IN FACT AND IN LAW

Transaction Law

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Demystifying “Swaps”

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Twenty years ago, a financial instrument joined the range of instruments already in use by financial institutions: namely, exchange agreements commonly known as “swaps”. These agreements are part of a family of financial instruments known as “derivatives”. Although swaps take numerous forms and may involve shares, commodities, options, currencies, etc., we intend to limit our discussion to interest rate swaps, which are one of the types of instruments most commonly used in financial transactions between a bank and its client.

Our firm often has occasion to draft the documentation for such transactions.

At first, only financial institutions and large corporations would take advantage of this mechanism. However, it is now used in transactions involving as little as $2,000,000.

Numerous small and medium-sized businesses have already entered into such contracts or are expected to do so in the future.

This bulletin summarizes the characteristics of a swap and the elements of the opinion that the legal advisor of the bank’s client must provide.

Origin

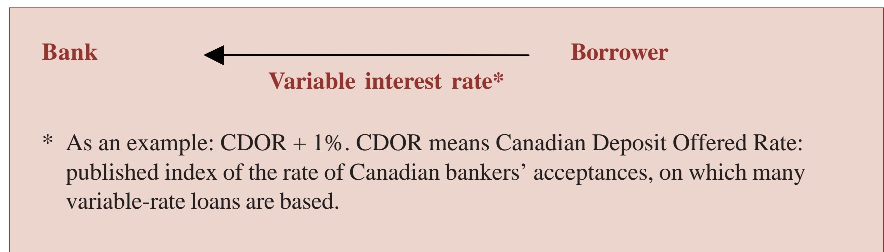
The first currency swap was executed in 1976. The first interest rate swap was signed in 1981.

Early interest rate swap transactions were initiated in order to take advantage of the differences in interest rates applicable to debtors of various qualities.

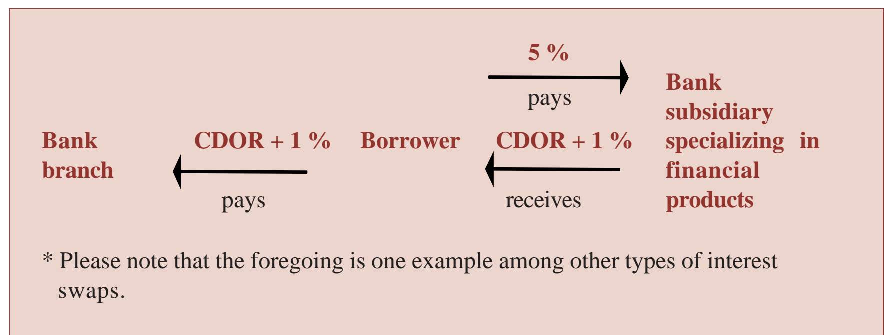
Description

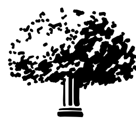
Before looking at these transactions, an example would be useful:

A company borrows from a bank. The interest flow is as follows:



The parties back the loan with an exchange contract (a “swap”) with a corporation specializing in financial products. The flows become as follows:





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The Benefits for the Borrower

- A fixed rate, agreed upon for a period of time specified in the exchange contract
- Easy to enter or exit the exchange agreement
- Benefit from a fixed interest rate for a longer term than with "traditional products"
- Lock in a fixed rate long in advance
- Convert an interest flow from one currency to another (if need be)
- Unwinding the swap before its due date:

Variable rate* < fixed rate:	the borrower must compensate the specialized subsidiary of the bank by the value of the swap **
Variable rate = fixed rate:	no cost for either party
Variable rate > fixed rate:	the borrower receives the swap value from the specialized subsidiary

* CDOR in force at the time of unwinding for the remainder of the term + 1%
** current value of the rate differential = (fixed rate x loan) – (variable rate x loan)

The Risk of Swap Transactions

The main risk is that of default (in other words, non-payment) of the counterparty. In theory, such risk is greatly reduced due to the bilateral character of the obligations and the use of compensation as a method of payment.

The Search for Legal Security

The magnitude of the amounts involved and the increasing use of transactions on derivatives encouraged the development of a standardized legal regime for these transactions.

The method chosen was that of codified rules and master agreements:

- The ISDA (*International Swap and Derivatives Association*) standards - *Code of standard wording assumptions and provisions for swaps – ISDA Definitions* – and the *ISDA Master Agreement,* which was published in 1987, amended in 1992 and then once again in 2002.

The ISDA documentation is by far the most common contractual form worldwide (representing approximately 75% of all Master Agreements). The *Fédération bancaire française* also adopted standard documents. The documentation may be used as is or modified by way of a schedule agreed to by the parties. For the actual use of the Master Agreement (a single basic agreement) and its Schedule, a confirmation, which reproduces the specifics of each transaction is then exchanged between the parties according to their needs.

