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Swaps 101 and the Death of LIBOR

There are many types of swaps: commodity swaps, foreign exchange swaps, but of primary interest to real estate lawyers are interest rate swaps. Interest rate swaps are colloquially thought of as contracts by which a naturally floating rate interest rate contract (a loan agreement or promissory note) is “converted” into a fixed-rate contract. Still, this understanding is fundamentally in error, as will be discussed below.

Misapprehensions Abound

Further, it is commonly assumed that all interest rate swaps are governed by an ISDA (International Swaps and Derivatives Association)¹ agreement, and while that too is not completely accurate, the overwhelming majority of interest rate swaps are governed by ISDA documentation, and accordingly, this discussion focuses on both how the ISDA system works (and doesn’t work) and the vocabulary used in ISDA documentation. But to emphasize how the common understanding of swaps is inaccurate, an ISDA interest rate swap transaction is not governed by an ISDA agreement. It is governed by at least three, and often four or more, agreements that have to be read together to understand the terms of the transaction the parties have entered into. Welcome to “ISDA land.”

For this discussion, we will use an example which can be described as a plain vanilla interest rate swap transaction (called here merely a “swap”). A single borrower is entering into a floating-to-fixed rate swap with the same lender (a bank for purposes of discussion and simplification only, but not necessarily always or even often the case). This single borrower is also entering into a loan transaction that is based on a floating, LIBOR-based interest rate convention. Both legs of the transaction (loan and swap) are being secured on a parity basis, with a mortgage or deed of trust on the asset being financed.

¹ The website of the International Swaps and Derivatives Association has many resources about interest rate and other types of swaps and derivatives. *See [here](#).*

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Vocabulary

In “ISDA land,” there is a unique and often unfamiliar (perhaps even bizarre) vocabulary that must be used and which does not correlate with the traditional borrower/lender nomenclature, but which is immutable and does correspond to loan document language. This difference in vocabulary can, in fact, help highlight some of the critical differences between what the swap transaction is trying to accomplish and what is being done in the loan transaction to which the swap is, in our example, intended to relate, and to remind the parties in which leg of the transaction the particular activity is taking place. To begin with, there is no “borrower” or “lender” in ISDA land—rather there are two parties, each denominated as a “Counterparty” and one (creatively) identified as “Party A” in the documentation and the other “Party B.” (For the purposes of this discussion and again for simplicity we will refer to the borrower in our example — the party seeking to pay a fixed rate — as the borrower, and the bank with which it is entering into the swap as the counterparty.) Second, there is no “principal amount outstanding concept” in ISDA land; rather there is a “notional amount” of the contract, which notional amount may change (typically decline) over time and, in a situation like our example in which the parties intend to “convert” (again an inaccurate term but used for convenience at this point) a floating- rate transaction into a fixed-rate transaction, the notional amount will decline based on the scheduled amortization of the loan. Finally, the documents themselves: a typical ISDA swap will be documented with three core documents- a Master Agreement (often simply called the “ISDA” or the “Master”)², a Schedule (called the “Schedule”) and a Confirmation (called the “Confirm”). In many transactions, there will also be one or more Credit Support Annexes. But in our example, credit support from the borrower is provided by a mortgage or deed of trust, which secures both the loan and swap transaction, and no credit support is required of the bank/counterparty.

Although over the years ISDA has promulgated several forms of ISDA Master Agreements for interest rate swap transactions, once the parties agree on which form is to be used, the form may not be edited or altered in any way within its four corners (changes if any, and there are only limited changes that practically can be made, and elections required to be made under the Master, are documented in the Schedule). The principal reasons for this immutability of the Master are twofold: first, ISDA land operates on the assumption of liquidity and balance — that is, that ISDA contracts are freely transferable (and thus that at some level there is transparency in pricing of ISDA trades), and that banks will fundamentally seek to maintain a balanced book of swaps- an equal notional amount of fixed-to-floating and floating-to-fixed rate exposures. Both of these assumptions reflect the implicit bias embedded in the ISDA forms — that the principal parties served by its authors are institutional swap dealers, not borrowers. (This

² Copies of the ISDA Master Agreement can be purchased on the [ISDA website](#).

