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Know Your Limitations

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Plus 2017 Delaware Trust Conference Section!

Lending Law Update

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Hedging Interest Rate Risk – "The Good, the Bad and the Ugly"

In the commercial lending world, both lenders and borrowers have a significant aversion to interest rate risk. Most lenders do not wish to maintain and hold loan obligations in their portfolio with fixed rates of interest, simply because the yield on the money lent may be higher or lower depending on market conditions. The opposite holds true for borrowers who seek to avoid rising interest rates that occur with variable rate loans. To manage this risk, the financial markets have developed derivative products called "swaps" or "hedges" that are designed to reduce risk. Interest rate swaps ("Swaps") are commonly used with commercial loans and obligations that are pegged to variable rates. The use of Swaps can be very beneficial but they also can have undesirable results if the parties are not cognizant of the good, the bad and the ugly as described below.

The "good" occurs when interest rate risk is bargained away through a Swap. In a rising interest rate environment, a borrower becomes protected with a fixed rate that can be counted on for the term of the loan. It can be a win-win situation if both the lender and the borrower get exactly what they want in negotiating the structure of the transaction.

The "bad" arises when a borrower does not understand that a Swap is a separate obligation apart from the loan. Notwithstanding this separateness, many Swaps are integrated as obligations that are required to be paid as part of the underlying loan and are sometimes secured by the same collateral as the loan. Thus, while a particular promissory note may permit prepayment, a Swap, on the other hand, may require that such a prepayment create a termination event which entitles the holder of the Swap to a breakage or termination fee. Moreover, many Swap obligations are cross-defaulted and cross-collateralized with all of the borrower's underlying debt to a particular lender. Therefore, the parties need to be acutely aware of all loan requirements along with any events which could trigger termination fees and/or prepayment penalties under the Swap.

The "ugly" rears its head when the parties do not comprehend the full implications of the underlying note and Swap obligations. For example, in a recent case entitled *Compass Bank v. Durant*, (2017 TEX.APP.LEXIS70) (dated January 5, 2017), the Second District Court of Appeals ruled that both a prepayment penalty and a termination fee were enforceable against a borrower notwithstanding the borrower's ignorance or lack of sophistication in understanding the Swap transaction. The contentious litigation that ensued could have been avoided if the parties had consulted with the proper professionals before entering into the Swap transaction.

Both lenders and borrowers should be fully apprised of the implications of undertaking a Swap transaction in a commercial loan. It is critical that the underlying terms and conditions upon which payments are made or will be prepaid are fully understood and vetted; otherwise there could be disastrous consequences for all parties involved in the transaction.