Feature

KEY POINTS

- One effect of the continued development of non-bank lending has been to open for discussion and negotiation the ranking of hedging liabilities within the creditor group.
- Hedge counterparties can expect to have very limited scope for directing the enforcement strategy provided they are continued to be paid any periodic payments due under their hedging agreements.
- Even in a distressed scenario, the borrower will be permitted to make payments under its hedging agreements to avoid a payment default under the hedging agreements.

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Hedging in loan transactions

In this article, Toby Hewitt and Alistair Hill consider how recent market developments are forcing hedge counterparties and lenders to re-examine their positions.

The recent restructuring of the Theatre Hospitals CMBS demonstrates once again the critical role that hedging liabilities can play in the restructuring of loan transactions. Despite this experience, the intercreditor provisions in finance documents determining the ranking of hedging liabilities, and the rights of hedge counterparties, are not always rigorously analysed or negotiated by creditors or their legal counsel. However, the experience of post-financial crisis restructurings and the continued rise of new lending structures have led both creditors and hedge counterparties to re-examine the previously accepted norms.

We consider below the traditional position of hedging liabilities in European leveraged loan market transactions, some of the factors which are of critical importance to both hedging providers and the other transaction participants and tentatively suggest some areas of future development.

BACKGROUND

It is customary in leveraged loan transactions to require the borrower to enter into hedging in respect of a minimum proportion of its term facilities in order to mitigate against upward interest rate fluctuations and/or adverse exchange rate movements. Where this is the case, the lenders will require any parties providing the relevant hedging (ie the hedging counterparties) to be party to the intercreditor arrangement governing the relationship between the various creditors to the borrower because, depending on the fluctuation in the hedged rates, the borrower may incur payment obligations to the hedge counterparties.

Such payment obligations can be significant and the other creditors will therefore be concerned to ensure that the ranking and priority of any hedging liabilities *vis-a-vis* the other lenders are regulated via the intercreditor agreement. For their part, the hedging counterparties will want to benefit from the transaction guarantees and security granted by the borrower for amounts that may become owing to them. For these reasons, any hedging counterparty will be party to the intercreditor agreement in its capacity as a hedge counterparty even if it is already party in another capacity.

HEDGING TERMS

The basic hedging requirements are normally agreed between the borrower and its lenders at the time the loan is entered into pursuant to a hedging strategy letter. Traditionally, such a letter would prescribe:

- the minimum amount of the term debt required to be hedged;
- the minimum term of such hedging; and
- the process for selecting the hedge counterparties to provide the required hedging.

In the past, hedging strategy letters have frequently left the maximum hedging term to the borrower's discretion. In certain circumstances, this allowed borrowers to enter into swaps with terms significantly exceeding the term of the debt facilities (so called, long-dated swaps) in order to benefit from better hedging rates. This practice has, on occasion, proved hugely problematic in work-out scenarios where the nature of the long-dated swaps has resulted in a situation where the borrower would incur very significant liabilities in the event that the swap is terminated upon an enforcement (in the recent Theatre Hospitals restructuring, for instance, the mark-to-market swap liability at the time of the restructuring was reportedly in excess of £600m). As we shall see, the ranking of hedging within the capital structure means that the crystallisation of significant hedge liabilities has the potential to cause unique issues upon any subsequent work-out of the debt facilities.

RANKING

Traditionally, it was taken as read that hedging liabilities would benefit from the guarantees and transaction security and would rank *pari passu* with the senior lenders' debt. This reflects the position adopted by the Loan Market Association precedent intercreditor agreement for leveraged acquisition finance transactions (LMA Intercreditor Agreement) where the hedging liabilities rank *pari passu* with the senior facility liabilities (ie the claims of the senior lenders and the senior administrative parties, such as the senior facility agent). Such an approach reflects the fact that historically hedging was typically provided by the senior lenders who expected their hedging liabilities to rank alongside their senior debt.

The emergence of non-bank lenders (who often have little capacity or interest in providing hedging) has fundamentally altered this dynamic. Whereas traditionally the senior debt was provided by banks, the period following the financial crisis has seen the continuing growth of senior debt products provided by one or more non-bank lenders. In these transactions the bank role may be limited to providing the revolving credit facility (RCF) which is typically provided on a super-senior basis (ie ranking ahead of the term debt which is itself senior to other liabilities of the borrower). In these circumstances, whilst the hedging will continue to benefit from the transaction guarantees and security, the ranking of the hedging liabilities is a matter of negotiation between the non-bank lenders and the bank RCF provider (with typically a portion of the hedging liabilities ranking *pari passu* with the super-senior RCF whilst the remainder ranks *pari passu* with the term debt provided by the non-bank lenders). One effect of the continued development of non-bank lending has therefore been to open for discussion and negotiation the ranking of hedging liabilities within the creditor group.

