

An Introduction To Interest Rate Hedging In Commercial Real Estate Loans (With Model Hedge Pledge)

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Volatile interest rates are a fact of life. That's why commercial mortgage lenders want interest rate protection. And here is how they obtain it.

A COMMERCIAL MORTGAGE LOAN (a “Loan”) often bears interest at a floating rate. That rate can rise dramatically at any time. But the rental income of the property owner (a “Borrower”) will change only gradually over time. In the worst case, a spike in interest rates can drive a Loan into early default. If the collateral does not yet produce income, as in the case of a construction loan, interest rate volatility can instead exhaust interest reserves or budgets faster than anticipated, creating similar problems.

To mitigate that risk, a real estate lender often requires its Borrower to enter into a third-party contract to protect the Loan from interest rate volatility. (Even if a single lender makes and intends to hold the Loan, the Loan documents will often identify the lender as “Administrative Agent” for a group of lenders, just in case the original lender decides to syndicate the Loan later.) By obtaining such a contract, Borrower and Administrative Agent can mitigate one source of uncertainty, surprises, and premature default for the Loan. The market calls any such arrangement a “hedge” against interest rate volatility (a “Hedge”).

HOW HEDGES WORK • A Hedge represents a form of “derivative contract,” an agreement whose value varies depending on the value or amount of some underlying index, here an interest rate. In commercial real estate finance, the most common Hedge consists of a “rate cap.” When Borrower purchases a rate cap, the “issuer” of that rate cap, often called a “counterparty” (the “Counterparty”), in effect issues an insurance policy. That policy protects against the risk that some specified interest rate (typically some subspecies of the London Inter-Bank Offered Rate—“LIBOR”) will rise above a specified level (the “strike price”) during a specified period. Like a fully paid insurance policy, the rate cap protects both Borrower and Administrative Agent from a risk—in this case, the risk of an increase in interest rates that could otherwise cause a premature default.

Hedges have traditionally appeared in commercial real estate transactions primarily to mitigate interest rate risks. Given the pace of new product development in the derivatives markets, Hedges may soon mitigate other risks in real estate transactions. For example, a Counterparty might issue a Hedge to protect against the risk that average Class A office building rents in Midtown Manhattan (as evidenced by an authoritative third-party index) will drop below \$x per foot during the next y years (or as of a particular date when leases will roll over) for a notional amount of rentable space equal to z square feet. For a good thumbnail summary of how this might work in the residential market, see James Surowiecki, *Through the Roof*, The New Yorker, May 8, 2006, at 28. To the extent that property owners purchase such Hedges and other similar products, they will reduce their real estate risks and also reduce their overall returns, a transaction that some property owners will like and some won't. Similar products may find their way into residential real estate. Now that homeowners and “flippers” have learned that markets can go down as well as up, they may want to hedge their bets on real estate

values in the next cycle. The derivatives market may eventually give them a product to do it, such as a “floor” contract to protect against price declines below a certain point (again based on a third-party index). Similarly chastened (or nationalized or at least more closely regulated) residential mortgage lenders may eventually demand such protection.

Rate Caps

For a typical floating-rate Loan requiring a Hedge, Borrower buys a rate cap and pledges it to Administrative Agent as additional collateral. At closing, Administrative Agent will want to confirm that the purchase of that rate cap (including payment) has actually occurred. Issuing any Hedge at closing is, however, not as easy as it sounds. Borrower typically does not resolve its hedging strategy until the last minute before closing. It then conducts an auction after the last minute. Though the Hedge will typically already represent a legally binding obligation of the parties, the Hedge documents will usually not be ready for closing. They become a post-closing loose end, sometimes requiring more time to tie up than one might intuitively expect. The last-minute nature of any hedging strategy arises less from Borrower irresponsibility or incompetence than from Borrower's desire to: (a) minimize the risk of obtaining a Hedge for a Loan that might not close; and (b) respond to the interest rate environment at the precise moment of closing.

Once Borrower has purchased a rate cap, if rates rise beyond the strike price in the rate cap, Counterparty must cover the resulting extra interest expense, thus protecting the Loan from possible stress and default. Like an insurance policy, any Hedge expires on a certain date, typically Loan maturity. If at that point interest rates are so high that values have dropped and Borrower cannot sell or refinance, a typical Hedge will not protect anyone from that risk, even though that risk ultimately arises from changes in the interest rate environ-

ment. The Hedge protects only each month's interest payment.

One could undoubtedly sculpt (and pay a high price for) a Hedge that would cover the interest-rate-environment component of maturity risk. Such Hedges are not (yet) used in real estate, though the Hedge market seems to be moving toward offering such products. Thus, a traditional interest rate Hedge mitigates only part of the interest-rate risk, leaving the most blatant part of the risk—the potential brick wall of inability to refinance because of generally higher interest rates—entirely unmitigated. An interest rate Hedge will also do nothing to mitigate the risk of a “frozen” credit market at maturity.

The extent of coverage under any Hedge depends on the hypothetical principal amount for which Borrower bought interest rate protection—the “notional amount” of the Hedge. A Hedge could cover interest rate exposure on only some part of the outstanding principal balance, much like an insurance policy that has a high deductible or high self-insured retention. The parties will determine the notional amount of the Hedge accordingly. The notional amount can drop over time based on anticipated amortization. That notional amount will typically far exceed either party's likely dollar exposure under the Hedge. If a reporter adds up the total notional amounts of all Hedges outstanding, and ignores the fact that many Hedges offset one another and thereby reduce risk rather than increase it (assuming all Counterparties perform their obligations), this will very quickly produce a very large number, suitable for headlines.

If the Loan goes into default and Administrative Agent forecloses, then at the foreclosure sale the high bidder will expect to acquire, among other things, the remaining term of the Hedge, which will continue to mitigate interest rate volatility and could represent a valuable asset. That transfer of the Hedge should occur because Administrative Agent's collateral will typically include the Hedge,

just as it includes leases, construction contracts, hotel management agreements, and other valuable rights not constituting real property.

Swaps

A rate cap creates a problem for any Borrower closing a Loan: Counterparty will want Borrower to pay a purchase price for the rate cap in advance, just like an insurance premium, but Borrower will probably want to do everything possible to conserve cash. The Hedge market offers any Borrower an alternative: an interest rate “swap.” Here, Counterparty agrees to cover Borrower's floating rate interest payments to Administrative Agent, and Borrower agrees to pay fixed-rate interest to Counterparty on the same principal amount.

In a typical swap, Borrower need not pay any purchase price at closing, because Counterparty sets the fixed interest rate at a level where Counterparty is just as happy to pay that fixed rate as the floating rate. (Counterparty is not entirely indifferent, of course, because Counterparty's all-in pricing for a swap builds in some profit above and beyond pure compensation for assuming interest rate risk and credit risk.) At any particular moment, the “swap rate” means the fixed rate of interest that Counterparty would swap for the particular floating rate index for the particular period. For example, if at a particular moment Counterparty would swap 30-day LIBOR (i.e., a LIBOR rate that adjusts every 30 days based on the current market) for three years for a five percent fixed rate of interest for the same period, then the “swap rate” for 30-day LIBOR for three years is five percent.

If Borrower enters into a swap and then floating rates rise, Borrower will happily watch Counterparty pay a floating rate while Borrower continues to pay a fixed rate. (Typically, Counterparty will “net” the two payment streams against one another, paying Borrower, or Administrative Agent, only the floating rate to the extent it exceeds the fixed rate.) If, on the other hand, interest rates drop,

Borrower may at times regret having entered into the swap. Borrower may consider the swap a liability more than an asset. Under these circumstances, Borrower might in perfect hindsight have done better without the swap.

