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Financial Services Client Alert

February 28, 2013

Impact of Dodd-Frank Swap Regulations on Guaranties and Loan Documentation

Often in connection with commercial loans, borrowers will enter into hedging transactions ("swaps") for the purpose of mitigating interest rate, commodity or currency risk. Such swaps will frequently be entered into directly with the borrower's lender or an affiliate of the lender[1] or, in a syndicated or club loan transaction, one of the syndicate lenders (or an affiliate of such syndicate lender). In such circumstances, lenders will typically require that guarantors of the loan (including borrower subsidiaries and/or affiliates), and the collateral securing the loan, also provide support for the borrower's obligations under swaps entered into with the lender and/or an affiliate of such lender. Recent interpretative rules related to the implementation of Dodd-Frank[2] have significant implications with respect to the documents governing such loan transactions.

Certain provisions of Dodd-Frank amended Section 2(e) of the Commodity Exchange Act (the "CEA")[3] and recent final rules interpreting these statutory reforms, published jointly by the U.S. Commodity Futures Trading Commission (the "CFTC") and the U. S. Securities and Exchange Commission (the "SEC"), have significant implications on loan documents, including guarantees and, potentially, security documents, where a related swap is (or in the future may be) involved. As a result of these new interpretations, Lenders should carefully review current loan document forms, including guaranties, pledges and other security documents to ensure that they are in compliance with Dodd-Frank and CEA restrictions and requirements for entities providing credit support for swap transactions. In particular, in light of these new interpretations, borrowers and their counsel should also be cognizant of the need to potentially modify enforceability representations and warranties contained in loan documents that they enter into, as well as qualifications and assumptions in forms of legal opinions, given in connection with commercial loan transactions.

Under current CFTC rules and regulations, swap transactions must either be executed on a registered exchange or each party thereto must qualify as an "eligible contract participant" ("ECP") under the CEA. As the result of the recently- issued No-Action Letter No. 12-17, (October 12, 2012) (the "No-Action Letter") from the Office of the General Counsel of the U.S. Commodity Futures Trading Commission (the "CFTC"), effective March 31, 2013, guarantors of obligations under such swap transactions, including plain-vanilla interest rate

[1] Note that a US commercial bank cannot require that the counterparty to a swap be the lender or its affiliate, in that such a requirement would normally violate the anti-tying rules of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. § 1972).
[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1736 (2010) ('Dodd-Frank")
[3] 7 U.S.C. § 1, et seq. (2012).

swaps, are subject to the same requirements as the direct counter-parties to the transaction and must themselves be ECPs in order to guaranty the swap transaction.[4] Although the CFTC interpretation in the No-Action Letter is limited to guarantees of swaps and does address other forms of credit support such as pledging collateral, it appears to recognize that the logic it employs applies equally to a non-ECP providing collateral to secure obligations under a swap and suggests that the CFTC and/or the SEC may, in the future, extend its interpretation such that pledgors of collateral securing obligations under swaps may also be required to be ECPs.

Under the CEA, ECP's include:

- Corporations, partnerships, proprietorships, organizations, trusts or other entities with more than $10 million in total assets, or any entity guaranteed by such entity;
- Entities with a net worth of at least $1 million that are hedging commercial risk;
- Certain financial institutions;
- State-regulated insurance companies;
- Investment companies subject to regulation under the Investment Company Act of 1940[5];
- Regulated commodity pools with more than $5 million in assets under management;
- Employee benefit plans subject to ERISA[6] with total assets exceeding $5 million or whose investment decisions are made by a registered commodity pool advisor or commodity trading advisor subject to regulation under the Investment Advisers Act of 1940[7] or by a financial institution or insurance company;
- Governmental entities;
- Corporations, partnerships, proprietorships, organizations, trusts or other entities whose obligations are guaranteed by an entity which is an ECP satisfying one of the foregoing descriptions;
- Brokers and dealers subject to regulation under the Securities Exchange Act of 1934[8] and similarly regulated foreign entities (if the broker or dealer is an individual, must have discretionary investments of greater than $10 million);
- Futures commission merchants and similarly regulated foreign entities (if an individual, must have discretionary investments of greater than $10 million);
- Individuals with aggregate amounts of greater than $10 million invested on a discretionary basis (or $5 million if hedging);
- Any entity that:
  - is owned entirely by ECPs,
  - together with its owners have an aggregate of at least $1 million in net worth and
  - is entering into an interest rate, foreign ex change or commodity derivative for purposes of hedging a commercial risk.