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implicit bias should be familiar to real estate lawyers, as we see it in the AIA form contractor and architect agreements that we all use, even when we are representing parties other than architects.)

The second construct implicit in a Master Agreement is that it is intended to establish a framework for what may be multiple transactions between the specified parties over time (each a “trade”) which would be expected to be effected quickly (in what is in effect a “spot market”) without the delay otherwise normal during the negotiation of complex documentation. To oversimplify, the Master establishes defined terms and consistent protocols and sets out a series of optional provisions that the parties are to elect in the Schedule which is to be used to further detail the relationship to be established in advance of the specific trade, the trade being memorialized in the Confirm.

The Schedule, then, is the document in which various elections contemplated in the Master are to be made and documented, various additions and amendments to the Master are to be made and documented (again few additions and amendments, except disclosures under Dodd Frank and the like, are practically available when dealing with banks and when the borrower has limited bargaining power) and various details of the relationship to be entered into are to be set out. Again, like the Master, a Schedule is intended to be worked out in advance of a spot market trade, but at least in theory, parties to a common Master Agreement can use different Schedules for different groups of spot market trades, while each trade is documented in a separate Confirm.

And finally the Confirm — literally intended to confirm a phone call in which the spot trade is effected. The Confirm will memorialize the fixed rate the borrower has agreed to pay and the variable rate the counterparty has agreed to pay in exchange, in each case multiplied against the same notional amounts also set out in the Confirm. (Borrowers may have independent advisors confirm the pricing of these agreements if either the borrower has an investment-grade credit rating or has locked in a pricing formula with its bank in advance.) And when we say that the Confirm memorializes what each party is to pay the other, that too is a bit misleading because almost invariably, the Confirm also will evidence the election of the parties to net those otherwise contracted-for exchange of payments, such that when variable interest rates are low, the borrower is, in fact, paying the bank the difference between the fixed rate it has agreed to pay the bank less the amount the bank would otherwise have agreed to pay the borrower (for example, (6% times the notional amount) less LIBOR times the same notional amount). The Confirm will also memorialize when payments are due (ideally on the same day payments are due on the loan) and business day conventions (again preferably the same in both legs of the transaction) and other similar trade-specific terms.

And while we have said that in our example, no need exists for a separate Credit Support Annex. In many transactions, each party may be obligated

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under various circumstances to post collateral to secure its obligations. Most commonly, this obligation to post collateral is triggered when a party that otherwise is rated has its rating reduced to a lower level (say AA to BBB) or certain financial covenants are violated.

For those of you who are more expert on swaps, please excuse the gross oversimplifications reflected in this discussion — it is after all Swaps 101. For the rest of you, are we having fun yet?

Principal Risks

So while, as in any transaction, there is a universe of risks to consider (including perhaps in ISDA land the greater than normal risk that our client will not understand the transaction it is entering into), there are four principal risks that inform all swaps. But as a preface to this discussion, it is important to discuss the first major misapprehension about swaps alluded to above. Critically, swaps do not “convert” a floating rate obligation into a fixed rate obligation (sticking with the facts of our example for the purposes of this discussion). Rather, a swap agreement is a separate and independent contract, albeit often, as in our example, with the same counterparty/bank that is making the loan. Accordingly, while the swap may incorporate the financial covenants of the loan agreement by reference (often without taking into consideration the effect of later amendments or waivers), the swap is freely transferable by the counterparty and need not be transferred to the same party or at the same time that the loan is transferred (remember the comment about liquidity above). This separateness is NOT affected by the election of netting discussed above, which concerns netting of payments to and from the parties to the swap, nor netting of payments across the separate loan and swap transactions. Thus, a swap does not convert an interest rate, but rather provides a stream of payments intended to offset the initial interest rate obligation of the borrower under a loan while imposing a different (here fixed rate) payment obligation under the swap.