If interest rates drop but Borrower decides not to make the payments the swap requires, then Counterparty could declare a default and require Borrower to terminate and buy out the swap—i.e., in essence pay Counterparty whatever Counterparty would need to pay to buy an equivalent swap under market conditions at the time of default. If rates have fallen or the market thinks they will fall (further), that payment could become rather large.

As a variation on a swap, Counterparty and Borrower might enter into a “collar.” Here, Counterparty agrees to “cap” floating-rate interest at a certain strike price. At the same time, Borrower agrees that if the floating rate drops below a “floor,” then Borrower will keep paying the “floor” interest rate to Counterparty. Hedges of this type raise the same Borrower credit issues as swaps, with smaller exposures.

Security

Counterparty, fearing that Borrower will lack the inclination or ability to pay any termination payment, will probably require security. The only available security will probably consist of the same real property that secures the Loan. Counterparty will demand a mortgage on that real property. In a bankruptcy, Counterparty will become not only a competing creditor (bad news), but a competing creditor with security (worse news).

If Counterparty consists of exactly the same lender group that provided the Loan, this will mitigate any intercreditor issues. But it rarely happens. Instead, Counterparty will typically be just one of the lenders in the group that holds the Loan—most typically the “swap desk” of Administrative Agent. So Administrative Agent will hold an interest in the collateral potentially adverse to the lender group

as a whole, thus creating intercreditor issues that rarely receive the attention they merit.

The commercial real estate finance market has historically ignored these tensions, having had little experience with how they play out in a meltdown. Everyone has simply said Borrower’s mortgage also secures Borrower’s swap obligations. No one has wanted to talk about what that really means and, above all, who gets paid first if proceeds of a foreclosure sale will not cover everyone’s claims. For a more extensive discussion of these intercreditor issues, see Joshua Stein, *Model Intercreditor Agreement (Among A Lenders, B Lenders, and Swap Provider)*, 2 Bloomberg Corporate Law Journal 439 (Fall 2007). The market will probably soon start paying more attention to these issues.

Perhaps in part because of intercreditor issues, Loans require rate caps more often than swaps, even though Borrowers might prefer the latter to conserve cash. Swaps do often appear in these transactions, though. And sometimes Borrower’s hedging strategy will contemplate a combination of a rate cap and a swap. Thus, Administrative Agent will often need to consider the special issues of a swap.

Whether Borrower decides to hedge interest rate volatility through a rate cap or a swap, Administrative Agent will typically want to receive, as additional collateral for the Loan, a collateral assignment of Borrower’s interest in the Hedge (a “Hedge Pledge,” also known less melodically, but more typically, as a “collateral assignment of interest rate protection product”). This article offers a model Hedge Pledge, with footnoted annotations on how to use it and some issues it raises. That discussion focuses on syndicated Loans held for portfolio, rather than securitized Loans.

THE HEDGE PLEDGE • By obtaining a Hedge Pledge, Administrative Agent prevents Borrower from pledging or selling the Hedge to anyone else, and denies Borrower’s unsecured creditors the value of the Hedge in a Borrower bankruptcy. A

proper Hedge Pledge should also assure that: (a) Administrative Agent can control any payments Counterparty would otherwise make to Borrower; and (b) in a foreclosure sale, the collateral will include the Hedge, a contract potentially valuable to the foreclosure purchaser if interest rates have risen or the market expects them to rise.

To handle a Hedge Pledge correctly, Administrative Agent's counsel must understand how Hedges work, and the security issues they can create. The footnotes in the Hedge Pledge introduce these and other issues.

Terms

Some provisions in the model Hedge Pledge cover issues that a typical Hedge Pledge does not cover, but probably should. Most such provisions were inspired by the discussion in Mark A. Guinn & William L. Harvey, *Taking OTC Derivative Contracts as Collateral*, 57 *The Business Lawyer* 1127 (May 2002) ("Guinn & Harvey"). Other provisions of this model Hedge Pledge go into more detail than typical. Even so, this model Hedge Pledge uses fewer words than do many similar documents. Footnotes make this model document seem longer than it really is. This model Hedge Pledge also seeks to demonstrate the principles of "Plain English" in legal writing, which one can summarize as follows. Keep sentences short and simple. Use ordinary language. Write in the active voice. Don't use section cross-references. Set up and use good defined terms. (For more, visit www.real-estate-law.com, and click on "Better Documents.")

Beyond handling the Hedge Pledge, Administrative Agent's counsel also must review and consider—and often help define—the terms of the Hedge being pledged. Administrative Agent's counsel must confirm that the Hedge terms conform to the requirements and business negotiations of Administrative Agent's term sheet or commitment letter. The Hedge should deliver an interest rate protection package that precisely matches Ad-

ministrative Agent's expectations and Loan terms. For example, if the Loan defines the floating interest rate or business day in a certain way, the Hedge should define it the same way. If the Loan rounds the interest rate upward to the nearest 1/100th of a percent, then the Hedge must do the same. If the Loan treats payments made on a non-business-day in a particular way, then the Hedge must treat them the same way, paying special attention to the rather complex definition of "Local Business Day" that appears in a typical Hedge. If the parties negotiated the Loan documents to define a specific package of covenants and defaults, the Hedge should not add a new or different package of covenants and defaults, beyond any specifically necessary to implement the Hedge.

Understanding any Hedge requires reading and applying a set of mostly standardized documents issued by the International Swaps and Derivatives Association ("ISDA"). ISDA's documents use specific terms—indeed an entire language—not at all intuitive or familiar to commercial real estate lawyers. For more on these documents and the language in which ISDA wrote them, visit www.isda.org.

Securitization

If an originator intends to securitize its Loan, the discussion in this article should be supplemented by a careful review of rating agency expectations about Hedges, all extensively documented in the rating agencies' various commercial mortgage loan criteria. *See, e.g.*, S&P Questionnaire for Interest Rate Cap Agreements, Appendix IX, starting at page 189, S&P, U.S. CMBS Legal and Structured Finance Criteria, May 1, 2003 (the "S&P Cap Criteria"). S&P updates the S&P Cap Criteria from time to time, publishing each update on www.standardandpoors.com. *See also* www.moodys.com and www.fitchratings.com.

The S&P Cap Criteria, for example:

- Scrutinize the interaction between Counterparty cure periods and timely payment of bonds;

- Prohibit any Borrower events of default under a Hedge, except nonpayment;
- Focus on Counterparty credit quality;
- Severely limit any Counterparty “early termination” rights;
- Seek to eliminate any Borrower obligation to reimburse Counterparty’s enforcement costs;
- Require Counterparty to agree not to (help) initiate a Borrower bankruptcy proceeding for a specified period; and
- Require certain additional provisions for cross-border Hedges.

The S&P Cap Criteria and other rating agency requirements devote great attention to the possibility of a downgrade in Counterparty’s credit, potentially requiring delivery of collateral, a guaranty, or a replacement Hedge under these circumstances. (The notion of requiring a downgraded Counterparty to obtain a replacement Hedge seems unthinkable to many in the Hedge market. The structured finance market regards it as routine.)

In retrospect, the rating agencies may have systematically had their eyes on the wrong balls, but this probably represents another discussion for another day, and a discussion that goes far beyond this article.

In portfolio commercial real estate Loans, Counterparty will typically be an Affiliate of Administrative Agent or at worst a member of the lender group. Traditionally, in such Loans the parties have devoted little attention to the possibility of a credit downgrade for Counterparty. That seems likely to change.

Bidding Package

Once Administrative Agent’s counsel has approved the form of Hedge, Borrower should include that approved form in the bidding package it circulates to prospective Counterparties. That package should also define any other documents the parties will expect from Counterparty, particularly any opinions of counsel that Administrative Agent will expect, and the form of Hedge Pledge,

as negotiated between Borrower and Administrative Agent. Administrative Agent will want to approve the list of bidders in any Hedge auction.

