In many of the transactions we have seen to date with a conversion from One-Month LIBOR to One-Month Term SOFR, the new interest rate might be expressed in the amendment documents as the sum of (i) (a) One-Month Term SOFR plus (b) a 9-10 basis point spread adjustment, multiplied by a fraction related to the tax-exemption of interest on the instrument (e.g. 79%) plus (ii) a spread based upon the borrower's creditworthiness.

Some lenders have required that the borrower provide a no-adverse effect opinion from bond counsel stating that the modification will not adversely impact the tax-exempt status of interest on the debt instrument. Usually, both the lender/bondholder and the borrower will provide a certificate that any amendments to the debt instrument were not made for one of the four prohibited reasons explained above.

Because modification of tax-exempt debt instruments can be complicated and involve federal income tax regulations, bond counsel should be consulted to ensure that such modifications do not cause bonds to lose their status as tax-exempt instruments. For more information or assistance navigating a post-LIBOR bond market, please contact the authors of this article or any attorney with Frost Brown Todd's [Public Finance](#) practice.

^[1] The ICE Benchmark Administrator has announced that it will publish "synthetic" 1-, 3-, and 6-month LIBOR after June 30, 2023

until September 30, 2024. These synthetic rates are not expected to reflect the underlying market or economic conditions and are unlikely to be widely used.

[\[2\]](#) These include Daily Simple SOFR in Arrears, Daily Compounded SOFR in Arrears, Forward-Looking Term SOFR and SOFR Averages (applied in advance).

[\[3\]](#) As of June 8, 2023, One Month Term SOFR was 5.14638%. The value of One Month Term SOFR changes daily making clear definitions for interest reset dates important.

[\[4\]](#) This fraction typically ranged from 65 to 67% before the Tax Cut and Jobs Act of 2017. That 2017 Act reduced the top Federal corporate tax rate from 35% to 21%.

[\[5\]](#) For the modification to be a “covered modification,” it must occur prior to June 30, 2024.

[\[6\]](#) Other “qualified floating rates” include the Sterling Overnight Index Average (“SONIA”), the Swiss Average Rate Overnight (“SARON”) and the Tokyo Overnight Average Rate (“TONA”).

[\[7\]](#) Negotiations over margin in going from LIBOR to SOFR can be strenuous. “Borrowers and lenders care a lot about small changes to the margin” according to Marcus Burnett, chief executive officer of SOFR Academy, Inc. “Companies, Lenders Clash Over Loan Spreads in Switch from LIBOR,” [CFO Journal](#), January 13, 2023.

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