In this article the authors provide an overview of the relevant legal and documentation issues arising from the hedging and lending relationship in commercial lending.

The dramatic rise in interest rates across financial markets in Europe and the US has brought back to centre stage the importance of "hedging" interest rate exposure in financing transactions. In the years since the financial crisis, rock bottom interest rates – at negligible and even negative levels – have obviated the need for carefully prescribed and precisely documented hedging strategies. Instead, borrowers could rely upon simpler interest rate cap transactions which could address the commercial concerns of unlikely interest rate increases, often without the need for either ISDA Master documentation or addressing the intercreditor issues, as borrowers would typically have no ongoing payments to the cap provider. Cap protection could be put into place for an up-front premium payable to a bank cap provider on the back of a simple trading confirmation.

In today’s new interest rate environment, “interest rate swaps” are back and have resumed their position as a central feature of most lending transactions – whether syndicated, club deals or simply a bi-lateral loan. Lenders are once again approaching loan transactions with the clear expectation that a borrower will hedge any variable interest rate exposure. Typically, the lenders will require the borrower to fix its interest rate costs for the full term of the loan. As in the past, one or more of the lenders (unless they are all alternative capital providers, in which case a third-party provider may be required) will generally step up to the role of "hedging bank" at the outset of the deal and provide interest rate swaps documented under an ISDA Master Agreement. The hedging banks will propose interest rate swaps reflecting the implementation of a hedging strategy and hedging coverage ratios specified in the financing documentation.

In a swap transaction the borrower typically pays the hedging bank a fixed rate of interest in return for the hedging bank paying the borrower a variable rate based on a specified market index which reflects the variable rate of interest payable on the related lending transaction. The notional amount of these swaps will also reflect an agreed percentage or ratio of the principal amount borrowed under the loan documentation.

The hedging component of a lending transaction raises a host of legal, commercial and risk issues to which counsel for both the lenders and hedging banks must be attentive. This article provides an overview of the relevant legal and documentation issues arising from the hedging and lending relationship in commercial lending.

**THE COMMERCIAL CONTEXT**

**Pari passu in principle**

The combined package of lending and hedging transactions has traditionally been constructed on a *pari passu* basis in payment waterfalls both prior to and after the occurrence of an event of default. The *pari passu* objective includes ensuring that the hedging banks benefit from the collateral security package on a pro rata basis in the event of enforcement. The intercreditor provisions or, if applicable, a separate intercreditor agreement, will generally reflect the *pari passu* position of the hedging banks. On their face, contractual provisions reflecting a *pari passu* position for both the lenders and hedging banks ostensibly reflect a balanced position. The relevant contractual provisions, however, should be carefully drafted so as to ensure the lending and hedging parties maintain a balanced approach even in the face of economic challenges to the credit transaction.

**Potential economic divergence**

Despite the *pari passu* approach under documentation, differences exist in the economic nature and related risks of a hedging transaction versus a loan transaction. This gives rise to issues which should be considered in preparing a hedging strategy and crafting the related documentation.

In the case of a swap transaction, a hedging bank’s risk exposure to its borrower counterparty will potentially decline simply with the passage of time as the parties approach the termination date – with each coupon payment that is made, a swap transaction is in effect economically amortising as it approaches the swap termination date. In a loan transaction, the lender’s risk exposure is tied to the outstanding principal amount of the loan. Unless a loan is substantially amortising over its life (rarely the case in big-ticket financings), the lenders face a large credit exposure up until the due date for a bullet repayment at the end of the loan.

On the other hand, a hedging bank’s credit exposure to the borrower will also be determined by volatility in interest rates in the market generally and the risk of an unforeseen rise or fall in interest rates. Specifically, a hedging bank will evaluate its counterparty risk on the basis of its daily marked to market exposure of the value of the instrument. In contrast, the lenders will always know the amount of the outstanding principal amount of a loan and, therefore, their maximum credit exposure to the borrower.