Understand The Transaction

Even though the model Hedge Pledge offered below is intended to be “comment-proof,” any counterparty will probably have at least a few comments, at least on administrative matters and its own procedures. But this form of Hedge Pledge should provide a good start for the process.

Because we live in an era of caveats, disclosures, and risk management, no model document would be complete without a reminder of the following rather intuitively obvious propositions. This model Hedge Pledge comes with no guarantee or warranty and is offered “as is.” No representation is made that this document complies with law or is enforceable. It may or may not work for any particular transaction. It may omit important provisions or contain provisions that don’t work perfectly in all circumstances.

Every transaction, however “routine,” can and usually does raise its own unique issues, which may require extensive tailoring and thought, going beyond mere shoveling of words from one wordpile to another. Anyone using a model document must read and consider every word of it to decide what works and what doesn’t. In the case of this particular document, the drafter must also consider how this Hedge Pledge interacts with the Loan documents and the Hedge, and correct any anomalies or inconsistencies.

This Hedge Pledge should be used only by a competent lawyer with substantial relevant experience admitted to practice in the state whose law applies. Any nonlawyer should not use this Hedge Pledge in any transaction. Don’t believe everything you read, even less of what you hear. Look both ways before you cross the street; if you don’t, you might get run over by a bus. If it’s cold, wear a jacket. If you think it might rain, bring along an umbrella.

APPENDIX

Model Hedge Pledge

This COLLATERAL ASSIGNMENT OF HEDGE (this “Hedge Pledge”),¹ dated as of _____, 200__ (the “Effective Date”), is made by _____, a _____,² with an office at _____ (“Borrower”), in favor of _____, a _____, with an office at _____, as Administrative Agent for the Lenders³ (with its successors and assigns in that capacity, “Administrative Agent”). This Hedge Pledge defines certain capitalized terms used in this Hedge Pledge, but may use a capitalized term before defining it.⁴ An index of defined terms follows the signatures. Capitalized terms used but not defined in this Hedge Pledge shall have the same definitions as in: (a) the Loan Agreement⁵ dated as of the Effective Date (as amended from time to time, the “Loan Agreement”), among Borrower, as borrower; Administrative Agent, as Administrative Agent for the Lenders; and such Lenders; and (b) subject to clause “(a),” the Hedge.

1 In ordinary Hedge transactions outside real estate, the parties would rarely enter into a separate Hedge Pledge. Instead, the Hedge itself would address the same issues, perhaps with a brief acknowledgment of Administrative Agent’s role. As another variation, also eliminating a separate Hedge Pledge, Borrower and Administrative Agent might include the Hedge in an omnibus security agreement, covering other collateral as well. In real estate financing, however, custom and expectations seem to favor use of separate security agreement(s) for multiple separate pieces of collateral. If particular collateral involves a third party, Administrative Agent will often require a separate direct agreement with that party structured in a way that supersedes anything in the underlying agreement, thus simplifying Administrative Agent’s due diligence and closing process and conforming to the usual treatment of third parties in real estate transactions.

2 The Hedge Pledge should identify Borrower by its exact legal name. Instead of relying on Borrower for this information, Administrative Agent’s counsel should obtain a copy of Borrower’s file-stamped organizational certificate or, at a minimum, look up Borrower’s name online with the appropriate Secretary of State’s office. Administrative Agent’s counsel should use the same validated information for the UCC-1 financing statement.

3 If the Loan Agreement describes the lender group as, for example, the “Secured Parties,” then conform all references. The definition of Administrative Agent should conform exactly to the Loan Agreement. Again, use the same information for Administrative Agent’s UCC-1 financing statement.

4 This avoids any need to keep saying “(as hereinafter defined).” Even the explanatory sentence in text seems gratuitous, given the reference to the index of defined terms. But lawyers seem uneasy about these things.

5 Use the correct name of the document. Confirm that the Loan Agreement defines all capitalized terms used without definition in this Hedge Pledge. Here is a list of such terms (including some used only in footnotes): Administrative Agent’s Remedies, Affiliate, Agreement, Business Day, Collateral, Event of Default, Lender, Loan, Loan Documents, Mortgaged Property, Nonrecourse Clause, Obligations, Security Documents, and Termination Date. The Hedge will typically refer to or define these terms used in this article (including some used only in footnotes): Affected Party, Affiliate, Confirmation, Early Termination Date, Event of Default, Local Business Day, Master Agreement, Schedule, Termination Event, and Transaction. The 1992 ISDA Master Agreement (still sometimes used) defines these terms: First Method, Loss, Market Quotation, and Second Method. The 2002 ISDA Master Agreement defines the term Close-out Amount. Some terms, such as Affiliate and Event of Default, may have different definitions in the Loan Agreement and in a typical Hedge. To the extent a term defined in the Loan Agreement affects Counterparty, try to (re)define it in the Hedge Pledge, so a careful Counterparty won’t want to see the Loan Agreement.

1. Collateral Assignment.⁶ To further secure the Obligations,⁷ Borrower⁸ collaterally assigns and pledges to Administrative Agent, and grants⁹ to Administrative Agent a security interest¹⁰ in, all of Borrower's right, title, and interest (but not Borrower's obligations or liabilities), whether now owned or later acquired, now existing or later arising, in, to, and under the following (collectively, as amended from time to time in compliance with this Hedge Pledge, the "Hedge"), to benefit the Lenders:¹¹

1.1 Hedge Transaction(s). The interest rate cap, collar, floor, swap, swaption, forward foreign exchange transaction, currency swap, cross-currency rate swap, currency option, forward rate transaction, basis swap, interest rate option, other interest rate protection product(s) or agreement(s), other derivatives contract(s), option(s) to enter into any of the foregoing, or combination(s) of any of the foregoing,¹²

6 Each paragraph of this Hedge Pledge begins with a section number and a section heading. The text of this Hedge Pledge never refers to any section number, however. Section number cross-references, though common in legal documents, cause mistakes, waste time, and impede comprehension. A drafter can always prevent section number cross-references by using defined terms and other techniques.

7 The Loan Agreement should define "Obligations" broadly enough to pick up all obligations under this Hedge Pledge, all other Loan Documents and Security Documents, and of course the Loan Agreement itself. If the Hedge is a swap, then sometimes the "Obligations" will include Borrower's obligations to Counterparty under that swap, so the Security Documents (including this one) will secure not only the Loan but also the Hedge. If the Loan Agreement uses some term other than "Obligations" (e.g., the "Indebtedness" or the "Secured Obligations"), edit the Hedge Pledge accordingly.

8 Counterparty may issue the Hedge in the name of a Borrower Affiliate, not Borrower. This will create complexity and issues about the Hedge and the relationship between Administrative Agent and the Borrower Affiliate (e.g., suretyship issues). Administrative Agent should try to have the Hedge transferred or reissued to Borrower before the parties sign this Hedge Pledge. Administrative Agent's counsel should at least confirm that (a) the Hedge Pledge and UCC-1 financing statement correctly identify and bind all the right parties, and (b) any Hedge Payments cannot end up in the wrong place.

9 Just in case the Loan Documents do not otherwise adequately provide for Borrower's granting of a security interest in the Hedge, this Hedge Pledge includes explicit granting language, unnecessary if the Loan Documents adequately cover the point.

