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Alert

Finance Digest

Lender Market Advisory: Swap Guarantees - Keepwells and Excluded Obligations

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There has been considerable discussion in syndicated lending circles recently regarding how to account for a new swap “clearing requirement” that significantly impacts loan documentation and will become enforceable on March 31, 2013. This advisory will focus on two particularly important means for lenders to address the clearing requirement in loan documentation so that the credit support of guarantors of swap obligations is maximized without risking the enforceability of the guarantees and collateral pledges provided in the loan documents: “keepwells” and excluding guarantee obligations of entities that are not “eligible contract participants”¹ (ECPs). We will also consider some other areas of loan documents where the clearing requirement is implicated.

The clearing requirement is a part of the Dodd-Frank Act, which was enacted in 2010 but only now is becoming operative due to the recent promulgation of relevant implementing regulations. The rule requires that swaps be entered into on designated contract markets unless the parties to the swap are all ECPs at the time that the swap is entered into.² On October 12, 2012, the Commodity Futures Trading Commission (CFTC), which is responsible for enforcing the clearing requirement, clarified that it considers guarantors of swap obligations to fall under the law’s umbrella.³ In that same letter, the CFTC provided no-action relief from enforcement of the clearing requirement upon guarantors until March 31, 2013.

In recent weeks, the LSTA has proposed model language that can be incorporated into loan documents to avoid violation of the clearing requirement.⁴ With the March 31, 2013 enforceability date approaching, lenders and borrowers need to be updating their loan documents to reflect an understanding of these issues and to incorporate the best solutions to them.

Various options for addressing the clearing requirement in loan documentation have been suggested. In addition to the “keepwell” inter-company credit support agreement and excluded obligation provisions to be discussed in more detail below, other loan documentation-related provisions to consider include: cross-guarantees; requiring borrowers and guarantors to provide representations (or other support) that they qualify as ECPs (and, therefore, are not subject to the clearing requirement), which representations

would be brought down each time that a swap is entered into (although this would not protect against a violation of the clearing requirement if false); ensuring that any proceeds from guarantees and collateral that are given by parties that are not ECPs are not shared in a waterfall, sharing, or similar provision with beneficiaries of swap guarantees or collateral pledges; and excluding from legal opinions delivered in connection with the loan any opinion as to the enforceability of guarantees where such guarantor is not an ECP.

This advisory focuses upon the LSTA-recommended keepwell and the excluded obligations provisions. Some commentators have suggested these two approaches should be considered separately, and some financings to date have taken only one approach or the other, but all available options should be considered within the context of each individual financing to determine the proper approach. Borrowers may negotiate to exclude the keepwell or other provisions and the market may evolve over time as to which provisions are customary. In many financings, for example, the keepwell provisions may be less significant because non-ECP subsidiaries already may be excluded from the guarantor pool as immaterial subsidiaries or by other customary exclusions.

The keepwell refers to paragraph (v)(II) of the definition of ECP, which confers ECP status upon entities the obligations of which are themselves guaranteed by ECPs. The LSTA has suggested language for incorporating such a keepwell into credit documentation.⁵ In essence, that language introduces the concept of a “Qualified ECP Guarantor” – an entity that is itself undoubtedly an ECP – that agrees to provide funds or other support for the obligations of each other guarantor under the loan documents. This allows ECPs to provide keepwell support to subsidiaries that would not otherwise be ECPs in order to allow them to become guarantors of swaps, and thereby incorporates entities that would otherwise be unable to provide guarantees into the guarantee package. In many financings, loan documents already include cross-guarantee provisions whereby each guarantor guarantees the obligations of each other loan party. These provisions may be used as the

foundation for the keepwell support described here, but it is important to ensure that the cross-guarantees or other support capture not only direct obligations of each guarantor (for example, in cases where a subsidiary itself enters into a swap) but also the guarantees of swap obligations that each guarantor provides. Moreover, in the LSTA’s recommended provision, the keepwell language explicitly refers to the ECP definition in the Commodity Exchange Act and makes clear that the parties intend the cross-guarantees of one another’s swap obligations to constitute a “keepwell, support, or other agreement” as referred to therein. If loan documentation forms are used without the additional LSTA-recommended provisions, care must be taken to ensure that the language achieves the desired support.

