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# Impact of the financial crisis on fixed rate swap payors

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The market for interest rate swaps has experienced explosive growth over the past three decades. The most common type of swap contract, the "plain-vanilla" interest rate swap, obligates one counterparty (Floating Rate Payor) to make payments equal to the interest that would accrue on an agreed hypothetical principal amount (notional amount), during a given period, at a specified floating rate of interest, while the other counterparty (Fixed Rate Payor) must pay an amount equal to the interest that would accrue on the same notional amount, during the same period, but at a specified fixed rate of interest. Swap payments are typically settled on a net basis, whereby if the specified fixed rate exceeds the specified floating rate during a given interval, the Fixed Rate Payor must pay the Floating Rate Payor an amount equal to the difference between the rates multiplied by the notional amount, and vice-a-versa.

Growth in the market for interest rate swaps has been particularly prevalent in commercial real estate finance transactions. Borrowers receiving floating rate financing relied on interest rate swaps to reduce exposure to adverse changes in interest rates or to obtain fixed rate financing otherwise unavailable through conventional lending. However, the unforeseen and precipitous drop in interest rates that has occurred in the wake of the financial crisis has significantly impaired borrowers' (as Fixed Rate Payors) financial position under their swap contracts, causing them to owe substantial interval, settlement and/or early termination payments to their counterparty Floating Rate Payors.

Accordingly, a surge of litigation has ensued in recent years as borrowers attempt to avoid, or receive reimbursement for, these substantial swap payments. Most cases feature a borrower and lender as plaintiff and defendant, interchangeably, as it is common for lenders to serve the dual role of Floating Rate Payor under the swap contract. The range of allegations asserted has been broad, including claims for breach of fiduciary duty, negligent misrepresentation, fraud, breach of contract, and breach of good faith and fair dealing.

Particularly in "plain-vanilla" cases, courts have been unsympathetic to borrowers, almost uniformly finding for lenders on dispositive motions thereby avoiding the need for trial. These cases not only offer console to lenders seeking to obtain, or retain, interval, settlement and/or early termination payments, but also provide the following important guidance for conducting future swap transactions:

* Maintain a "Commercial Relationship": As with the lending relationship, the swap relationship should be, and at all times remain, a "commercial relationship." Whether a relationship is "commercial," as opposed to "special" or "fiduciary," is ultimately a question of fact. However, absent specialized circumstances, such as excessive lender control over, or influence in, borrower's business activities, courts have been unwilling to find a special or fiduciary relationship where swap counterparties are sophisticated business people, engaged in an arms-length transaction, represented by legal counsel, and expressly disclaim the existence of a special or fiduciary

relationship by execution of the standard ISDA Confirmation document. That a relationship is cordial, built on confidence and trust, and/or of extended duration is not, alone, sufficient to establish a special or fiduciary relationship.

* Explain the Transaction & Avoid Promising Results: Given the complexity of the standard ISDA documentation, and the disparate experience of lenders and borrowers in navigating such documentation, lenders should provide borrowers written materials or presentations regarding the mechanics of, and risks associated with, the swap transaction. In so doing, lenders must ensure the accuracy of all information presented, that no material information is omitted, and that no definitive outcome or result is promised. That being said, courts have proved unwilling to stray from the principal tenet of contract law - that absent evidence of misrepresentation, fraud, or the like, a signed contract is binding against the signatory. Accordingly, notwithstanding the "confusing and protracted details" of the swap documentation, absent any such evidence courts have enforced borrowers' obligations reasoning that "individuals and entities should fully understand the ramifications of the agreements they sign before doing so."

Fixed Rate Payors under interest rate swap contracts are among the countless unforeseen victims of the recent financial crisis. However, absent exigent circumstances, courts are unwilling to excuse their performance under the contract, as doing so would improperly deprive the counterparty Floating Rate Payor of the benefit of their bargain.

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