10 Administrative Agent must perfect this security interest. For that purpose, the UCC treats a Hedge as a general intangible (and, more specifically, as a payment intangible). Therefore, Administrative Agent will need to file a UCC-1 financing statement in the jurisdiction where Borrower is located under UCC § 9-307 (usually the jurisdiction of organization), identifying the Hedge as collateral and Administrative Agent as secured party. This is true even if Counterparty constitutes Administrative Agent or Administrative Agent's Affiliate. If the Hedge were a bank deposit in the same institution, entirely different perfection rules would govern. Use of those rules for a Hedge could produce disaster. The Loan Agreement, or some other document, should expressly authorize Administrative Agent to file a UCC-1 financing statement, perhaps even before the Effective Date. UCC § 9-309(2) may give Administrative Agent an excuse not to file. That section says a security interest in a payment intangible (e.g., a Hedge) is automatically perfected upon attachment if the payment intangible is not "a significant part of the assignor's outstanding accounts or payment intangibles." This analysis would argue that Borrower holds numerous other accounts and payment intangibles, making the Hedge only a small part of its universe of accounts and payment intangibles—not necessarily persuasive for a real estate Loan. The author would recommend saving this theory as a fallback for litigation if a particular Administrative Agent forgot to file a UCC-1 financing statement. No Administrative Agent should forgo filing based on UCC § 9-309(2).

11 One might regard the following litany of Hedge components as unnecessary and implied in any reference to the transaction identified in **Exhibit A**. But real estate lawyers know that a valid mortgage on real property doesn't always include the rental income from the real property or from business operations on the real property. And bankruptcy lawyers know that in a subordination agreement, "interest" might not really include all "interest." And a judgment will not bear interest at the contractually negotiated interest rate unless (and perhaps not even if) the parties expressly and very clearly provide for it. Hence, lawyers err on the side of overinclusion. Bad law makes longer documents.

12 This list does not cover all possible derivatives transactions, particularly those likely to arise outside real estate financing. ISDA has promulgated standard document formats for Hedges, vastly simplifying transactions that once required extensive negotiations, an extreme example of commoditization of legal work that started out as highly sophisticated and labor-intensive.

as described (or copies of which are attached) in Exhibit A,¹³ entered into with the counterparty(ies)¹⁴ identified in Exhibit A (the “Counterparty”);¹⁵

1.2 Confirmations. Only the confirmations and schedules listed in Exhibit A that Counterparty issued for the transaction(s)¹⁶ Exhibit A identifies (the “Confirmation(s)”);

ISDA offers its forms through its Web site, www.isda.org. As of 2008, some counterparties still use 1992 ISDA documents, but the market is migrating to ISDA's 2002 Master Agreement. ISDA documentation for any Hedge typically consists of some or all of these: (1) a Master Agreement; (2) a Schedule to the Master Agreement, giving details about the parties and other matters, and modifying some Master Agreement terms; and (3) a Confirmation to memorialize the terms of a specific hedging transaction. Item “1” is an ISDA printed form and quite standard. Item “2” reflects the tastes of each Counterparty's swap desk and legal department, overriding printed provisions in item “1.” Item “3” should precisely match the terms of the Loan being hedged, to assure that the Hedge delivers interest rate protection that exactly matches the interest rate risk exposure. A lender accepting a Hedge Pledge should review all three components, emphasizing the last. If a mortgage lender intends to securitize its Loan, it should also review the Hedge terms for compliance with rating agency requirements, which generally seek to eliminate any risk of an unexpected early termination of the Hedge. *See, e.g., S&P Cap Criteria*. Although this model Hedge Pledge seeks to cure the most common problems in Hedge documents, other issues could arise. Identify and fix them before closing; otherwise, don't close. For a discussion of how Hedges work and what a lender should look for, see Guinn & Harvey. Counterparties sometimes use non-ISDA Hedge documents, requiring greater scrutiny by all parties, particularly of definitions. The extra scrutiny will almost inevitably identify issues and problems and increase transaction costs.

13 Exhibit A can also become the collateral description attachment for a UCC-1 financing statement, subject to confidentiality concerns.

14 Even if Counterparty is the “swap desk” of the institution acting as Administrative Agent, Administrative Agent should deal with Counterparty as a third party. This would include, for example, asking Counterparty to review and comment on the Hedge Pledge. This approach recognizes that the lender group, rather than Administrative Agent, represents the “real party in interest.” It also imposes a healthy level of discipline and care. One could refer to Counterparty as “Issuer” of the Hedge. This seems particularly likely for a rate cap. For a swap, however, the parties stand on more equal footing, and it seems inappropriate to anoint either with the special status of “Issuer.” Some institutions use special-purpose subsidiaries to issue Hedges, backing them with a parent guaranty. Any such structure raises all the same credit, perfection, and due authorization and execution concerns as any other guaranteed obligation in a collateral package (*e.g., a major lease*).

15 For closing documentation and perfection of security interests, Administrative Agent should treat Counterparty as an independent third party, even if part of the same institution. Still, that institution's involvement in the transaction will usually give its swap desk an “inside track” to issue the Hedge. Also, if the Hedge is a swap, Counterparty will typically want security for Borrower's swap obligations, but a real estate Borrower typically can offer only one thing: the Mortgaged Property. Administrative Agent would probably not allow the Mortgaged Property to secure the swap unless an Affiliate of Administrative Agent, or perhaps of another lender in the Loan, had issued the swap. (These and many other issues go away with a rate cap.) Sometimes, Administrative Agent tries to require Borrower to use Administrative Agent's swap desk to purchase any Hedge. Any such requirement would typically not create “tying” issues under antitrust or banking law, unless Administrative Agent somehow has special market power, such as by offering a unique product that its competitors cannot reproduce. But see 12 U.S.C. § 1972(1) (prohibiting certain tying arrangements). As a compromise, Borrower may give Administrative Agent a limited advantage in the auction, such as a formal or informal right to match Borrower's best bid. Though Borrower may argue otherwise, any such matching right will probably not chill other bidders, as bidders can generate their bids quickly and easily by plugging numbers into their “modeling” software.

16 A single Master Agreement can cover more than one Transaction (as defined in the Master Agreement). A Hedge for a real estate single-purpose entity should, however, typically relate to only one Transaction. The Hedge documents should cover no other Transactions involving that entity or anyone else. For example, Administrative Agent should beware of references to Affiliates and netting of any obligations running from those Affiliates to Administrative Agent. For more on netting, see discussion of the Netting Waiver below.

1.3 Security. Any and all collateral supporting (and any supporting obligations for) Counterparty's obligations under any of the preceding Hedge documents;¹⁷

1.4 Rights and Remedies. All rights and remedies under any of the preceding Hedge documents, including any right (if one exists) to declare an Early Termination Date;

1.5 Hedge Payments. All payments that any of the preceding Hedge documents require or permit Counterparty to make, when and as such documents contemplate, whether upon termination¹⁸ or default (including default, cross-default, or early termination, a "Termination Hedge Payment"), or otherwise, but in all cases subject to and in accordance with the terms of such Hedge documents as affected by this Hedge Pledge (the "Hedge Payments");

1.6 Proceeds. All proceeds, as defined in the Uniform Commercial Code of the jurisdiction whose law governs this Hedge Pledge (the "UCC"), of any of the foregoing; and

1.7 Other. All rights of Borrower to receive, or otherwise relating to or arising from, any of the foregoing.

2. Counterparty Consent. Counterparty confirms that it has received notice of, and has consented to, this Hedge Pledge. Counterparty consents to any direct or indirect Transfer of the Hedge (an "Administrative Agent's Transfer") that: (a) results from (or in lieu of) Administrative Agent's exercise of any Administrative Agent's Remedies;¹⁹ or (b) is made by any transferee resulting from "(a)" or by any of its direct or indirect successors or assigns.²⁰

17 UCC § 9-203(f) and (g) provide for this result automatically, but security agreements nevertheless often provide for it by contract.

18 If the Hedge consists of a swap and it terminates because of Borrower's default, the amount of the Termination Hedge Payment will depend on the interest rate environment at the time, and the remaining life of the swap. This unpredictability creates a disconnect and a problem in any state that imposes a tax on mortgages, such as New York. In those states, a mortgage must secure a defined amount of principal. Real estate lawyers optimistically try to characterize swap termination payments as interest rather than principal, but the tax officials do not necessarily concur.