The “excluded obligations” approach excludes swap obligations from the guaranteed obligations of a non-ECP subsidiary. This exclusion is a solution that introduces the concept of an “Excluded Swap Obligation”, which is defined to include any swap obligation of a guarantor that is or becomes illegal as a result of the clearing requirement or any other aspect of Dodd-Frank or any present or future CFTC regulation. Such “Excluded Swap Obligation” is then carved out of the provisions defining the obligations that are guaranteed under the loan documents.⁶ While the keepwell provision described above will increase the universe of eligible guarantors, this excluded obligations provision protects against illegal swap guarantees – and, therefore mitigates the risk of unenforceability of guarantees under the loan documents. Used in conjunction with the waterfall provision described above, such additional exclusion ensures that lenders can benefit from guarantees by non-ECPs of the loan obligations without fearing that such guarantees will be tainted by also including guarantees of swap obligations by non-ECPs. At the same time, the waterfall provision ensures that the proceeds of any such guarantees are not shared with the beneficiaries of the swap guarantees, so as to preclude any “back door” guarantee of a swap by a non-ECP.

It is important that the application of the clearing requirement to guarantors is addressed properly by

lenders in new and amended loan documentation.⁷ The good news is that once the options described above are implemented, the clearing requirement should not affect the enforceability of loan documents or, in many cases, the level of credit support available for syndicated loan financings.

- 1 See Section 1a(18) of the Commodity Exchange Act (7 U.S.C. § 1), which defines eligible contract participant. The term includes "(v) a corporation, partnership, proprietorship, organization, trust, or other entity— (I) that has total assets exceeding \$10,000,000; (II) the obligations of which under an agreement, contract, or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by an entity described in subclause (I) ... "
- 2 See Dodd-Frank section 723(a)(2), amending section 2(e) of the Commodity Exchange Act (7 U.S.C. § 1) to introduce the following requirement: "It shall be unlawful for any person, other than an eligible contract participant, to enter into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market under section 7 of this title."
- 3 See Commodity Futures Trading Commission No-Action and Interpretation Letter No. 12-17 ("Staff Interpretations and No-Action Relief Regarding ECP Status: Swap Guarantee Arrangements; Jointly and Severally Liable Counterparties; Amounts Invested on a Discretionary Basis; and 'Anticipatory ECPs'").
- 4 See LSTA Market Advisory February 15, 2013 "Swap Regulations' Implications for Loan Documentation" (original Market Advisory dated February 1, 2013 was updated).
- 5 LSTA suggested language to be incorporated into the guarantee: "Keepwell. Each Qualified ECP Guarantor hereby jointly and severally absolutely, unconditionally and irrevocably undertakes to provide such funds or other support as may be needed from time to time by each other [Loan Party] to honor all of its obligations under this Guaranty in respect of Swap Obligations (provided, however, that each Qualified ECP Guarantor shall only be liable under this Section ____ for the maximum amount of such liability that can be hereby incurred without rendering its obligations under this

Section ___, or otherwise under this Guaranty, voidable under applicable law relating to fraudulent conveyance or fraudulent transfer, and not for any greater amount). The obligations of each Qualified ECP Guarantor under this Section shall remain in full force and effect until a [Discharge of Guaranteed Obligations]. Each Qualified ECP Guarantor intends that this Section ___ constitute, and this Section ___ shall be deemed to constitute, a "keepwell, support, or other agreement" for the benefit of each other Loan Party for all purposes of Section 1a(18) (A)(v)(II) of the Commodity Exchange Act."

- 6 The LSTA has provided the following additional definitions and suggested language in relation to the concept of Excluded Swap Obligation:

"Commodity Exchange Act" means the Commodity Exchange Act (7 U.S.C. § 1 et seq.), as amended from time to time, and any successor statute.

"Excluded Swap Obligation" means, with respect to any Guarantor, any Swap Obligation if, and to the extent that, all or a portion of the Guarantee of such Guarantor of, or the grant by such Guarantor of a security interest to secure, such Swap Obligation (or any Guarantee thereof) is or becomes illegal under the Commodity Exchange Act or any rule, regulation or order of the Commodity Futures Trading Commission (or the application or official interpretation of any thereof) by virtue of such Guarantor's failure for any reason to constitute an "eligible contract participant" as defined in the Commodity Exchange Act and the regulations thereunder at the time the Guarantee of such Guarantor or the grant of such security interest becomes effective with respect to such Swap Obligation. If a Swap Obligation arises under a master agreement governing more than one swap, such exclusion shall apply only to the portion of such Swap Obligation that is attributable to swaps for which such Guarantee or security interest is or becomes illegal.

"Swap Obligation" means, with respect to any Guarantor, any obligation to pay or perform under any agreement, contract or transaction that constitutes a "swap" within the meaning of section 1a(47) of the Commodity Exchange Act.

- 7 Counsel should be consulted to discuss possible solutions to these issues in existing syndicated loan financings as well. Tax and accounting implications of these provisions should be considered as well.

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