REPRINTED FROM THE

TUESDAY, SEPTEMBER 12, 2006 ny NEW YORK

Real Estate Journal

COVERING ALL OF LONG ISLAND, NEW YORK CITY AND UPSTATE NEW YORK

Rate-swap agreements allow for borrowers and lenders to mitigate risk of interest rate fluctuations

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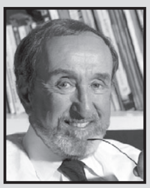

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This article is a brief overview of the expanding rate-swap market segment being utilized by commercial lenders. Although the rate-swap product has been used by lenders for decades in large commercial transactions (i.e. deals involving tens or hundreds of millions of dollars), the availability to "smaller" commercial borrowers has been limited. In an effort to lure commercial borrowers in the competitive market for loans in the amount of $1 million to $5 million, many lending institutions have started offering a product allowing this type of borrower the option to enter into what is known as an interest rate-swap agreement. This agreement is enticing to both commercial borrowers and lenders because it allows the parties to mitigate the risk of interest rate fluctuation during the term of the loan/credit facility. This obviously is of great importance in this time of rising interest rates.

As noted above, these types of facilities were only offered to larger borrowers due to the great amount of security which could be offered by such borrowers. Now, with the increase in property values, a prospective borrower who purchased a building ten years ago for $500,000 in Manhattan, could be sitting on a $1.5 to $2 million property, which affords the lender greater security and allows the lender to offer more d[illegible] ucts when offering loans [illegible]

The principles of excha[illegible] ing swap transactions are [illegible] tal when looked at in a sim[illegible] For example, as succinctly [illegible] Carolyn Jackson in the F[illegible] Review: "Even young chi[illegible] playground, as they sw[illegible] their lunchbox for those of a friend, demonstrate they understand the principle of exchange. A swap, in its most basic form, is simply an exchange of cashflows. . . A swap is a bilateral contract between two parties (counterparties) to exchange or swap defined cashflows at specified intervals . . .The most frequently transacted swap is the interest rate swap, in which cashflows are determined in reference to two different interest rates. The most simple of these, a "plain vanilla" or "fixed-for-floating" swap, involves the exchange of cashflows determined in reference to a fixed rate of interest for cashflows determined in reference to a floating rate of interest. See, 67 Fordham L. Rev. 3205, 3208-09, May 1999, *Have You Hedged Today? The Inevitable Advent of Consumer Derivatives*.

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The amount paid by a party to the swap transaction depends on the current floating interest rate. An example of this is as follows:

"If a borrower enters into a swap with XYZ Bank, in which the borrower swaps a floating rate for a fixed rate of, say, 9%, the borrower would be obligated to pay the fixed rate, to XYZ Bank, and XYZ Bank would be obligated to pay a floating rate to the borrower. In this example, when the specified floating rate is higher than 9%, XYZ Bank would pay to the bor[illegible]ount equal to (x) the dif[illegible]een the floating rate and [illegible]y) the notional amount. [illegible]ed rate (here 9%) is higher [illegible]ent floating rate, the bor[illegible]d pay to XYZ Bank an [illegible]al to (x) the difference [illegible] and the floating rate, times [illegible]nal amount. Over the life of the swap, the payments could change direction many times." Laura Hannusch, Practising Law Institute, Real Estate Law and Practice Course Handbook Series, February, 2003, *Commercial Real Estate Financing 2003: What Borrowers & Lenders Need to Know Now*.

The swap agreement is typically governed by an "ISDA Master Agreement" prepared by the International Swap and Derivatives Association, Inc. (www.isda.org). This standard form is almost universally utilized by lenders in the U.S. The master agreement expressly sets forth the mechanics of the swap where the borrower will essentially cap the interest rate (and the borrower's maximum exposure) or swap the loan's floating rate for a fixed rate. In addition to the master agreement, other documentation used in an interest rate swap includes a confirmation (setting forth the basic economic terms of the swap transaction) and a schedule to the master agreement. The schedule to the master agreement allows the parties to modify the standard terms of the master agreement. This schedule contains the default provisions, which often include "breakage costs." Breakage costs are based on what other market makers would charge or pay to effectively take over the defaulting party's rights and obligations under the swap. Of course, it is possible that, depending on how interest rates have moved, termination of the swap might actually benefit the defaulting party, and in this case there would be no breakage cost. For a detailed explanation of these costs and the risks and benefits to terminating the swap, see ALI-ABA Course of Study, January 16, 1997, *Real Estate Financing Documentation: Coping with the New Realities, Interest Rate Hedging Productions*, Eric Schiller and Steven Davidson.

Although we have attempted to summarize interest rate-swap agreements in the context of commercial lending, this is a complex field with many variables which will shape and mold each transaction. Therefore, it is advisable to become well versed in the language and terminology of swap transactions, and to employ experienced professionals, prior to entering into an interest rate-swap agreement.

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