Large corporate borrowers would typically not have an issue meeting the $10 million asset threshold[9], or one of the other thresholds to be an ECP. However, subsidiaries, affiliates or principals, may very well not qualify as ECPs. Further, there are many borrowers in smaller transactions (as well as guarantors) who do not meet the minimum requirements to be considered an ECP.

The consequences of failing to comply with these provisions, as interpreted by the No-Action Letter, include the illegality and un-enforceability of a guaranty by a non-ECP guarantor in connection with swap transactions and the potential for an enforcement action by the CFTC against the guarantor, the borrower as the "Guaranteed Swap Counterparty" or the lender as the "beneficiary" of the swap guaranty[10]. This also raises further issues as to the over-all enforceability of a "universal" guaranty where the guarantor is not an ECP.

[4]See, CFTC No-Action Letter No. 12-17, (October 12, 2012).
[5]15 U.S.C.§§ 80a-1—80a-64.
[6]29 U.S.C. § 1002, et seq.
[7]15 U.S.C. §§ 80b-1—80b-21.
[8]15 U.S.C. § 78a, et seq.

[9]It should be noted that the No Action Letter provides that receipt by a borrower of proceeds of a loan will count toward the $10 million or more in assets requirement, since the requirement is not a "net asset" requirement. Thus, a borrower receiving a loan in excess of $10 million would be an ECP.
[10]7 U.S.C. §§ 6b-1. 9(1).

The No-Action Letter does not address whether only the guarantee of the swap under such a "universal" guaranty is invalidated or whether the guarantee of the underlying loan obligations could also be tainted and rendered invalid and unenforceable as a result of the invalid guarantee as to the swap obligations. Additionally, many existing loan documents could be subject to technical default where the definition of "obligations" is broad enough to include swap obligations, since invalidity of the underlying obligations (i.e., the swap obligation, if a borrower or a guarantor is not an ECP at the time the swap is entered into) very often constitutes a default. This obviously should raise a number of concerns for lenders who are also counterparties under loan-related swap transactions. This is not only a prospective issue: this issue should be addressed in loan transactions currently in negotiation, as well as in existing loan and swap documentation that may be required to be amended as of or subsequent to the March 31, 2013 effective date, since the determination of when the guarantor is required to be an ECP is the time as of when the swap is entered into[11], which may be after the guaranty is executed and delivered.

This also has implications for loan parties and their counsel in connection with representations and warranties in loan documents and with qualifications and assumptions in opinion letters given in such transactions addressing the enforceability of loan documents, including guaranties and security documents.

There are a number of potential solutions to addressing non-ECP guarantor issues including:

- adding carve-outs in the definition of "obligations" in guaranties and other loan documents so as to exclude swap obligations for which the guarantor is a non-ECP;
- providing for severability provisions in guaranties providing that if a loan party is not an ECP, such status would not affect the non-swap obligations under their guaranties;
- considering whether "waterfall" provisions should be modified so as to exclude amounts recovered from non-ECP loan parties from application to swap obligations;
- providing for representations by loan parties that they are ECPs. However, this may be of limited value, and the representations would have to be "re-upped" each time a swap is entered into, since ECP qualification must be satisfied at each such time;
- including provisions that require "keepwell" support from loan parties that are ECPs to those that are not ECPs [12]; and
- if the loan documents are not drafted in a manner to exclude non-ECP party guaranty obligations, borrowers and their counsel should make appro priate carve-outs in loan party representations and warranties and opinion assumptions and qualifications regarding validity and enforceability of loan documents[13].

Obviously, these changes, set to go in effect on March 31, 2013, have serious implications for lenders and they should consult with their legal counsel to determine the best approach in addressing these issues in the context of their individual transactions. If you would like to discuss these issues further, please contact a member of the **Shumaker Financial Services Team**.

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[11]Note that no violation of the law occurs when an entity which at the time of entry into the swap transaction is an ECP later ceases to be an ECP.
[12]Borrowers or affiliates that are ECPs can under certain circumstances confer ECP status by agreeing to provide sufficient assets to, or guaranty the obligations of, a non-ECP party so that it qualifies as an ECP at the time of entry into the swap.
[13]If loan documents contain appropriate exclusionary language, there should be no need for carve-outs in representations and warranties and opinions.