CFTC's No-Action Relief on Guarantor Swap Requirements Ends March 31, 2013

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") requires that swaps (as defined in 7 U.S.C. § 1a(47)) be entered into on designated contract markets unless the parties to the swap are all eligible contract participants ("ECPs") at the time they enter into the swap. The Commodity Futures Trading Commission ("CFTC"), which is responsible for enforcing the swap requirement, issued a No Action and Interpretation Letter (the "Interpretation") on Oct. 12, 2012, clarifying that guarantors of swap obligations fall under the Dodd-Frank Act's requirements and that guarantees of swaps are themselves swaps for purposes of the act. In its Interpretation, the CFTC provided no-action relief to guarantors from enforcement of the swap requirement until March 31, 2013.

In anticipation of the termination of the no-action period, we have prepared this brief summary to explain the Interpretation and its impact on loan documentation (both for existing facilities and for facilities yet to be documented).

Lenders often seek guarantees from a borrower's affiliates or related entities as credit support. Generally, guarantees broadly define the guaranteed obligations covered by a guarantee to include all obligations of the borrower to the lender, which may include the obligations of the borrower to the lender as a swap counterparty. Guarantees can also expressly include the swap obligations as covered by the guarantee. Pursuant to the Interpretation, any guarantors guaranteeing the swap obligations must be ECPs unless the swaps are entered into on designated contract markets or unless the guarantors are covered by the no-action scenarios specified in the Interpretation.

ECPs are defined to include, among others:

1. financial institutions;
2. investment companies subject to regulation under the Investment Company Act of 1940;
3. insurance companies regulated by a state;
4. corporations, partnerships, proprietorships, organizations, trusts or other entities with more than $10 million in total assets, or any entity guaranteed by these entities;
5. entities with a net worth of at least $1 million that are hedging commercial risk;
6. employee benefit plans subject to ERISA with total assets exceeding $5 million or for which investment decisions are made by a registered commodity pool advisor or commodity trading advisor subject to regulation under the Investment Advisers Act of 1940 or by a financial institution or insurance company;
7. governmental entities;
8. corporations, partnerships, proprietorships, organizations, trusts or other entities whose obligations are guaranteed by an entity that is an ECP satisfying one of the foregoing descriptions; or
9. individuals with aggregate amounts of greater than $10 million invested on a discretionary basis (or $5 million if hedging).

In many, if not most, transactions, the borrower and its affiliates would not have an issue meeting the $10 million asset threshold, or one of the other thresholds, to be an ECP. Subsidiaries, affiliates or principals that may be required to sign onto the guarantee as guarantors may not qualify as ECPs, however. The consequences of failing to comply with the requirements of the Dodd-Frank Act and the regulations of the CFTC include the illegality and unenforceability of a guarantee from 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 guarantee. The Interpretation does not address whether only the guarantee of the swap under such a universal guarantee becomes invalid or whether the guarantee of the underlying loan obligations could also be tainted and rendered invalid and unenforceable as a result of the violation. Therefore, caution and prudence are recommended.

We recommend changes to loan documentation in cases in which the parties are contemplating swaps, including those changes suggested by the market advisory issued by The Loan Syndication and Trading Association on Feb. 15, 2013. Parties should consider making one or more of the following changes:

1. carving out any guarantee of the swap obligations by a guarantor that is not an ECP;
2. including robust severability provisions in guarantees providing that the non-swap obligations of a non-ECP guarantor are not affected by the unenforceability of any other aspect of the guarantee;
3. modifying waterfall provisions to exclude amounts recovered from non-ECP loan parties from application to swap obligations;
4. including representations by the borrower and the guarantors that they are ECPs, which representations are remade upon the entry into each swap (however, a breach of this representation by the borrower or the guarantors may still open the lender to enforcement action by the CFTC);
5. expressly including in the indemnification provisions of the loan documents any liabilities imposed on the lender because a borrower or guarantor was not an ECP; and
6. including provisions that require keepwell support from loan parties that are ECPs to those that are not ECPs.

Loeb & Loeb LLP's Finance Department can provide further guidance on the application of the CFTC's Interpretation, as well as on the structural and documentary implications of the Interpretation. For more information about the content of this alert, please contact Bryan G. Petkanics, Peter G. Seiden, Kenneth D. Freeman or Anthony Pirraglia.

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