To illustrate, assume that in the loan transaction, the borrower agreed to pay LIBOR plus a credit spread and in the swap transaction the borrower agreed to pay 6%, but in exchange, the borrower is to receive LIBOR, in both cases times a notional amount that matches the unpaid (unamortized) principal balance of the loan being hedged. Ignoring the netting that is typically elected in the swap, this means that the parties agreed that periodically (let's assume monthly) (a) the borrower has agreed to pay the lender/counterparty the credit spread plus both LIBOR (times the principal amount outstanding) AND 6% (times the notional amount- the same initially as the outstanding principal amount of the loan) and (b) the counterparty/bank has agreed to pay the borrower LIBOR (times the same notional amount). So if everything goes right, the borrower is, on a net basis, paying the lender the credit spread plus 6% times the outstanding principal/notional amount and the exchange

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of LIBOR-based payments functionally cancel one another out.³

So that brings us to the first principal risk in swap transactions — “basis risk” — the risk that is fundamentally the subject of the discussion below about the death of LIBOR. At the core, basis risk is the risk that the basis of the two separate transactions, here LIBOR, will not remain the same (or remain in the same relationship to one another) such that the exchange of variable-rate payments will not in fact functionally cancel one another out. In our plain vanilla example, both separate transactions start out as based on LIBOR, and thus functionally the transaction affects a “perfect swap.” But many swaps and many loans are denominated against other indices (FHLBB, Treasury, SIFMA in a tax-exempt deal, etc.), and thus there is basis risk from the outset in such transactions. And loans often have triggers that cause a change in the payment obligation of the borrower, most typically affecting the credit-spread element of the borrower’s payment obligation (default rates) but, as should be obvious, when LIBOR goes away — and if the swap counterparty and bank elect different replacement rates — the expectation of the parties that the variable rate legs of the transaction would perfectly cancel one another out is frustrated. Similarly, if the transactions started with different interest rates but which the parties assumed would correlate in a predicted way (for example, SIFMA and LIBOR) when that correlation ceases to operate as expected, basis risk is manifested.

The second principal risk in a swap transaction is counterparty risk. Since the swap and loan transactions are separate, if the swap counterparty/bank fails to honor the contract, the borrower is left with the variable rate risk it thought it had contracted away but is not relieved of its obligation to pay interest on the loan. (Note, swaps hedge interest rate risk but do not affect the principal component of a loan transaction.) If one thinks of a swap of this sort as an insurance policy, if the policy premiums have been paid by the borrower, but the bank as insurer fails to honor the swap when variable rates go higher than the fixed-rate contracted for, the borrower will

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Borrower	Bank/Counterparty
<u>Note Transaction – Borrower</u>	<u>Note Transaction – Bank/Counterparty</u>
(\$100 x .33%) = (\$33)	Bank receives \$1.33
Credit Spread (\$1.00)	<u>Swap Transaction – Bank/Counterparty</u>
Borrower pays: (\$1.33)	(\$100) x .33% = (\$0.33)
<u>Swap Transaction – Borrower</u>	Bank pays (\$0.33)
(\$100 x 6%) = (\$60)	
Borrower pays (\$60)	
Borrower receives \$.33	
<u>Net Effect</u>	
Borrower pays (\$61)	
i.e., credit spread plus fixed rate (6%) times notional amount (\$100)	

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experience the manifestation of counterparty risk. Generally, in bankruptcy, executory contracts are subject to rejection, but swaps are treated generally as financial accommodations not subject to rejection. Of course, banks have counterparty risk with borrowers who fail, and just because a bank cannot generally reject a swap in bankruptcy does not mean, obviously, that the borrower is without counterparty risk if its bank fails.

The third principal risk in swap transactions is durational risk. If a swap has a different tenor (duration) than the loan, the interest rate protection the borrower is contracting for may not be able to be obtained again, or at the same “price” (a 6% fixed rate in our example) after its initial term of the swap expires. As an example, if the loan has a 30-year term and the swap a 15-year term, in year 16, the borrower may not be able to swap again to the same 6% or may have to pay a significant price to do so.