On a commercial level, if a hedging bank is also a senior lender and its position...
in the overall hedging transaction is proportionate to its participation in the loan transaction, the differing perspectives between the two desks within the same institution are typically not brought to light given the economic balance of such a transaction for that party. However, when the hedging bank’s exposure under the swap is considerably disproportionate to its participation in the loan (or indeed if it is not a lender) – each element of the intercreditor provisions organising the relationship between the hedging banks, on the one hand, and the senior lenders, on the other hand, may become a battlefield. This dynamic underscores the importance of having counsel review the documentation from both the hedging bank’s and the senior lender’s perspective and, to the extent possible, involving separate legal teams for the two sides.

**ACHIEVING THE RIGHT BALANCE: DOCUMENTATION**

Against the backdrop of the differing economic and commercial perspectives between lenders and hedging banks in syndicated loans, a fair balance of interests between these two groups would certainly be in the interests of the borrower. More generally, the smooth operation of the credit over the life of the loan notwithstanding changes in the economic or commercial environment would generally be in the interests of all parties to a credit transaction. This may be achieved at the outset of a deal by anticipating and addressing the potential issues in, on the one hand, the senior loan documentation (senior facility agreement and often a separate intercreditor agreement) and, on the other hand, the relevant ISDA Master Agreement documentation governing the hedge transactions.

We address below the key provisions for careful consideration. Where there are only senior loan facilities and the hedging banks are party to the loan agreement (either from the outset or by way of a later accession), the intercreditor provisions are commonly included in the loan agreement itself. Where there is a more complex capital structure (eg both senior and mezzanine facilities, as well as hedging transactions) and/or the hedging banks are not party to the loan agreement, a separate intercreditor agreement is frequently required. From a legal perspective, it does not matter where the relevant contractual provisions are set out, provided that all of the relevant parties are bound by their terms. It may be, therefore, that the issues set out below under the heading of Syndicated Loan Agreements are in fact dealt with in an Intercreditor Agreement, or vice versa.

**Syndicated loan agreements**

Syndicated loan documentation, whether under the LMA or LSTA form agreements, provides a framework for discipline and collective action among the lenders acting through the facility agent. Although the hedging banks are typically referenced in the loan agreement, and are sometimes party to it, they are generally not subject to the loan agreement’s framework for collective action. Most notably, for example, the hedging banks will usually receive or make payments directly with the borrower and not via the facility agent. Nevertheless, at the outset of a deal, the lenders and hedging banks are advised to seek to incorporate a number of contractual provisions which can help ensure consistency in actions, even during difficult times. While this may be accomplished in a broad-brush fashion by designating a hedging bank as a “Finance Party” and the hedging agreement as a “Finance Document” under the loan agreement, specific noteworthy points should include the following:

- **Default events**: Loan agreement default provisions are generally carefully negotiated, including elements such as grace periods. As a consequence of this negotiation, they are likely to differ from the standard “boilerplate” Events of Default contained in the printed form ISDA Master Agreement. The parties should ensure that the loan agreement and hedge agreement events of default are aligned so that the triggers for the parties to be able to take any action are the same, or only differ in clearly agreed circumstances reflecting the different economic positions of the parties (eg a hedging bank may want to be able to crystallise its exposure to the borrower in a market where the interest rates are rising, even if there has been no event of default under the loan agreement).

- **Voting rights**: The loan agreement may grant some or all voting rights to the hedging banks. This may depend upon whether hedging banks are required to be lenders and, as a contractual matter, may be captured through the loan agreement’s defined term for a “Finance Party”. Generally, the voting rights of a Finance Party are designed to take into account the outstanding principal amount of a senior lender or the mark-to-market value of the hedging transaction in respect of a hedging bank, so that the hedging bank’s position is weighed into the decision-making process. It is not uncommon, however, for a hedging bank’s voting rights only to become “live” when it has actually crystallised the mark-to-market value of the instrument so that there is a “Close-Out Amount” which is due.