19 Define this term in the Loan Agreement to mean all rights and remedies of Administrative Agent and the Lenders, whether under the Loan Documents, at law (usually with a statement such as "including the UCC," as if "law" might not otherwise include the UCC), or in equity.

20 Standard ISDA documents (both 1992 and 2002 editions) prohibit assignment without the other party's consent. Even if Counterparty does not enter into an ISDA Master Agreement, the Hedge documents will often incorporate the ISDA Master Agreement by reference or by implication, including the assignment prohibition. That prohibition alone justifies using a Hedge Pledge with Counterparty's consent and acknowledgment -- the universal practice in these transactions. But what if the parties ignored the assignment prohibition in the Hedge? What if Administrative Agent cared only about being perfected in bankruptcy? Could the parties just go ahead with their business and not bother with Counterparty consent? Probably. Any Hedge will nearly always constitute a "payment intangible" under the UCC. Therefore, UCC § 9-406(d) should: (a) override Borrower's agreement with Counterparty not to grant a security interest in the Hedge, and hence (b) validate the security interest this Hedge Pledge creates. The "override" in UCC § 9-406(d) also extends to "enforcement" of the Hedge Pledge and hence any resulting Transfer of Hedge Payments—not just the mere grant of a security interest in the Hedge—which helps Administrative Agent. In contrast, if the Hedge were deemed only a "general intangible" and not a "payment intangible," then UCC § 9-408 would govern instead. The more limited override in UCC § 9-408 might not cover an outright Transfer of the Hedge Payments

3. No Impairment. Without Administrative Agent's prior written consent,²¹ which Administrative Agent may withhold for any reason or no reason ("Consent"):²²

3.1 Additional Transactions. Counterparty shall not issue or confirm any transaction(s) under the Hedge, except the Confirmation(s).

3.2 Amendment. No amendment, cancellation, modification, or termination of the Hedge (including any Termination Notice) by Borrower, or Borrower's waiver of any Hedge terms, shall be effective.²³

3.3 Transfer. Counterparty shall not acknowledge, honor, or recognize any assignment, conveyance, encumbrance, grant of security interest or option relating to, hypothecation, mortgage, pledge, sale, or other disposition of (directly or indirectly, voluntarily or involuntarily, by operation of law or otherwise, in whole or in part, collateral or absolute, and whether or not for consideration) (a "Transfer") of the Hedge, except any Administrative Agent's Transfer.

4. Administrative Agent's Security.

4.1 Counterparty Transfer. To the extent the Hedge requires Borrower's consent to any Transfer by Counterparty, such Transfer shall also require Administrative Agent's Consent.

through a UCC foreclosure under the Hedge Pledge. *See, e.g., Singer Asset Finance Co. v. Continental Casualty Co.*, 886 So. 2d 1004 (Fla. Dist. Ct. App. 2004). Administrative Agent could then find itself unable to collect Hedge Payments after foreclosure, thus rendering the assignment prohibition fully effective in one of the few circumstances where it really matters. Also, if Administrative Agent relies on UCC § 9-406(d) to dispense with Administrative Agent's consent to the Hedge Pledge, UCC § 9-406(a) would still allow Counterparty to make Hedge Payments to Borrower until Counterparty received notice of the Hedge Pledge. Administrative Agent would presumably give that notice upon any UCC foreclosure, at the risk of losing any earlier Hedge Payments. Though perhaps interesting, the preceding discussion is almost universally moot because Administrative Agent will almost universally require Counterparty to sign and deliver a Hedge Pledge. Also, because the cited UCC sections are opaque, Administrative Agent should try to steer clear of them, not hard to do. As a final note, the "override" of Transfer restrictions in UCC § 9-406 (or UCC § 9-408) should not affect provisions in this Hedge Pledge that prevent Borrower from further Transferring the Hedge.

21 A securitized transaction would probably substitute a requirement for a rating agency confirmation for a requirement for Administrative Agent's Consent. In such a transaction, the ratings agencies in effect take over many of the approval functions of a traditional lender, in part because of the servicer's lack of any judgmental or decision-making capacity and the impracticality of obtaining consent from numerous investors.

22 In this Section and several others, Administrative Agent enlists Counterparty to block Borrower from taking actions that could erode the value of the Hedge. Administrative Agent refuses to rely just on Borrower's covenants to the same effect. That cynicism conforms to any commercial real estate lender's treatment of ground leases, space leases, hotel management agreements, take-out commitments, insurance policies, and any other third-party obligations that create value or security. In a corporate credit financing, a lender might instead satisfy itself with covenants from its borrower or by weaving appropriate provisions into the Hedge itself, without demanding a separate direct undertaking from Counterparty. Real estate lenders have less faith in borrowers.

23 Borrower or Counterparty might propose adding the words: "as against Administrative Agent." Administrative Agent would prefer the simplicity of not adding those words.

4.2 Intended Beneficiary. Administrative Agent is an intended beneficiary of the Hedge. Whenever any Event of Default exists under the Loan Agreement²⁴ (a “Loan Event of Default”), Administrative Agent may exercise any right or remedy, and give any notice, under the Hedge, with no need for Borrower’s consent, confirmation, or signature (“Borrower Concurrence”). Counterparty shall perform accordingly under the Hedge.

4.3 Loan Event of Default. If a Loan Event of Default exists, any Termination Event occurs under the Hedge and Counterparty is the Affected Party, or an Event of Default occurs for Counterparty under the Hedge, then Administrative Agent may (but need not) notify Counterparty in writing that an Early Termination Date has occurred under the Hedge (a “Termination Notice”). Counterparty shall honor any Termination Notice, and it shall be fully effective, without Borrower Concurrence.

4.4 Loan Repayment. If the Hedge imposes any material obligations on Borrower and Borrower repays the Loan, then an Early Termination Date²⁵ shall automatically occur under the Hedge unless Administrative Agent or Counterparty elects otherwise in writing. Notwithstanding anything to the contrary in any Loan Document, Administrative Agent need not release any Security Document unless and until Borrower has performed all its obligations (if any) arising under the Hedge on account of any such Early Termination Date.²⁶

4.5 Netting Waiver. Counterparty waives any right to net or setoff against any Hedge Payment(s),²⁷ except on account of the transactions(s) described in Exhibit A²⁸ (the “Netting Waiver”).

24 The Loan Agreement should say, once, that if a Loan Event of Default has been cured and is no longer continuing, then it no longer exists. This avoids any need to say so again and again with every reference to “Loan Event of Default.” The Loan Agreement should define Event of Default broadly enough to include a default under this Hedge Pledge beyond applicable cure periods.

25 The Hedge will define this term. It triggers an obligation for whichever party “bet wrong” under the Hedge to make a payment to the other party to “close out” the Hedge.

26 This paragraph applies only if (and can be deleted unless): (a) the Hedge imposes obligations on Borrower (e.g., a swap); (b) the Security Documents secure those obligations; and (c) the Hedge documents and the Loan Documents do not already cover this matter. In cases that satisfy conditions “a” through “c,” this paragraph protects Counterparty (almost certainly Administrative Agent or its Affiliate under these facts) from the risk of having a swap outstanding without security.

