



INTEREST RATE SWAPS AND OTHER DERIVATIVE PRODUCTS FOR NON-PROFIT ORGANIZATIONS

Interest rate swaps, rate locks and other derivative products are now widely used by non-profit organizations as part of their debt structure. They are important financial tools in managing risks and in providing access to the lowest borrowing costs. They also involve a number of risks. Derivatives, however, can be dangerous if misused, as evidenced by the bankruptcy of Orange County, California a decade ago and recent investigatory attention from the Department of Justice, the Securities and Exchange Commission and the Internal Revenue Service.

In recent years, we have advised and assisted a number of non-profit organizations in analyzing, negotiating and documenting derivative products. This experience includes extensive use of traditional interest rate swaps that effectively convert variable rate debt to fixed rate debt or vice versa. Our experience also includes analysis, negotiation and documentation of forward rate locks for organizations that wish to lock in fixed interest rates prior to the date their bonds are sold.

In the most common derivative product, an interest rate swap, a non-profit organization obligates itself to pay a fixed interest rate to the swap provider (counterparty) in return for receiving a variable interest rate intended to cover the payments the non-profit is obligated to make on variable rate bonds issued to finance its facilities. This permits the non-profit to avoid part of the risk it assumes when it obligates itself to pay a variable interest rate. For non-profits, this is usually desirable, since most revenue streams for non-profits are not “interest rate sensitive” and overall revenues are unlikely to increase simply because variable interest rates rise.

Swaps can be done for all or part of the variable rate exposure. It is sometimes true that issuance of variable rate debt that is immediately 100% swapped to a fixed rate results in a rate lower than the borrower could get

for traditional fixed rate bonds. This seemingly illogical result comes from the fact that swap providers usually hedge their obligations in the taxable market, so swap rates track taxable rates more closely than tax-exempt rates.

Derivative products can substantially benefit non-profit organizations, but they raise a number of important issues for both governing boards and senior management. Almost every derivative product involves taking some kind of risk as to future changes in interest rates. Also, for any entity using or expecting to utilize tax-exempt bonds, there is a practical need to ensure compliance with the complex federal tax regulations that govern the relationship between derivative products and tax-exempt bonds.

Furthermore, both the Internal Revenue Service and the Securities and Exchange Commission have expressed concerns that many organizations are being sold inappropriate derivative products at excessive prices. The IRS looks with particular concern whenever an institution purchases a derivative from an entity that has another financial relationship with the purchaser, such as service as a bond underwriter. The failure to obtain a fair price for a derivative product, of course, is never in the best interest of a non-profit. Furthermore, it may create regulatory risks if the Internal Revenue Service is able to attack the fairness of the pricing.

We at Hunton & Williams believe it is extremely important that both governing boards and senior management understand all of the potential risks and rewards in the use of derivative products. Relevant risks include:

► Risk Taking and Fiduciary Duty

In the current environment, non-profit boards need to understand fully the risks in any derivative product. The entire board should receive a full and clear expla-



nation of the risks being taken, the benefits received and the analysis behind the decision to take such risks. It is particularly important that the written records evidence compliance with fiduciary duty in this regard.

▶ Variable Rate Risk and Hedging

Interest rate swaps and other derivative agreements often are undertaken by non-profits to obtain low interest rates without assuming the special risks of variable rate debt. Increasingly, however, large non-profit organizations assume some variable rate risk. Any decision by a non-profit to take variable rate “exposure” and the types of derivatives to be used in doing so should reflect an understanding of the risks and how they may be appropriately limited by both use of derivatives and the non-profit’s investment strategies for its reserves and endowment.

▶ Basis and Tax Risks

In executing interest rate swaps and locks, it is important to understand that the variable rate being paid to a non-profit by the counterparty may not be identical to the variable rate the non-profit is obligated to pay on its bonds. Thus, in most circumstances, the swap will not be a “perfect hedge” and the non-profit organization may be required to make interest payments in addition to the fixed rate for which it has “swapped.” For tax-exempt bonds, the risk of a substantial mismatch is greater with a LIBOR-based swap than with a BMA-based swap.* This reflects the fact that with a LIBOR-based swap, the swap purchaser will assume the “tax risk,” which relates to what happens to variable rate, tax-exempt instruments when marginal income tax rates are changed.** Many organizations find it is appropriate to take this tax risk because of the financial savings of a LIBOR swap, but the risk should be understood, especially if the swap is for a lengthy period, and the borrower must recognize that in the future it may

* In simplest terms, LIBOR is a taxable rate; BMA is a tax-exempt rate. LIBOR is the London Interbank Offering Rate, an interest rate set by international markets. BMA refers to the variable rate index known as the Bond Market Association index, which is based directly on tax-exempt short term variable rate debt issued in the United States. The LIBOR swap market is significantly larger and more liquid than the market for swaps based on BMA rates.

** If marginal income tax rates go up, the rate on variable rate bonds and BMA will go down. If marginal income tax rates go down, the rate on variable rate bonds and BMA will go up. In both situations, generally speaking, LIBOR will not change. Therefore, in a BMA-based swap, the provider is taking the tax risk, but in a LIBOR-based swap, the purchaser, *i.e.* the non-profit borrower, is assuming the tax risk.

be required to pay substantially more than the fixed rate payments it makes under the swap.

▶ Counterparty Risks

In any interest rate swap, the non-profit organization needs to be satisfied that the party on the other side of the transaction, the counterparty, is financially able to perform its duties. This risk can be mitigated in several ways, including requiring the provider to post collateral, either generally or if it falls below a certain credit rating.