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PAYMENT WATERFALL

The ranking of the hedging liabilities will need to be reflected in the payment waterfall which determines the order in which the security trustee applies recoveries received in connection with the realisation or enforcement of all or any part of the transaction security. The payment waterfall is invariably key in determining the relative rights and commercial negotiating position of the different creditor groups on any work-out and care should be taken to ensure that it clearly reflects the proposed ranking of the different liabilities (including the hedging liabilities) and the intention of the commercial parties. This aspect of the intercreditor documentation has been subject to increased focus following numerous post-financial crisis restructurings where the payment waterfall failed to reflect the expectations of the original transaction participants.

The position of hedge liabilities at (or near) the top of the waterfall is potentially critical in determining the shape of any subsequent restructuring particularly if movements in the underlying hedged rates have resulted in those liabilities, if closed-out, being substantial. As we shall see, the ability for hedge counterparties to crystallise or close-out liabilities under their hedge agreements (and thereby crystallise a claim at the top of the payment waterfall) will be a key consideration in an enforcement or work-out scenario.

ENFORCEMENT INSTRUCTIONS

A critical question for the transaction participants when negotiating intercreditor terms is how, and by whom, an enforcement or work-out strategy should be devised and implemented following the occurrence of an event of default under the finance documents. Prior to the financial crisis, the guiding principle was that this would be in the hands of the senior lenders subject to any subordinated or mezzanine lenders having certain protective rights such as the right to make cure payments, buy-out the senior debt or take enforcement action if the senior lenders fail to do so within a specified time period.

Importantly, although hedge counterparties will usually benefit from the transaction security and guarantees, they are not typically included within the creditor group empowered to instruct the security trustee to enforce the transaction security except to the extent that they have crystallised their hedging claims by terminating or closing-out the relevant hedging (no account is taken, for instance, of any mark-to-market calculation of the outstanding hedging liabilities when determining the instructing group). The circumstances in which the relevant hedging agreements can be terminated are therefore crucial in determining when (and to what extent) the hedge counterparties can influence the instructions to be given to the security trustee. As we shall see below, there are in fact limited circumstances in which hedge counterparties can terminate/close-out the hedging required under the hedging strategy letter. The implication of this is that hedge counterparties can expect to have very limited scope for directing the enforcement strategy provided they are continued to be paid any periodic payments due under their hedging agreements. Whilst this remains the prevalent market position, it presents an unsatisfactory position for hedge counterparties with substantial exposures.

In such circumstances, there is the potential for a divergence of interests between hedge counterparties and senior lenders – hedge counterparties may wish to crystallise their exposure and benefit from their priority ranking whilst the senior lenders are incentivised to ensure that the hedging liabilities remain outstanding and uncrystallised. Going forward hedge counterparties may increasingly explore ways in which they can greater influence work-out situations, particularly in transactions where they have little representation in the other creditor classes. It remains to be seen how other transaction participants respond to any such development.

EARLY HEDGE TERMINATION

Traditionally, senior lenders have been incentivised to ensure that hedge counterparties are not able to terminate hedging agreements even after the occurrence of an event of default under the finance documents because any such termination would:

- expose the borrower (and ultimately the lenders) to interest rate and, if applicable, exchange rate risk; and
- crystallise a hedging liability at the top of the payment waterfall and, importantly, mean that the hedging liabilities would be included for the purposes of determining the creditor group empowered to instruct the security trustee upon an enforcement.

As a result, in practical terms, the hedging provisions in the LMA Intercreditor Agreement mean that the hedge counterparties' ability to terminate the hedging prior to an acceleration of the lenders' debt or an enforcement of the transaction security are extremely limited unless there is a payment default under the applicable hedging agreements or an insolvency of the borrower.

Importantly, the payment provisions of the LMA Intercreditor Agreement are structured to ensure that scheduled payments under the hedging agreements are permitted and that, even in a work-out scenario, the borrower is allowed to keep the hedge liabilities paid current. This will mean that, even in a distressed scenario, the borrower will be permitted to make payments under its hedging agreements in order to avoid a payment default under the hedging agreements. Indeed, it is frequently in the interests of the other creditors to ensure that the borrower continues to make such payments to avoid triggering an ability on the part of the hedge counterparty to terminate/close-out the hedging.

CONCLUSIONS

Whilst the intercreditor agreement terms dealing with hedging liabilities remain relatively under considered or negotiated, developments in the market have resulted in both hedge counterparties and lenders examining their positions afresh with a view to ensuring that the terms remain fit for purpose. We would expect this process to continue. ■

Further Reading:

- Reserve based lending and commodity hedging [2013] 7 JIBFL 431.
- Punch Taverns' successful restructuring of £2.2bn of whole-business securitisation debt [2015] 2 JIBFL 107.
- LexisNexis Loan Ranger blog: Bank lenders and internal swaps.