27 Counterparty’s waiver of set-off and netting can help give Administrative Agent the interest rate protection it wants. Absent this waiver, Counterparty could net (or offset) any payments it might owe under other (unrelated) Transactions under the same Master Agreement. Moreover, given the widespread use of very broad “netting agreements” in the derivatives world, Counterparty could probably even net its Hedge obligations against Borrower’s obligations under unrelated derivatives involving the same Borrower and Counterparty or even their Affiliates, unless otherwise applicable law—such as UCC § 9-406—would prevent such netting. Any such netting could dilute or eliminate the protection against interest rate volatility that the Hedge should have delivered for the Loan. For more on these issues, see Guinn & Harvey. Nothing in this paragraph prevents Counterparty from netting within the Hedge. For example, any swap contemplates that each month’s swap payment will be calculated by netting the parties’ payment obligations against one another. That netting takes place within the single Hedge, as opposed to within multiple transactions. Outside of asset-specific transactions such as real estate Loans and structured finance generally, “netting” of multiple transactions represents the universal practice in the derivatives market, and represents part of any Hedge purchaser’s overall hedging strategy. Asset-specific transactions require an entirely different mentality, one regarded as unconventional in parts of the derivatives market.

28 If (a) Counterparty is also a Lender, and (b) the Hedge does not require direct payment of Hedge Payments to Administrative Agent, then this Hedge Pledge should allow Counterparty to offset for “any sums Borrower owes Counterparty in Counterparty’s capacity as a Lender under the Loan Agreement.” To the extent that any such offset allows Counterparty (as a Lender)

4.6 Termination Value.²⁹ Any Hedge termination value shall be determined using the “Market Quotation” method (not the “Loss” method).³⁰ The net termination obligation shall be determined using the “Second Method.”³¹

5. Administrative Agent Protection. This Hedge Pledge does not impose on Administrative Agent any obligations of Borrower under the Hedge. Any person that acquires the Hedge through an Administrative Agent’s Transfer shall have no personal obligations and no personal liability under the Hedge, including any personal obligation to make any payment the Hedge requires of Borrower. Counterparty shall at all times look solely to Borrower under the Hedge. Nothing in this paragraph limits Counterparty’s: (a) obligations as Counterparty; or (b) right to offset or net any payment, or exercise any other rights and remedies (including termination rights), as the Hedge allows, subject to the Netting Waiver.³²

6. Hedge Payments. Whether or not a Loan Event of Default exists, Borrower directs Counterparty to remit all Hedge Payments only as Administrative Agent directs from time to time in writing, with no need for Borrower Concurrence.³³ Administrative Agent initially directs Counterparty to remit to this account:

.³⁴

to recover any Borrower Obligations under the Loan Agreement, the Loan Agreement should (and typically does) require that particular Lender to share its recovery with the other Lenders under the Loan Agreement. If the Loan Agreement does not require sharing (highly unlikely), Counterparty should agree that to the extent Counterparty asserts any offset of the type this footnote suggests, “Counterparty shall promptly remit to Administrative Agent the amount of such offset, for Administrative Agent to apply as a Loan payment.”

29 For reasons the next two footnotes explain, delete this paragraph if Counterparty uses the 2002 ISDA Master Agreement.

30 When a Hedge (swap, in this case) terminates prematurely, the party that turns out to have “bet wrong” on interest rates must compensate the other party for the loss of future interest rate protection. The “Market Quotation” method (only in the 1992 ISDA Master Agreement) measures that compensation based on an average of marketplace quotations of the cost to buy equivalent protection for the remaining Hedge term. The “Loss” method lets the winner calculate its total losses based on a number of elements, some hard to pin down and easy to overstate. The “Market Quotation” method is simpler and more objective. The 2002 ISDA Master Agreement replaces both methods with a single defined “Close-out Amount.”

31 The “First Method” prohibits a defaulting party (or an “affected party,” such as a party whose merger triggered an unexpected termination) from ever receiving a termination payment. The “Second Method” lets either party—even the defaulting party—receive a termination payment, if it “won the bet” based on market conditions when the Hedge terminated. The 2002 Master Agreement eliminates this distinction, using the “Second Method” in all cases.

32 If the Hedge consists of a swap, then significant obligations could travel with it, and Administrative Agent will typically not want to assume those obligations. In that case, Counterparty will still want the right to exercise its rights under the Hedge if the new beneficiary of the Hedge (the foreclosure-sale purchaser) declines to make any payments the Hedge requires it to make. As an occasional variation, Loan Documents sometimes require Administrative Agent to assume Borrower’s obligations under a swap, backed by Borrower’s obligation to indemnify Administrative Agent against those obligations. This structure eliminates the need for Counterparty to obtain security for the swap, but the cure could be worse than the disease.

33 This sentence assumes Counterparty will pay Hedge Payments directly to Administrative Agent, eliminating risks and delays. Administrative Agent will particularly favor direct payment if the Loan requires a “hard lockbox” for rents, as Hedge Payments seem rather similar. Borrower might not want direct payment, offering this language instead: “If either (a) Administrative Agent notifies Counterparty of any Loan Event of Default; or (b) the Hedge terminates or is in default, then unless Administrative Agent Consents otherwise, Counterparty shall pay all Hedge Payments only as Administrative Agent directs in writing, with no need for Borrower Concurrence.” Borrower’s proposal would not comply with the S&P Cap Criteria. Unless Borrower seeks an opportunity to divert Hedge Payments, direct payment seems to make sense for everyone.

34 Though not essential, the last sentence can eliminate a separate direction letter, assuming the parties know what account they want to use. Setting up an earmarked bank account at closing often turns out to be harder to accomplish than one might intuitively expect, however.

7. Counterparty Protection. Counterparty may conclusively rely on any notice, demand, or instruction from Administrative Agent about the Hedge or any Hedge Payment, Loan Event of Default, or related matter (an “Administrative Agent Direction”), with no independent investigation or Borrower Concurrence. Borrower irrevocably instructs Counterparty to disregard and ignore any instruction from Borrower that either: (a) conflicts with any Administrative Agent Direction; or (b) Counterparty receives after Administrative Agent has notified Counterparty of a Loan Event of Default (unless Administrative Agent has rescinded that notice). Borrower shall hold harmless and indemnify Counterparty from and against any and all claims, damages, actual reasonable out-of-pocket expenses, judgments, liabilities, actual losses, and penalties (including reasonable attorneys’ fees and disbursements but excluding lost revenue; diminution in value; and punitive, special, and other consequential damages) that Counterparty incurs because Borrower or any other Person asserts any claim against Counterparty regarding any act or omission of Counterparty in reliance on any Administrative Agent Direction (unless caused by Counterparty’s gross negligence or willful misconduct). To the extent Counterparty pays Administrative Agent any Hedge Payment, it shall satisfy Counterparty’s corresponding obligations to Borrower under the Hedge.

8. Legal Status Assurances. Counterparty represents and warrants to Administrative Agent as follows (the “Legal Status Assurances”): (a) Counterparty has duly authorized, executed, and delivered³⁵ the Hedge and this Hedge Pledge; (b) Counterparty has been fully paid for the Hedge³⁶; (c) the Hedge is in full force and effect and enforceable against Counterparty; and (d) Counterparty and Borrower have entered into no agreements about the Hedge except this Hedge Pledge and as the Hedge states.