▶ Reinvestment Risks

Non-profit corporations need to understand the risks that may be involved in the use of derivatives and other transactions when the term of the derivative is not coterminous with the related bond issue or other debt. Similar risks may arise if the “notional amount” of the derivative is substantially different from the principal amount of tax-exempt bonds.

▶ Termination and Unwind Risks

Some non-profit corporations have found to their dismay that the termination provisions in interest rate swaps may require them at various times to make substantial payments. Terminations and other unwinds of swaps can involve payments of millions of dollars. With sufficient care and attention ahead of time, this risk can be reduced or at least limited to highly unlikely situations. Swap termination provisions vary widely. A borrower may—or may not—be able to terminate at any time without cause. The provider may want to retain such power. Termination may also be triggered by such factors as the failure of either party to transfer collateral or a decline in the value of collateral already transferred, rating declines, default under or repudiation of a credit support document, defaults under unrelated debt documents, a major legal judgment against the borrower, a claim that one of the representations made to the provider by the borrower was not true or a default under one of the many kinds of financial and operating covenants contained in swap agreements. These covenants include restrictions on mergers and the incurrence of debt and failure to meet specified economic performance tests. Termination provisions can and should be negotiated with care.

▶ Covenant Risks

There are two kinds of covenant risks with derivative products. The first reflects the covenants that are



embedded in the derivative document itself. Counterparties customarily require financial and operating covenants and may be able to force a termination of the swap if these conditions are not met, sometimes at a substantial cost. In this sense, a derivative agreement is much like a long-term debt agreement, and despite the use of standard forms as a starting point, it needs to be negotiated with care.

Furthermore, non-profit organizations need to ensure that they do not violate existing bond or other debt documents by entering into the derivative agreement. They also need to consider the circumstances under which compliance with their basic bond documents, now or in the future, may result in a covenant violation under the derivative agreement and vice versa. This is a particular problem under derivative agreements that require the posting of collateral in certain circumstances such as credit downgrade.

▶ **IRS Rules**

There are strict IRS rules that may apply whenever derivative products are utilized in connection with tax-exempt bonds. Relevant circumstances include the use of interest rate swaps in connection with advance refundings. The borrower also needs to make an informed decision as to whether, for tax purposes, to “integrate” the swap agreement with the tax-exempt interest it pays on its bonds. This decision can have important implications with respect to the amount of rebate that a borrower may have to pay under the federal tax regulations. The decision to “integrate” a derivative must be made contemporaneously with the execution of the derivative agreement, even if that is months before the issuance of the related bonds.

▶ **Securing the Derivative**

Increasingly, counterparties want to share the security that a non-profit has given to its bondholders, such as mortgage liens and security interests in revenues. Older bond documents frequently do not permit the granting of parity security for derivatives. We have assisted non-profits in amending bond documents to permit such security and in drafting new documents that accommodate market demand. Such demands for security sometimes raise tricky questions in bond documents related to the relative powers of bondholders and their trustee, credit enhancers (such as bond insurers) and the derivative counterparties. In addition, derivative providers often seek collateral to be posted by swap purchasers in certain events in the future (e.g., a bond rating down-

grade). Such a requirement can create obvious business and document concerns that need to be addressed.

▶ **Accounting Issues**

Non-profit organizations need to understand thoroughly the accounting implications of derivative products. In some circumstances, even if no payments are required under the derivative agreement, changes in its value reflecting changes in interest rates will ripple through an organization’s financial statements, affecting both balance sheets and income statements, even through there is in fact no effect on its operations or the traditional measurements of its financial health. In some cases, this has even resulted in defaults under bond documents because of unrealized losses on derivative products causing organizations to fail financial covenants. Care should generally be taken to avoid default provisions triggered by “unrealized losses and gains.” Any non-profit organization entering into a derivative agreement should understand the effects that such agreement may have on its financial statements in different interest rate environments.

▶ **Disclosure**

The Securities and Exchange Commission has made clear that, in the sale of tax-exempt bonds, borrowers need to make careful and clear disclosure of the extent to which they have used derivative products and have assumed related risks.

POST-EXECUTION PROBLEMS

The volume and complexity of derivatives often make it difficult for non-profit organizations to monitor various matters after contract execution. Evidence, for example, suggests that a high percentage of invoices for net swap payments are miscalculated, and it is often difficult to calculate the amount that would be paid or received upon a termination (and therefore difficult to quickly determine the net effect of market changes). Non-profits frequently have problems understanding how market movements affect a portfolio of multiple swaps or other derivatives with different terms. Non-profit borrowers need to take steps to protect themselves against such problems (several of which can be ameliorated by good drafting of the derivative contracts) and enhance their ability to understand market effects when they have multiple swaps with different terms.



SUMMARY

Ultimately, decisions as to derivative products must be made by boards and management, based on their best assessment of future financial conditions affecting their debt. Sound advice from independent financial advisory firms often is needed, and “fairness opinions” often are appropriate and sometimes required. Appropriate legal advice is essential in understanding both the risks and the limitations imposed by derivatives. Hunton &

Williams’ public finance lawyers have advised non-profit organizations on all of the above issues. Furthermore, we work regularly with the derivative specialists in our firm who deal with the broadest range of derivative products. We believe that our non-profit clients can benefit substantially from our combination of derivative knowledge, public finance experience, and thorough knowledge of the interaction between derivatives and tax-exempt bonds.

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available to public bodies, including variable rate, credit enhanced and short-term transactions.

Our lawyers also are active in legislative matters affecting public finance and have extensive experience in workouts and other matters related to defaulted and troubled bond issues.

Please visit www.hunton.com for more information about Public Finance at Hunton & Williams or to contact our Public Finance Lawyers.

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