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The need to be an eligible contract participant

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The over-the-counter derivatives market experienced explosive growth in recent years, particularly in connection with commercial real estate finance transactions. In such transactions, commercial real estate borrowers often use a floating rate loan/interest rate swap (or cap) combination to synthetically fix its interest expense on the loan. This financing structure affords a number of possible advantages to borrowers, including access to competitive fixed-rate financing and greater flexibility as compared to a traditional fixed-rate loan.

However, the unforeseen and abrupt drop in interest rates that occurred in the wake of the financial crisis illuminated the disadvantages of this structure. The drop significantly impaired borrowers' financial position under swap contracts, as they were required to pay what became a disproportionately high fixed rate while receiving an unexpectedly low floating rate. Accordingly, a surge of litigation ensued as borrowers' sought to avoid these substantial swap payments by claiming, among other things, that they did not fully understand the ramifications of the swap contracts.

Although courts have been unsympathetic to borrowers, legislation, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), has been passed to increase transparency in the over-the-counter derivatives market and, thereby, reduce risk to borrowers and lenders alike. Among the most significant changes promulgated by the Dodd Frank Act, and affecting commercial real estate finance transactions, is the "limitation on participation" rule. Under this rule, which became effective October 12, 2012, only "eligible contract participants" (ECPs) are permitted to enter into over-the-counter "swaps." The term "swap" is defined broadly, to include swaps, caps, and guarantees of a swap.

Therefore, subject to limited exceptions, each counterparty to a swap (i.e. each commercial real estate borrower), even if liable on a joint and several basis with other parties that are ECPs, and each guarantor of a swap, must itself be an ECP. Generally, ECPs include:

(1) Entities with $10 million in total assets;

(2) Entities with a guarantor that is an entity which has $10 million in assets;

(3) Entities with a net worth of at least $1 million and are using the swap to hedge a commercial risk;

(4) Individuals with "amounts invested on a discretionary basis" that exceed $10 million, or $5 million if the individual is using the swap to hedge a commercial risk;

(5) An entity who meets all of the following conditions: (i) all of its owners are ECPs; (ii) it and its owners have, in the aggregate, $1 million in net worth; (iii) it is entering into a "swap"; and (iv) it is using the swap to hedge a commercial risk.

In determining whether an entity's "total assets" meets the $10 million threshold set forth in (1) above, cash proceeds from the loan may count as assets. However, based upon early experience verifying ECP status, most commercial real estate borrowers and guarantors qualify as ECPs under

(3) above.

To verify ECP status, each borrower and guarantor will, separately, be required to sign an ECP verification form prior to trade execution. The parties must be ECPs at the time the swap is entered into, or, if later, when the party becomes a guarantor. Thus, if the swap is entered into post-closing, having obtained an ECP verification at closing is only a partial solution. Under those circumstances lenders' are encourage to re-verify ECP status.

Additionally, as noted above, there are narrow exceptions to the "limited participation rule," which apply to guarantors who are non-ECPs. The circumstances under which these exceptions apply are very specific, and, therefore, guarantors should not rely on them. Useful guidance can be found in the Commodity Futures Trading Commission (CFTC) Letter No. 12-17 (October 12, 2012). Finally, it should be noted that, while the extraterritorial application of these provisions of the Dodd-Frank Act are not entirely clear, the CFTC is asserting broad jurisdiction. Accordingly, one should not assume that these rules do not apply simply because the borrower, guarantor and/or lender are not U.S. persons.

Along with the documentation verifying ECP status, the Loan Syndications and Trading Association recommends that commercial real estate loan documentation include specific provisions which carve-out from the obligations secured, or the obligations guaranteed, "Excluded Swap Obligations." Such carve-outs eliminate the risk that the grant of a security interest, or a guarantee, by non-ECPs would be deemed unenforceable as to the loan obligation itself. In addition, a guaranty agreement may include a "keepwell" provision, pursuant to which ECPs can effectively confer ECP status on non-ECPs. Suggested language for inclusion in loan documentation can be found in the LSTA Market Advisory (March 15, 2013).

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