9. Factual Assurances. Counterparty confirms to Administrative Agent that Counterparty knows of no default under the Hedge or presently effective Transfer of the Hedge, except this Hedge Pledge.³⁷

35 Lenders that will securitize their loans often request an opinion of Counterparty’s counsel on these matters, driven by the rating agencies’ belief that an opinion of counsel will best mitigate any imaginable risk, however small and unlikely (perhaps another example of the rating agencies keeping their eyes on the wrong ball). Did this requirement for a legal opinion result from an epidemic of unauthorized Hedge transactions? Does the likely benefit of such an opinion exceed its cost? If Administrative Agent will require such an opinion, Borrower should say so in the Hedge bid package, include the required form of opinion, and perhaps budget a bit more for the Hedge (though these opinions are often issued in-house and hence incur no identifiable direct cost, though also provide no more value than an officer’s certificate). If Counterparty is an Affiliate, Administrative Agent might waive the opinion, slightly tilting the playing field. A practical Administrative Agent might accept an incumbency certificate or a secretary’s certificate, or equivalent language offered at the end of this model Hedge Pledge. The S&P Cap Criteria say they require opinions on enforceability (from Counterparty’s outside counsel); *pari passu* status of the Hedge Payments (as against other unsecured and unsubordinated obligations of Counterparty); choice of law; recognition of judgments (if a foreign Counterparty); and no withholding tax. Outside of real estate securitization and other structured finance transactions, Counterparties do not ordinarily deliver opinions of any kind. No one has been known to suffer as a result. ISDA has obtained generic enforceability opinions about the ISDA documents (or at least their most important provisions), and makes those opinions available to ISDA members on its Web site, www.isda.org. Even nonmembers of ISDA know those opinions exist and gain some practical comfort from their assurances on enforceability, at least for typical Hedge documentation. Of course, generic enforceability opinions don’t address internal corporate issues, but most Hedge market participants seem to live without opinions even on those issues. The notion that a Hedge issuer might disown a Hedge based on lack of authority is simply inconceivable to those who transact business in this area.

36 This assurance will not apply if the Hedge imposes future payment obligations on Borrower (e.g., a swap). Beyond obtaining this assurance, Administrative Agent will also want to confirm Counterparty has in fact received payment.

37 For reasons explained above, Administrative Agent technically does not need Counterparty’s consent to obtain a good security interest, even if the Hedge requires it. Nevertheless, Administrative Agent should, and virtually always does, obtain

10. Effect on Hedge. This Hedge Pledge does not limit Borrower’s obligations or liability, or impose any obligation or liability on Administrative Agent, under the Hedge or the Loan Agreement. Administrative Agent need not enforce the Hedge or collect any Hedge Payment. If this Hedge Pledge and the Hedge conflict, the former governs; otherwise, this Hedge Pledge is subject to all Hedge terms.³⁸

11. Loan-Related Covenants. Without affecting Counterparty, Borrower and Administrative Agent agree as follows (the “Loan-Related Covenants”):³⁹

11.1 Assurances. Borrower represents and warrants: (a) the Hedge and this Hedge Pledge are enforceable against Borrower; (b) the copies of the Hedge attached to this Hedge Pledge (or otherwise given to Administrative Agent) are true, correct, and complete; (c) Borrower owns Borrower’s rights under the Hedge free and clear of any claims of others, and has not Transferred its interest in the Hedge to anyone, except Administrative Agent; (d) no party is in default under the Hedge⁴⁰; (e) Borrower has reviewed the Hedge, approves its terms, and confirms that the Hedge refers to an interest rate index that precisely matches an interest rate index used in the Loan Agreement⁴¹; and (f) unless Counterparty is an Administrative Agent Affiliate, the Legal Status Assurances are true and correct. Borrower acknowledges that Administrative Agent makes no representation or warranty about the effectiveness, if any, of Borrower’s hedging strategy.⁴²

11.2 Collateral; Remedies. The Hedge constitutes Collateral. If any Loan Event of Default exists, Administrative Agent may exercise all Administrative Agent’s Remedies. Administrative Agent may exercise them partially, cumulatively, sequentially, and in any order. If Administrative Agent liquidates or terminates the Hedge upon any Loan Event of Default, Administrative Agent shall have no liability to Borrower for any resulting loss.

11.3 Covenants. Borrower shall: (a) perform all its obligations, if any, under the Hedge; (b) promptly give Administrative Agent a copy of any notice Borrower sends or receives about the Hedge; and (c) hold in trust (as Administrative Agent’s fiduciary) and within two Business Days remit to Administra-

appropriate assurances from Counterparty.

38 The preceding sentence favors Counterparty, not Administrative Agent, but Counterparties often request it. By including it, one saves time and mitigates possible risks of sloppy concessionary language. The second clause (after the semicolon) does not add much, but makes Counterparties happy.

39 These covenants (and a few others elsewhere in this Hedge Pledge that relate to the linkage between the Loan and the Hedge) could instead go in the Loan Agreement or other basic “deal document.” Counterparty might insist on it.

40 Borrower may prefer to add a “knowledge” qualifier.

41 If the Hedge does not precisely match an underlying interest rate index, this discrepancy may randomly benefit Administrative Agent, Borrower, or Counterparty, but more importantly will dilute the practical value of the Hedge and potentially create surprises. Clause “e” seeks to shift this risk to Borrower. At a minimum, it should estop Borrower from complaining about any discrepancy. Administrative Agent and its counsel should, of course, not rely on Borrower’s assurance. They should scrutinize the Hedge during the closing process.

42 This acknowledgment can go in the Loan Agreement. Waivers like these would seem intuitively obvious (hence unnecessary) to anyone unfamiliar with litigation over defaulted loans in the United States, and the claims and theories that Borrowers assert in such litigations.

tive Agent any Hedge Payment Borrower receives. Except with Administrative Agent's Consent, Borrower shall not: (d) take any action that would allow Counterparty to assert a claim, counterclaim, or defense against its Hedge obligations; (e) Transfer the Hedge; (f) enter into any transaction(g) under the Hedge, except the Confirmation(s); (h) release any Counterparty obligations; or (i) give any Termination Notice.

11.4 Hedge Enforcement. Borrower shall exercise with reasonable diligence its rights and remedies under the Hedge, except: (a) during any Loan Event of Default, Borrower shall comply with Administrative Agent's directions regarding how, when, and whether to enforce such rights and remedies; and (b) Borrower shall not give a Termination Notice without Administrative Agent's Consent.

11.5 Hedge Payments. If Administrative Agent receives any Hedge Payment, Administrative Agent shall apply it against the Obligations, as if a Loan payment.⁴³ Borrower shall remain responsible for the full and timely payment of all other Obligations.

11.6 Nonrecourse. The Nonrecourse Clause: (a) is incorporated by reference as if set forth in full; and (b) shall apply to Borrower's obligations under this Hedge Pledge.⁴⁴

11.7 UCC-1 Financing Statement; Further Assurances. Borrower authorizes Administrative Agent to file a UCC-1 financing statement (and make any other filings) necessary or appropriate, in Administrative Agent's judgment, to perfect Administrative Agent's security interest in the Hedge. Borrower shall execute such certificates, deliveries, and documents as Administrative Agent reasonably requests from time to time to further effectuate the parties' intentions. Borrower represents and warrants that its correct legal name appears on the signature page(s) of this Hedge Pledge.⁴⁵

12. Notice of Assignment. If Administrative Agent assigns its interest in the Hedge, then Administrative Agent shall promptly notify Counterparty in writing, with the assignee's name and notice information. Failure to do so shall not constitute a default, or limit Administrative Agent's rights, under this Hedge

⁴³ Administrative Agent could agree to apply any such payment first to interest, but that statement probably belongs in the Loan Agreement (and also seems intuitively obvious absent a Loan Event of Default).

⁴⁴ Consider adding a nonrecourse "carveout" for Borrower's failure to apply correctly any Hedge Payments that Borrower might receive, functionally equivalent to a misapplication of rental income. Also, other Borrower breaches under this Hedge Pledge might constitute "waste," but Administrative Agent might prefer a more direct route to recourse for such breaches.