- **Information reporting**: The hedging banks may reasonably seek provisions which obligate the facility agent to furnish them with the same level of financial and other information as the senior lenders are entitled to receive from the borrower.

- **Notices**: Hedging banks may also seek provisions which ensure that the facility agent furnishes them with all notices and related communications from the borrower or the lenders including notices related to defaults or early payment events.

- **Amendments**: Lenders may seek to restrict the ability of the borrower and/or hedging banks to amend the terms of the hedging arrangements without the consent of the facility agent (acting on behalf of the lenders). This is aimed at ensuring that the commercial deal does not change substantially from that which was in place when the respective priorities, rights and obligations of the parties were negotiated.
**Intercreditor provisions**

Intercreditor provisions primarily regulate the respective priority of the rights of different creditors against a debtor. They frequently, however, also govern the way in which the relevant creditors can exercise their various rights both before and after a default situation, and sometimes include provisions obliging creditors to act in particular ways. The key provisions where the creditors are a mix of lenders and hedging banks are as follows:

- **Termination of hedge transactions:** Provisions will generally limit a hedging bank’s right to terminate its hedge position and receive a termination payment pre-enforcement. As insolvency laws in many jurisdictions now provide for “safe harbour” enforceability of derivative contract netting provisions, the practical effect for a hedging bank’s position, absent contractual limitation, would be to give the hedging bank a priority position over the lenders against a distressed borrower in the event of insolvency. Accordingly, lenders may seek to prevent the hedging banks from terminating, demanding payment, and enforcing any collateral security under the hedge agreements at any time prior to enforcement by the lenders. On the other hand, the hedging banks will understandably want the flexibility to limit their marked to market exposure under the swap. As mentioned above, this may lead to a compromise position in which the hedging banks are allowed to “crystallize” their exposure in certain limited circumstances such as a failure to pay under the hedging transaction, while accepting limitations on rights to receiving payment or enforcing collateral security or margin and being bound by the collective action rules applicable to all the Finance Parties.

- **Payment waterfall:** Hedging banks should carefully consider their position in any post-enforcement payment waterfalls under the loan agreement and particularly relative to the lender group. If there is an enforcement situation, it is extremely likely that there are insufficient assets to meet all of the borrower’s liabilities, so how they are allocated becomes of great importance.

- **Limitations on set-off rights:** Limitations upon the lender group to exercise set-off rights absent collective action may apply to a lender which is also a hedging bank and, depending on how the provisions are drafted, could arguably impact upon the netting provisions of an ISDA Master Agreement as well as any separate set-off rights which a borrower may have agreed upon under an ISDA Master Agreement. Any provisions in a loan agreement relating to set-off rights should be carefully reviewed for consistency with a hedging bank’s payment netting, close-out netting and set-off rights under the ISDA Master Agreement.

- **Voting rights:** As mentioned above, the loan agreement may grant hedging banks certain voting rights. In transactions with more complex capital structures, the intercreditor agreement may well include distinctions between the voting rights of “Senior Creditors”, which would typically include hedging banks, and those of the “Senior Lenders”, with certain decisions needing different approval rights.

- **Waivers/amendments:** Again as mentioned above, if the “day one” rights and obligations of the parties are negotiated on the basis of a particular set of commercial circumstances, the parties will want to restrict the ways in which those circumstances can be changed during the life of the transaction. Typical intercreditor provisions would therefore not only restrict the amendment of certain key commercial terms (such as the principal amount of the loan, the margin payable and/or the notional amount of the hedging transactions) but also the extent to which creditors can waive their rights under the relevant documents. If, for example, a lender agrees to postpone or even waive repayment instalments which have been “matched” in the profile of the hedging arrangements but not postponed or waived by the hedging bank, this can shift the commercial balance between the creditors. In a different scenario, the lenders may be amenable to waiving an event of default under the loan agreement if they consider that the borrower is still fundamentally able to perform its obligations, but if the hedging banks choose not to grant that same waiver (perhaps because interest rates have risen considerably), then the lenders may be forced into a restructuring by a default under the hedging. The intercreditor agreement will usually provide for what types of waivers and amendments are permitted without the consent of other class(es) of creditors, and also whether there are circumstances in which a waiver by one type of creditor will constitute a waiver by all other types.

