

Derivatives for Lawyers: Terminology, Documentation and Legal Issues

By Beverly Sanders Gates
and Anne B. Mathes

Beverly Sanders Gates is an associate in the Corporate group of Baker, Donelson, Bearman, Caldwell & Berkowitz. She concentrates her practice in the areas of general corporate, securities, mergers and acquisitions and securitization. She received a B.B.A. magna cum laude in Banking and Finance and an M.B.A. from Mississippi State University. She received a J.D. cum laude from the University of Mississippi School of Law. Ms. Gates is a member of the Memphis, Tennessee, Mississippi and American Bar Associations.

Anne Mathes is of counsel in the Financial Services and Transactions group of Baker, Donelson, Bearman, Caldwell & Berkowitz. Her practice areas include bank lending, structured and municipal finance, and real estate. She received a B.S. with honors and distinction from Rhodes College, an M.S. from the University of Memphis, and a J.D. from Fordham University. Ms. Mathes is a member of the Memphis, Tennessee and American Bar Associations.

In today's interest rate market, your clients may have been asked to enter into an interest rate swap in connection with a commercial loan. Were you able to negotiate the documentation presented to your client in connection with the interest rate swap?

Derivatives play a huge role in world financial markets. According to a recent survey by the International Swaps and Derivatives Association, or ISDA, 92% of the world's 500 largest companies use derivative instruments to manage and hedge their risks more effectively. If you represent business or bank clients, chances are you will encounter a derivatives contract (most likely an interest rate swap) at some point in your career.

In this article, we will attempt to help you understand the terminology used in the complex world of derivatives. We will describe the typical documentation you are likely to see when you are asked to review such an instrument. Finally, we will describe the legal issues surrounding this complex area of financial management.

TERMINOLOGY

A derivative is a financial instrument whose value depends on the value of an underlying financial asset, interest rate or index. Examples of derivatives include *futures contracts, forward contracts, options and swaps*. Derivatives may be traded on an exchange or through an investment bank in the over-the-counter market.

Derivatives are most commonly used

to hedge risk. Once a company determines that a particular type of risk may affect its business, the company may desire to hedge that risk by becoming a party to a derivative. For example, a financial institution may want to manage its exposure to interest rate risk by entering into types of derivatives called interest rate swaps, caps or floors. An airline may want to manage its exposure to rising fuel prices by entering into a type of derivative called a futures contract.

A company that is hedging a risk will enter into a derivative that generates a financial result that is the opposite of the financial result generated by the risk. As the value of the company's asset declines, the value of the derivative should increase and vice versa. While most participants in the derivatives market use derivatives to hedge risk, companies may enter into the derivatives market for the purpose of generating profits by entering into a derivative without an offsetting position.

A *futures contract* requires the delivery of a specific item on a specific future date or over a limited period of time. A farmer may enter into a commodity future. A commodity future is a contract in which a seller promises to deliver a given commodity by a certain date at a predetermined price. The farmer is using the commodity future to shift price risk. For agricultural crops, seasonal production and inventory risks exist. Because the pricing of agricultural products is affected by an increase in

Continued on next page

Derivatives for Lawyers: Terminology, Documentation and Legal Issues

supply after harvest and the storage of excess throughout the growing cycle, the farmer may wish to control the price fluctuations through the use of a futures contract. Currency futures, which are contracts for delivery in a major currency, are used to hedge the risk of adverse exchange rate movements. Very few futures contracts involve actual delivery at maturity. Instead, buyers and sellers of a futures contract independently purchase off-setting positions to close out the contract at maturity. Futures contracts are traded on exchanges. To facilitate trading, futures contracts are standardized in quantities, delivery periods, and categories of deliverable items. The largest exchanges on which futures contracts are traded are the Chicago Board of Trade and the Chicago Mercantile Exchange.