⁴⁵ Administrative Agent's UCC-1 financing statement must state Borrower's full and exact legal name. This sentence provides a cross-check. Administrative Agent should, of course, confirm the name independently and not rely solely on Borrower's assurances. Counsel can often do this online, such as in New York by visiting dos.state.ny.us. Administrative Agent's UCC-1 financing statement should identify Administrative Agent (by its correct name) as secured party, but need not recite Administrative Agent's representative capacity. UCC § 9-503(d). The UCC imposes looser standards on the description of the Hedge, including Counterparty's name, as no one will need to search the UCC records by Counterparty's name. *See, e.g.*, UCC § § 9-108 and 504(1). Nevertheless, anyone preparing a UCC-1 financing statement (or any other legal document) will probably want to be absolutely precise about Counterparty's name—an example of bringing to any legal drafting exercise the mindset of being "more precise" and "more careful" than strictly necessary. That mindset, though perhaps tedious and painful, tends to produce favorable consequences throughout the document and the subsequent history of the Loan as it unfolds.

Pledge. If Administrative Agent gives such a notice of assignment, then Counterparty shall upon request confirm to the assignee that it has succeeded to Administrative Agent's rights and obligations under this Hedge Pledge and such other matters as the assignee reasonably requests.

13. Termination. This Hedge Pledge and Administrative Agent's rights under this Hedge Pledge shall terminate and Administrative Agent shall at Borrower's expense so confirm in writing if and when either: (a) the Hedge terminates or expires and Counterparty has paid all Termination Hedge Payments as this Hedge Pledge requires; or (b) a Termination Date⁴⁶ has occurred under the Loan Agreement. Administrative Agent shall then have no rights, remedies, or claims under this Hedge Pledge, and Counterparty shall pay all Hedge Payments and recognize all Transfers as Borrower directs, subject to the Hedge, without regard to this Hedge Pledge.

14. Jury Trial. All parties waive any right to have a jury participate in any way in resolving any dispute, in contract, tort, or otherwise, arising out of, connected with, related to, or incidental to: (a) this Hedge Pledge; (b) its interpretation or determination; (c) enforcement of any Administrative Agent's Remedy; or (d) the parties' relationship about the Loan, the Hedge, this Hedge Pledge, and all related matters (any of the foregoing, a "Dispute"). Any Dispute shall be resolved in a bench trial without a jury.⁴⁷

15. Role of Administrative Agent. Wherever this Hedge Pledge refers to any benefit, claim, expenditure, or right of Administrative Agent, each such reference also refers automatically to all Lenders, all as the Loan Agreement more fully provides. Wherever this Hedge Pledge benefits Administrative Agent, it automatically benefits all Lenders. In acting under this Hedge Pledge, Administrative Agent acts in all respects for all Lenders. Administrative Agent shall, however, have sole authority to enforce this Hedge Pledge and the Hedge for Lenders. No Lender shall have any right to enforce this Hedge Pledge or the Hedge directly, but only through Administrative Agent. Nothing in this paragraph limits any Lender's right to exercise any right of set-off or offset on account of the Loan, provided that such Lender delivers the proceeds of such exercise to Administrative Agent to be applied in accordance with the Loan Agreement.⁴⁸ In enforcing this Hedge Pledge and the Hedge for the Lenders, Administrative Agent need

⁴⁶ If the Loan Agreement does not define a "Termination Date," then refer to the date when Borrower has paid and performed all its obligations and Administrative Agent and the Lenders have no further obligations under the Loan Agreement.

⁴⁷ This may represent the single most important paragraph in every legal document. It refers not only to this Hedge Pledge and Administrative Agent's security, but also to the parties' entire relationship about the Loan, the security, and anything related. Recent California cases limit the enforceability of jury trial waivers. Those cases may alone justify choosing New York law if the parties have not already done so for other reasons (e.g., the tendency of California courts to revise business transactions after the fact to reflect what the judges consider fair and right, as opposed to what the parties agreed and took into account in structuring and pricing their business deal). Though jury trial waivers often appear in ALL CAPITAL LETTERS, the author knows of no generic legal basis (as opposed to possible state-specific reasons) for that custom, which interferes with comprehension and often leads the reader to ignore the language in question.

⁴⁸ The Loan Agreement will typically address this issue at some length, requiring the Lenders to share any offset or payment any of them obtains from Borrower.

not demonstrate that Administrative Agent has obtained any necessary concurrence or approval of any Lender(s). Any lack of, or deficiency in, any such concurrence or approval shall not constitute a defense to enforcement of this Hedge Pledge or the Hedge.

16. Miscellaneous. The law that⁴⁹ governs the Loan Agreement shall govern this Hedge Pledge and any Dispute.⁵⁰ The parties may execute this Hedge Pledge in counterparts. Each constitutes an original. All constitute one instrument.⁵¹

IN WITNESS WHEREOF, Borrower has executed this Hedge Pledge as of the Effective Date.

BORROWER: _____

NAME OF ENTITY: _____

[SIGNATURE BLOCK]

Attached:

Counterparty Confirmation

Confirmation of Counterparty's Signing Authority

Exhibit A: Description or Copy of Hedge

⁴⁹ Common practice would often use the word "which" in this context, which would be incorrect for reasons that any grammar book will explain. Others might laugh at the distinction between "restrictive" and "nonrestrictive" phrases, arguing that only William Safire and the author still recognize or care about it.

⁵⁰ A cross-reference to the Loan Agreement for "choice of law" eliminates the need to repeat a long complex provision on choice of law in every Loan Document; then modify that long complex provision every time the parties negotiate some nuance within it; and in doing so probably make some Loan Documents inconsistent. Might the choice of law vary for this Hedge Pledge? Probably not. Here is a (rare) example of a comprehensible and perfectly appropriate choice of law clause for a Loan Agreement:

New York law governs this Agreement, the Loan Documents, the parties' relationship, the creation of any personal property security interests, and any Dispute arising from the Loan or the Loan Documents, with four exceptions. First, any New York law on conflict of laws that would result in applying any law except New York's shall be disregarded. Second, the law of the state where the Mortgaged Property is located shall govern perfection, effect of perfection or non-perfection, priority, and enforcement (collectively, "Implementation"), and creation and validity, of liens on the Mortgaged Property, except personal property. Third, UCC mandatory choice of law rules shall determine which law governs Implementation of any personal property security interest. Fourth, mandatory federal law supersedes state law.

Does this verbiage change the result that the courts would reach if the Loan Agreement said nothing about choice of law? Probably yes, starting but not ending by mitigating the potential for a fact-based judicial exegesis into conflicts of law.

⁵¹ No law prohibits short sentences written in the active voice.

COUNTERPARTY CONFIRMATION

Counterparty accepts, agrees to, and acknowledges the preceding Hedge Pledge and all its terms (except the Loan-Related Covenants).

COUNTERPARTY:

NAME OF ENTITY:

[SIGNATURE BLOCK]

Date: _____, 200__

CONFIRMATION OF COUNTERPARTY'S SIGNING AUTHORITY⁵²

The undersigned, who holds the office in Counterparty identified below, confirms that the above Counterparty Confirmation was duly authorized, executed, and delivered, and the person signing such Counterparty Confirmation for Counterparty had the power and authority to do so.

Name: _____

Title: _____

EXHIBIT A**DESCRIPTION OF COUNTERPARTY AND HEDGE⁵³**

Counterparty	_____
Hedge (Master Agreement)	_____ Agreement (_____ Reference No. _____), between Counterparty and Borrower, dated as of _____, as supplemented only by the Schedules listed below as amended from time to time (in compliance with the foregoing Hedge Pledge)
Schedules(s) to Master Agreement	Schedule _____ dated _____
Amendment(s)	Transaction Amendment (_____ Reference No. _____) dated as of _____
Confirmation(s)	Confirmation(s) issued under Counterparty's Reference No. _____ dated as of _____

⁵² This confirmation offers a reasonable substitute for an opinion of counsel. If Counterparty is committing fraud, however, why would the fraud end at Counterparty's signature block?

⁵³ Tailor description as appropriate to reflect actual document structure for this particular Hedge. As an alternative, attach copies. Consider confidentiality before using the same attachment for any UCC-1 financing statement.