Finally, there is a risk that the notional and the outstanding principal amounts of the loan fail to remain equivalent. As noted in the example above, when the swap notional and loan principal amounts are the same, the payments made by the variable ratepayer party to the swap (the bank in our example) and the variable-rate obligation of the borrower on the loan practically cancel one another. But if the borrower prepays the loan in whole or in part and does not (or is not obligated to) Early Terminate the swap in a corresponding notional amount, the exchange of payments mismatch, leaving the borrower in our example with a 6% swap obligation on the larger swap notional amount, with the variable-rate payments coming back to it on the swap based on a larger principal amount (which does not correlate to what happens in the case of the prepayment of a loan in many cases). And that brings us to the consequence of early termination of swaps, discussed below.

Early Termination/(Automatic) Termination

When a loan is prepaid, we are used to prepayment penalties, typically calculated on a yield maintenance basis and always due exclusively from the borrower to the bank. In ISDA land, however, the payments can go in either direction, based on the change in the relationship between variable rates and fixed rates from the date the swap was entered into to the relationship between variable rates to fixed rates when the swap is terminated (again in whole or in part). To illustrate, if LIBOR was at 1% when the swap was initiated, and the agreed-upon fixed rate was 6%, but when terminated LIBOR was at 12%, then the borrower is “in the money” and the bank owes the borrower an Early Termination payment (again, oversimplified and in most cases). Conversely, if LIBOR was much higher when the swap was entered into than when terminated, the borrower will be “out of the money” and will owe the bank an Early Termination payment. The determination of how much either party owes the other on Early Termination turns on several elections made in the Schedule or Confirm.

The first election of consequence offered by ISDA is (creatively) “First

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Method” and “Second Method” of calculation, but First Method is almost never used in the setting we are discussing (it provides that no matter how deep in the money a party is on Early Termination, if it is the defaulting party, it never gets paid on Termination), so we will not discuss it here. The second election is as between “Market Quotation” and “Loss.” For a change, these terms do suggest what ISDA intends the outcome of these elections to mean. Loss, to oversimplify, mimics indemnification, while Market Quotation assumes that three market makers will evaluate what the cost of buying or selling a swap in a notional amount equal to the amount of the swap being terminated and otherwise on the same material terms as the swap being terminated (but without regard to the credit implications of the parties affected by the termination of the swap if it is being terminated by reason of a default) is in the swap marketplace on the date of termination. The problem with Market Quotation is that if the borrower was not a rated, investment-grade credit when the swap was entered into, it is difficult to get three market makers to quote on such a replacement transaction, and in such a case, ISDA falls back to Loss. Under both Loss and Market Quotation, the amount payable by one party to the other ignores the assumption that a party may have an offsetting or balancing trade which it would be reasonable to assume the “out of the money” party would terminate at the same time as it is obligated to make a payment to its counterparty, thus deriving funds with which to make such payment and thus eliminating the loss it would suffer. This convention is reasonable, of course, as without it, there would be no way to calculate Loss, and further, while borrowers are unlikely to have an offsetting swap, there can be no assurance that a bank will, in fact, terminate such a position, if it has one, in order to cover its payment obligation to the borrower when the borrower is the “in the money” party. The termination value of a swap is called the “mark to market” value, and as that name too indicates, it changes as the spot market changes.

The third election (not overtly called out as such) is who gets to calculate the amount of the Early Termination payment. It is certainly not uncommon for borrowers to insist that in the case of an Early Termination caused by a bank’s default, the borrower gets to select the Calculation Agent. Absent a default, however, the Calculation Agent is typically the counterparty bank, which may cause borrowers to seek an independent advisor to verify termination payment calculations.

Swaps and the Death of Libor

As noted above, one of the principal risks in ISDA land is basis risk: the risk that the basis on which a swap exchange of payments is made will not match the basis on which the payments on the debt which the swap is intended

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to hedge is made. With the impending death of LIBOR at the end of 2021⁴, the risk that swap and loan basis will deviate is not insubstantial. Whether the bank, even assuming it is the same institution on both the swap and the loan, will select or agree to the same replacement index for both is uncertain and certainly unknowable at this time. And this uncertainty does not derive from banks being irrational or unhelpful; rather it derives from the fact that the liquidity that banks presume exists to support swaps and the desire of many banks to maintain a balanced book for their swap exposures arise in a different marketplace and pricing environment than the cost of funds that underlie loan pricing. And most swaps do not specify an alternative rate for LIBOR, nor do they cause an Early Termination Event to occur when LIBOR goes away.⁵