A *forward contract* is a non-standardized instrument that economically functions much the same as a futures contract except that it is sold in the over-the-counter market, usually between two financial institutions or between a financial institution and one of its clients, rather than on an exchange. In a forward contract, one party contracts with another party to exchange one item for another for a predetermined price at an agreed-upon point in time. Generally, the parties to a forward contract are obligated by the contract and cannot be released from that obligation prior to its fulfillment unless they renegotiate the contract. Because forward contracts are not traded on an exchange, they are less liquid than exchange-traded contracts. Also, parties to forward contracts are exposed to the risk that the other party may default on the contract. Forward contracts may be customized to address any agreement between the parties as to quantity, delivery periods and deliverable items.

An *option* is a derivative that derives its value from an underlying security. There are two basic types of options. The holder of a call option has the right to buy the underlying asset by a certain date for an agreed upon price. The holder of a put option has the right to sell the underlying asset by a certain date for an agreed upon price. The agreed upon price is referred to as the exercise price or strike price. The date specified in the contract is known as the expiration or maturity date. Note that the holder of an option is given the right, but

not the obligation, to do something. The holder is not obligated to exercise its right.

Every option contract has two sides. On one side is the entity who has bought the option or taken the long position, and on the other side is the entity that has sold the option or taken the short position. The entity that sells the option typically receives cash up front, but has potential liabilities if the purchaser exercises its option. Options are traded both on exchanges and over-the-counter. They are especially useful for hedging risk in one direction, such as the risk of an increase in the price of a stock.

A *swap* is an agreement between two companies to exchange cash flows in the future. This might be done when a company has the ability to borrow money under a certain type of financing but prefers another type. The agreement defines the calculations of the cash flows and the dates on which the cash flows are to be paid.

The two most common types of swaps are currency swaps and interest rate swaps. In a currency swap, two parties exchange interest obligations on debt denominated in different currencies. At maturity or on a series of specified dates, principal amounts are exchanged, typically at a rate of exchange agreed upon in advance. In an interest rate swap, interest payment obligations denominated in the same currency are exchanged between two parties.

In an interest rate swap, no principal is transferred between the parties. Instead, a notional principal amount is used to calculate the interest to be exchanged. The exchange of interest between the parties usually occurs on a net settlement basis. In other words, the party that owes more interest than it receives in the swap pays the difference. The most common type of interest rate swap is a swap of a fixed rate for a floating rate where the floating rate payments are tied to the London interbank offer rate (LIBOR). You may see this when a client who is offered a LIBOR rate loan seeks to manage its interest rate risk by entering into a fixed rate swap at the same time it obtains the LIBOR loan. Such a swap allows a borrower with a floating rate loan to have an effective rate which is fixed. See Figure 1 for an illustration of how such a swap works.

Figure 1:

Borrower enters into a floating rate loan with Lender. Borrower also enters into a fixed rate for a floating rate swap with Lender.

If Borrower's rate of interest under the loan equals LIBOR (assume equals 4.5%) and Borrower pays a fixed rate of 3.4% to Lender and receives LIBOR from Lender under the swap, then

Loan: Borrower pays 4.5% to Lender
Swap: Borrower pays 3.4% to Lender;
Borrower receives 4.5% from Lender

RESULT:

Borrower nets 1.1% under the swap
Borrower's effective rate is 3.4% (4.5% - 1.1% = 3.4%)

If LIBOR falls to 2.5%, then

Loan: Borrower pays 2.5% to Lender
Swap: Borrower pays 3.4% to Lender;
Borrower receives 2.5% from Lender

RESULT:

Borrower nets -0.9% under the swap
Borrower's effective rate is 3.4% (2.5% + 0.9% = 3.4%)

In addition to the simple derivative instruments presented here, financial engineers have developed innumerable permutations of these instruments. These instruments have exotic names such as straddles, strangles, swaptions, zero-cost collars, cylinder options and chooser options. While derivatives offer companies the ability to manage their risks, they can be very complex and should be entered into only when the financial and legal obligations and risks of such derivatives are completely understood by the company.