Security mechanisms, such as margin calls, pledging of securities, guarantees, hypothecs or mortgages are put in place in order to secure the risks of these transactions and ensure payment. In a typical financing, the security also secures the swap backing the financing.

For instance, where the bank is "in the money", that is, in the event the swap is cancelled, the counterparty owes money to the bank. In such a case, it will be important to have this debt secured by the same security that is applicable to the underlying loan.

The Common Provisions

No specific contract is drafted in respect of every transaction. The Master Agreement applies to all the transactions to occur between the parties. It is modified by way of a Schedule, according to the specific needs of the parties.

Formation of the Contract

The Agreement may be entered into by correspondence and even by telephone. In the case of an agreement by telephone, the telephone conversation must be confirmed in writing. Several Canadian provinces recognize the validity of such verbal agreements. The telephone conversation is recorded, with the express consent of the parties, and the recorded conversation constitutes admissible evidence in the event of a dispute.

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Reciprocal Obligations

The Agreement governs the performance of the obligations by either party, in the absence of default of the other party.

The reciprocity of obligations is expressly stipulated.

The payments must be made in a timely manner, in the specified currency at the specified place, free of any withholding tax.

Default

Any late payment may bring about interest on arrears as provided in the Agreement.

The right to unilateral cancellation is available to either party in the event of default by the other party, e.g.:

- default in payment;
- non-compliance with the other contractual obligations, uncured within a predetermined delay;
- insolvency, bankruptcy, reorganization;
- cross-default;
- nullity, unenforceability or loss of the security granted.

The right to unilateral cancellation is also available where new circumstances render the Agreement illegal or bring about tax withholdings on payments to be made (only if the parties have their tax domiciles in different jurisdictions) or if the financial condition of the other party deteriorates materially.

The cancellation must specify a settlement date. The defaulting party must then pay the following:

- the amounts due as of the date of cancellation, which are equal to the amount that the non-defaulting party should have received had the Agreement been honoured;
- interest on arrears;
- an amount to compensate the net costs and losses incurred to secure replacement counterparties (*replacement value*).

Indemnification may be mutual, and is often only partial.

The Agreement specifies that such indemnity does not constitute a penalty but rather compensation in respect of losses, costs and expenses.

Various Clauses

The Master Agreement refers to ISDA Definitions, which are very precise and well-known within the industry. It also contains representations of the parties concerning the validity of their incorporation and their legal capacity, as well as clauses respecting waivers of immunity, the applicable law and the applicable jurisdiction in case of dispute.

Intuitus Personae

Swap transactions are said to be "*intuitus personae*", which means that they are always entered into taking into consideration the specific identity of the co-contracting party.

Essentially, a swap is an obligation to pay an amount of money in consideration for the payment of another amount of money.

Compensation

Civil Law has the advantage of giving the parties who are reciprocally debtor and creditor of one another the benefit of legal compensation:

- reciprocity of debts between the same parties;
- fungibility;
- liquidity;
- exigibility.

The Master Agreement also provides for application of the rules of compensation.

The Legal Opinion

The legal opinion required by the financial institutions is very similar to that used for financings by means of a loan, suretyship, hypothec or mortgage. It includes a confirmation by legal counsel that the company has been validly incorporated, that it is still in existence, that it has the legal capacity to engage in the transaction, that such transaction has been duly authorized and that the persons who signed the relevant documents (i.e., the Master Agreement, the schedule and the confirmations) were duly authorized to do so, that no provision of the company's by-laws or constating documents nor any of its commitments precludes it from entering into a swap transaction and that, finally, the Agreement is enforceable.

The legal opinion also includes a confirmation that no law or regulation prevents the company from entering into a swap transaction. Taking for granted that this kind of Agreement constitutes more or less a financing contract, since the company undertakes to pay interest on a given amount, the laws that would prevent the company from entering into a swap transaction are nearly the same as those that would preclude it from entering into a financing.

Legal counsel should therefore be confident in issuing such an opinion, his main obligation being to ensure that the company is in good standing, that the Agreement has been duly authorized and that the persons who signed it had the authority to do so. The swap transaction, even though it is drafted in an often daunting and technical vocabulary, is in fact only a method of financing with clauses that are usual for this type of contract.

Conclusion

Derivatives like swaps, more particularly interest rate swaps, are increasingly used by small and large Quebec companies. It is therefore important for legal counsel to familiarize themselves with this type of contract.

Please do not hesitate to contact the authors if you have any questions related to this bulletin or to swaps in general.

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