- **Enforcement:** The economically different positions of lenders and hedging banks highlighted above means that the parties may wish to take different approaches to enforcement where there is an issue with the credit arrangements. The finally agreed position for any transaction will inevitably reflect the negotiations between the parties, but it is not unusual for the enforcement rights of creditors to differ depending on the nature of the event which gives rise to the enforcement right – for example an illegality may well be treated differently from an insolvency, a non-payment from a breach of a financial covenant. As alluded to above, sophisticated parties will also consider situations where one type of creditor is entitled to require another type to take enforcement action so that everything is resolved at the same time. The key point for the smooth running of what may well be a relationship which runs for several years and through differing economic situations, is for the parties to have carefully considered the position at the time of negotiating the documents and
agreed a balanced approach which covers all of the reasonably likely scenarios.

**ISDA Master Agreement**
- **Prepayment and repayment events**: Under a loan agreement, prepayments may be mandatory or voluntary and may be for all or a portion of the loan. Hedging banks and their counsel should ensure that prepayment and repayment events under the loan agreement allow a commensurate reduction in the notional amount of the swap transaction or a complete termination if a full payment is made. If this is not addressed, the comparative economic positions of the lenders and the hedging banks which was assumed at the start of the transaction and which will therefore have informed the negotiation of their respective rights and obligations, will most likely change upon any such prepayment or repayment. This risks one or the other group of creditors finding themselves in an unexpected position. It is customary to include a provision in the ISDA Schedule providing for a reduction in the notional amount which reflects periodic amortisation or permitted prepayments. Generally, in such cases, the hedging banks will have priced the swap transaction at the outset so as to take account of foreseen amortisation repayment events. Otherwise, the reduction in notional amount would justify a marked-to-market settlement for amortising amounts and the hedging banks will want to control the timing and calculation of such settlement amounts.
- **Security package**: Hedging banks and their counsel should carefully consider the coverage of the security package. This includes verification that each facility under a loan agreement is secured equally and whether the hedging banks benefit from the full security package. Based on this assessment, counsel to the hedging banks need to reflect the security position in the ISDA Schedule including appropriate references to “Credit Support Documents” and “Credit Support Providers” and to ensure that in the security documents, the secured obligations and the beneficiaries cover properly any obligations, present or contingent, due by the borrower to the hedging banks under the hedging transactions.
- **Conflicting agreement clauses**: Both the loan documentation and the hedge documentation should reflect a consistent position in the event of a conflict of terms among the principal finance documents – the loan agreement, any intercreditor agreement and the swap agreement. Most often, the loan agreement or the intercreditor agreement is stated as the prevailing agreement in the event of inconsistencies.
- **ISDA Master Events of Default**: ISDA Master Agreements contain a classic but thorough set of contractual events of default which, as a substantive matter, are generally within the contractual events of default in a loan agreement. As mentioned above, these should be largely aligned to the events of default in the loan agreement, or any discrepancies should be deliberate ones!

**CONCLUSION**
Consistency and alignment in lending and hedging documentation will go a long way in addressing the potential tensions between lenders and hedging banks in a credit transaction. At the heart of these contractual provisions, however, must be a clear understanding, at the outset of a deal, of the economic risks and commercial objectives of the parties. This requires a recognition that the lenders and the hedging banks may well be in different economic positions and cannot simply be treated as “Finance Parties” whose interests are automatically aligned. This common understanding will then inform the parties over the life of the deal including new lenders who may trade into the transaction. Moreover, in the face of unforeseen market and commercial events which may adversely affect the borrower, this approach will ensure that the lenders and hedging banks, together with their counsel, adopt a unified and consistent strategy in navigating through any difficult times.