DOCUMENTATION

If your client enters into a derivative contract, you may be asked to review the documentation for the derivative. Parties who purchase derivatives that are traded on an exchange will typically receive a confirmation from their brokers. The confirmation is the result of a trader completing a deal ticket that contains the financial

Derivatives for Lawyers: Terminology, Documentation and Legal Issues

details of the transaction. Because exchange rules govern trading procedures, contract terms, margin requirements, position limits and maximum price movements, the confirmations used for exchange-traded derivative contracts are generally limited to the financial terms of the transaction. Due to the standardized nature of this type of contract, the need for legal review is minimal for exchange-traded derivatives.

Conversely, contracts associated with over-the-counter derivatives (such as interest-rate swaps) are often heavily negotiated. ISDA has developed standard market documentation for over-the-counter derivatives. The ISDA documentation architecture consists of a master agreement, a schedule to the master agreement which amends, adopts or opts out of provisions in the master agreement, the confirmation and any credit support documentation. As an alternative to renegotiating all terms for each derivative transaction between two parties, the master agreement and schedule create an ongoing bilateral relationship between the contracting parties. Ideally, two parties would have only one master agreement and schedule, and multiple confirmations that memorialize the details of the individual transactions entered into between the parties. The philosophy behind the ISDA documentation is that all confirmations entered into between two parties, together with their master agreement, schedule and credit support documentation are construed as constituting one single contract. The reason for creating this link between transactions is to facilitate payment netting and to set off any amounts owed upon termination of the relationship so that one final, net amount will settle all of the parties' obligations to each other.

The master agreement itself is a form document that is structured as a complete contract and cannot be altered by the parties. The master agreement sets forth the manner in which payment netting will operate, the types of events of default which will cause a contract to terminate and how to calculate the parties' obligations upon the termination of all outstanding contracts covered by the event of default. The master agreement also contains the full range of contractual terms dealing with contingencies such as a

change in the tax regulations, payment netting, withholding tax, and representations as to the parties' ability to enter into the master agreement. The master agreement facilitates an agreement between the parties to cooperate in due diligence and to establish the factual underpinnings of the agreement.

The master agreement defines certain events that the parties may agree constitute events of default. These events include the failure to perform a payment or delivery obligation, breach of the agreement, failure of guarantee or other credit support, misrepresentation, default under other specified transactions, credit downgrading, corporate restructuring and bankruptcy. If an event of default occurs, all derivative transactions between the parties are terminated. The master agreement also specifies certain no-fault events of termination. These events include illegality, force majeure, a tax event that causes a disruption in the amounts actually payable under the agreements, credit downgrading due to a merger

and merger without an assumption of the obligations of the merging entity. The difference between an event of default and an event of termination is important because the calculation of amounts owed by the parties when a derivative contract is terminated prior to expiration depends upon whether the triggering event was an event of default or an event of termination.

The schedule is used by the parties in an over-the-counter derivative transaction to amend the master agreement so that it reflects the deal negotiated by the parties. The schedule is unique based upon the negotiations of the parties to the master agreement, and is the document in which the parties seek to control their respective legal and credit risks. The usual method of negotiating the schedule is for the parties to exchange their own standard forms of schedules which are naturally drafted to seek the maximum advantage for the drafter. The main negotiations of a schedule center around which of the parties'

Continued on next page

■ LAW OFFICES OF BARRY J. WALKER ■



IMMIGRATION LEGAL SERVICES FOR BUSINESS, INFORMATION TECHNOLOGY AND HEALTH EMPLOYERS

Barry J. Walker,
Member of the Mississippi Bar

P.O. Box 1023
211 N. Madison Street
Tupelo, Mississippi

M. Gabriela Ungu,
Member of the New York Bar

Telephone 662-841-0629
Facsimile 662-841-0620
Email immigration@msslawyer.com
www.immigrationpage.com