So what can we expect when LIBOR goes away and no alternative rate has been identified in advance in a swap (or loan) in which one party is paying the other on the basis of LIBOR? ISDA documentation does not use a force majeure concept, and this should not be surprising because generally, in financial transactions, we do not see force majeure applied to payment obligations. So absent a deus ex machina like the proposal that the Alternative Reference Rates Committee of the Federal Reserve Board and the Federal Reserve Bank of New York have made to mandate an alternative rate (overriding any contractual provisions), where does that leave us?

As a gating matter, it should be noted that ISDA agreements usually are governed by New York law (remember the liquidity principle discussed above). Accordingly, what follows will focus on New York law. In the absence of a force majeure clause excusing performance we must look to the common-law principles of impossibility and frustration of purpose for guidance. Under New York law, “[i]mpossibility excuses a party’s performance only when the destruction of the subject matter of the contract or the means of performance makes performance objectively impossible.” *Kolodin v.*

4 Additional information about the transition from LIBOR to another benchmark is available on the ISDA website [here](#). The Alternative Reference Rates Committee (ARRC), formed by the Federal Reserve Board and the Federal Reserve Bank of New York, has recommended that the Secured Overnight Financing Rate (SOFR) as a replacement rate for LIBOR. *See here*. Fannie Mae and Freddie Mac have announced plans and timelines for transitioning from LIBOR-based reference rates to SOFR. *See here and here*. However, work remains to be done before SOFR is ready for use in commercial transactions on the same terms as LIBOR. *See ARRC’s Frequently Asked Questions, June 2, 2020*.

5 ARRC has issued suggested [best practices](#) for transitioning from LIBOR. ISDA is working on amendment to its standard definitions to provide a fallback rate and expects to issue new definitions in July 2020. Contracts entered into after that date would include the fallback language by definition. Contracts in existence before the amendment would have to be voluntarily amended by the parties to include the fallback. *See here*. ARRC has also proposed a mandatory, override alternative rate be adopted as well.

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Valenti, 979 N.Y.S. 2d. 587, 589, (2014). This principle is typically “...limited to the destruction of the means of performance by an act of God, vis major, or by law.” 407 E. 61st Garage, Inc. v. Savoy Fifth Ave. Corp., 23 N.Y.2d 275, 281 (1968). Certainly, the “destruction” of LIBOR by a regulatory body is similar to that wrought by an act of God (certainly many regulators think they are gods), but we have no direct guidance on the application of this principle to the imminent death of LIBOR.

Frustration of purpose “...focuses on events which materially affect the consideration received by one party for his performance.” United States v. Gen. Douglas MacArthur Senior Vill., Inc, 508 F.2d 377, 381 (2nd Cir. 1974). “Discharge under this doctrine has been limited to instances when a virtually cataclysmic, wholly unforeseeable event renders the contract valueless to one party.”*Id.* Certainly the prospective death of LIBOR is frustrating and appears catastrophic, and certainly it was unforeseeable when many swap and loan agreements were entered into. Most importantly, the elimination of LIBOR makes LIBOR-denominated swaps valueless to both parties, as the termination value of a swap cannot be determined since the termination value is based, at least under the market quotation formulation, on the cost of assumed comparable trades which, absent LIBOR, will not occur. Again, however, no directly applicable case law exists.

Assuming however that either the impossibility or frustration principles will be applied to swaps under which the calculation of what is due, based on the no longer available LIBOR index, becomes impossible to perform, we are still left with the quandary of how termination values will be determined, and while we can imagine the courts looking to some sort of equitable reformation principles, we are in uncharted waters without a compass.

Conclusion

It is fair to say that with the prospective death of LIBOR, unexpected risks will be encountered by parties to swaps. It is also fair to say that it will be a wild ride.

Arent Fox’s [Real Estate](#) group will continue to monitor this issue. If you have any questions, please contact [Richard A. Newman](#) or the Arent Fox professional who usually handles your matters.