Foreign Languages: Spanish & French

Derivatives for Lawyers: Terminology, Documentation and Legal Issues

affiliates should be named in the contract for credit control purposes and what type of contracts between the parties should have an impact upon their relationship. From a credit perspective, there is often a difference between the entity that conducts the derivatives business and the entity that is the party's most creditworthy affiliate. In general, the parties to a master agreement are eager to have as few of their own affiliated companies and as many of the opposing party's affiliates named in the contract as possible. As this discussion indicates, negotiating the schedule is a balancing between legal decisions and credit decisions.

While lawyers generally think the schedule is the most important part of the derivatives contract because it defines the relationship between the parties, the business people typically believe that honor goes to the confirmation. The confirmation is, as its name indicates, a memorial of the financial terms of each individual derivative. The derivative, through the confirmation, is incorporated into the master agreement. If a discrepancy exists between the terms of the master agreement, the schedule, and the confirmation, then the confirmation overrides the sched-

ule which overrides the master agreement. This interpretation provision allows the parties to alter the provisions of the master agreement with reference to one particular derivative so that they can customize a derivative without having to renegotiate a master agreement.

Parties who enter into master agreements should be aware of certain weaknesses of the master agreement system.

*As this discussion indicates,
negotiating the schedule
is a balancing between
legal decisions and
credit decisions.*

First, the legal basis adopted by ISDA for the master agreement is New York law because New York is considered to have one of the most mature systems of commercial law in the country. As the laws of New York are guided by the legislature and by common law, it is possible that the laws applicable to the master agreement could change simply by the decision of a court in New York. Second, the master agreement system may not adapt to the introduction of new derivative products. Finally, parties to a master agreement have a tendency to enter into a master agreement and forget it. The parties fail to re-evaluate the agreement periodically to make sure it continues to meet their needs.

LEGAL ISSUES

We have discussed the basic types of derivatives and their documentation. We will now move to the regulation of the derivatives market. The Securities and Exchange Commission, or the SEC, and state blue sky laws regulate "securities." The primary regulator of the futures market is the Commodity Futures Trading Commission, or the CFTC.

While certain commodity futures remain under the regulatory authority of the CFTC, the Commodity Futures Modernization Act of 2000, or the Act, greatly impacted the regulatory and supervisory roles of the CFTC and the SEC as they relate to derivatives. The Act clarifies that certain over-the-counter derivatives

are exempt or excluded from the Commodity Exchange Act, or the CEA. The Act specifically excludes from the CEA bilateral transactions between eligible contract participants in excluded commodities, provided that they are not traded on an exchange. The Act defines excluded commodities very broadly to include most financial derivatives. Although, these derivatives are exempt or excluded from regulation under the CEA, they remain subject to the provisions of the CEA which prohibit fraud and market price manipulation in relation to commodity transactions. In addition, the Act excluded swap transactions, other than those in agricultural commodities, from the CEA and from securities laws if the swap is the subject of individual negotiations by eligible contract participants and not traded on an exchange. However, securities-based swaps remain subject to provisions in the Securities Act of 1933 and the Securities Exchange Act of 1934 prohibiting fraud, manipulation and insider trading. The Act also legalized securities futures. Securities futures are treated as both securities and futures and are therefore subject to the regulatory authority of both the SEC and the CFTC.

To determine whether state blue sky laws apply to a derivative, the laws of the state in which the purchaser lives or is domiciled must be researched to determine whether the derivative in question is subject to regulation. Often, states will have a securities law that exempts limited offerings to accredited investors. As the parties to derivatives tend to be institutions or high net worth individuals, the parties often qualify for this exemption.

While default risk is borne by the exchange for exchange-traded derivatives, parties to over-the-counter derivatives should be concerned with the default risk of the other party to the derivative. Default risk is the risk that that the other party will fail to perform. Often the parties to an over-the-counter derivative are not of equal credit risk and default or credit risk exists with respect to the net difference in payments due under the contract.

The Bankruptcy Code provides special treatment for derivatives in the context of the automatic stay, avoidance and the contractual right to liquidate in the event of the bankruptcy of one of the parties. Derivatives are expressly exempt from the

Elam Consulting, Inc. Independent Insurance Consultants

*Since 1988
Offering*

**INSURANCE
EXPERT WITNESS
&
LITIGATION SUPPORT**



Eric Elam, President

**15 Northtown Drive, Box 2
Jackson, MS 39211
Phone 601-952-0403 Fax 601-977-0807**

Derivatives for Lawyers: Terminology, Documentation and Legal Issues

automatic stay to permit a party to set-off any mutual obligations with a bankrupt party arising under a swap agreement and to use any collateral to satisfy amounts due from the bankrupt party. The bankruptcy trustee may not avoid derivatives, i.e. as a preference, unless the debtor actually entered the derivative to delay, defraud or hinder creditors. Further, the Bankruptcy Code also recognizes a party's contractual right to net or set-off termination and payment amounts in a derivative without being subject to the automatic stay or similar provisions. The Financial Institutions Reform, Recovery and Enforcement Act, which governs the insolvency of certain federally regulated financial institutions, provides similar treatment for derivatives entered into by a bank. One question that remains somewhat open arises when a loan and an interest rate swap are entered into contemporaneously. The issue is whether, and on what facts, a bankruptcy court may find a loan and an interest rate swap to be an integrated transaction and therefore disallow the swap termination payment as unsecured interest which is not due to the lender.

Legal actions involving derivatives most commonly allege securities fraud. Common law fraud, breach of fiduciary duty and negligent misrepresentation are also alleged in one-third of cases involving derivatives. In these cases, plaintiffs commonly allege that the defendant either failed to disclose material information or disclosed misleading information about the derivative or the underlying asset. The inaccurate disclosure is then used to prove that poor information caused the plaintiff's losses because the plaintiff could not have fully understood the derivative's true risk-return characteristics or accurately valued the derivative. Negligence and breach of contract are also typical allegations. Note that parties to a derivative are not generally considered to be fiduciaries to each other. However, at least one Ohio court applying New York law found an implied contractual duty to disclose where (i) one party has superior knowledge of certain information; (ii) that information is not readily available to the other party; and (iii) the first party knows that the second party is acting on the basis of mistaken knowledge.

While clients should consult with their accountants regarding the impact of deriv-

atives on their financial statements, companies that hold derivatives generally must recognize all derivative instruments on the balance sheet as assets or liabilities measured at fair market value. Derivatives can be either *hedged* or *non-hedged* instruments. The difference relates to when the fair market value is required to be calculated and recorded on the books of the company. For non-hedge instruments, gains and losses on derivative instruments must be marked-to-market and recognized currently in earnings. For hedge instruments,

gains and losses can be deferred on derivative instruments which have been designed as hedges but only to the extent the hedge is effective.

To conclude: We have provided you with a little background that we hope will help you meet your client's needs if you are approached with a question regarding derivatives. But please remember that we have only discussed the tip of the iceberg in this article. The world of derivatives is very broad and new instruments are being developed every day. ■

ARE HEALTH INSURANCE COSTS “PUSHING YOUR BUTTONS”?



Does it seem like your employee benefits are reversed?...benefits keep reducing, prices keep going up?



Would you like to explore your health insurance options under the State Bar Association Insurance Trust (SBAIT) program?



NOW is the time to move your firm forward...to investigate the TAX CREDITS & PREMIUM SAVINGS available under the SBAIT Medical Savings Account (MSA) plan.



HELP IS JUST A PHONE CALL AWAY. For a no-obligation quote and benefit highlights on the SBAIT program call:

ROBERT ELLIS & ASSOCIATES
1-888-503-5547
Ask for Joan or David