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# Derivatives 2020

A practical cross-border insight into derivatives

**First Edition**

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# Expert Chapters



# Q&A Chapters

# Structural Considerations in Deal Contingent Hedges



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## Introduction

A domestic corporation or private equity sponsor committing to a cross-border acquisition will confront a number of practical and legal issues and risks. Where the buyer finances its operations – or maintains investor commitments – in US dollars ("USD"), but commits to a non-USD-denominated purchase price, the buyer assumes the risk that the required USD funding may increase materially as a result of foreign exchange ("FX") movements between signing the acquisition agreement and closing the acquisition.[1] While FX and cross-currency derivatives have long been available to mitigate such risks,[2] corporations and private equity sponsors in the acquisition context only need and want such protection to the extent the acquisition closes. The primary solution to address these requirements is for the buyer, concurrent with (or soon after) signing the acquisition agreement, to enter into a deal contingent hedge: a derivative providing the desired protection to the buyer that becomes effective – and requires the parties to make the applicable payments – only upon and subject to the occurrence of the acquisition closing. This chapter discusses the customary structure of deal contingent hedges as well as certain issues for corporations and private equity sponsors to consider, especially to the extent the buyer has obtained "limited conditionality" financing commitments in connection with the acquisition.[3]

## Structure

Derivatives transactions with a swap dealer are most typically documented under the framework of an ISDA Master Agreement that, as modified by the parties through a negotiated Schedule, sets forth the general operational and credit terms under which the parties are willing to transact. The specific terms and conditions of each derivative transaction agreed to by the parties are set forth in a trade confirmation entered into pursuant to the ISDA Master Agreement. Upon the occurrence of an event of default under the ISDA Master Agreement, the negotiated early termination and settlement terms apply to all transactions set forth in all confirmations governed by the ISDA Master Agreement.

In contrast, most deal contingent hedges are documented under a standalone long form confirmation ("LFC") between the parties that incorporates by reference the terms of the ISDA Master Agreement and includes a limited number of the elections and modifications that would otherwise be addressed in the Schedule.[4] The basis for this different practice is that deal contingent hedges are not effective until a later date (if at all); and, when effective, the trade terms – specifically the required payments at closing – are intended to be ring-fenced from any broader trading relationship between the parties. In addition, ISDA Master Agreement negotiations between a well-advised counterparty and swap dealer often take, as a practical matter, weeks or even months to complete, which may not be feasible in connection with a fast-moving, competitive acquisition process.

The LFC, similar to all trade confirmations, will include the specific economic terms and conditions of the underlying hedge, including, in the context of a cross-currency derivative, the applicable currencies, the notional amount with respect to which the payments are calculated and the settlement terms. In addition, the LFC will include the "contingent" aspects of the hedge, including the conditions to settlement and the period in which such settlement must occur, if at all, and provisions addressing circumstances in which settlement fails to occur during the term of the trade, including where the acquisition is reconstituted and consummated at a later date.

## Conditions to Settlement

The most fundamental requirement of any deal contingent hedge for a corporation or private equity sponsor is that, under all circumstances, the swap is available when needed at acquisition closing. Put otherwise, upon the satisfaction of all conditions precedent by the buyer and seller and the closing of the acquisition, the deal contingent hedge must settle.

To ensure this is the case, the buyer should carefully consider which (if any) of the standard events of default and termination events (and related provisions, including representations and covenants) contained in the ISDA Master Agreement (which are, as noted above, incorporated by reference into the LFC) should apply to the buyer prior to acquisition closing. To the extent any such event of default or termination event occurs with respect to the buyer during the pre-closing period, the swap dealer would have the contractual right under the LFC to designate an early termination date on which the transaction – and the swap dealer's obligation to make the agreed payments at acquisition closing – would terminate. In determining the appropriate scope of these events, it is often useful for buyers to analyse the terms of any committed financing obtained to support the acquisition. In particular, in both the investment grade and leveraged financing markets, the terms of limited conditionality financings are well settled and set forth as an exhaustive list on an annex to the applicable financing commitment. These "SunGard" conditions precedent are generally limited to the accuracy of specified representations with respect to the financing and the acquisition, execution and delivery of definitive documentation, payment of fees and expenses and delivery of "know your customer" ("KYC") information and a solvency certificate, but not, in most cases, a cross-default or similar condition.[5] With limited exceptions, these customary financing conditions would appear to be satisfied as of the

trade date of a deal contingent hedge as (x) the LFC contains the required terms of the hedge transaction, (y) the swap dealer will generally obtain all necessary KYC information in advance of executing the LFC, and (z) payments by the parties are only made at closing.[6] As such, buyers may resist any conditionality other than the closing of the acquisition in accordance with the terms of the acquisition agreement in effect on the trade date.

Where the primary use of the deal contingent hedge in a leveraged buyout ("LBO") is to mitigate ongoing (post-closing) risks, swap dealers will insist on the inclusion of customary additional termination events ensuring that the post-closing hedge benefits from the same guarantee and collateral package (on a *pari passu* basis) as the secured acquisition financing of the buyer. To ensure this treatment, the LFC – and associated hedge – will often need to be transferred through novation from the "shell" entity formed by the private equity sponsor to consummate the acquisition to the target operating company that is the ultimate borrower of the financing (and grantor of collateral). To avoid triggering this additional termination event at closing, it is critical that the novation of the LFC to the acquisition financing borrower occurs automatically and concurrently with the acquisition closing, subject to limited (or no) conditions other than satisfaction of the swap dealer's KYC requirements with respect to the target, which, consistent with the financing, should be satisfied well in advance of closing.

## Termination Date

One of the key features of any acquisition agreement is the "end date", "outside date" or "long stop date" at which either party to the acquisition may terminate the agreement to the extent closing has not yet occurred. While most often structured as a fixed date following acquisition signing, a fair number of agreements permit one or both parties to extend that date for specified periods to the extent the sole unsatisfied condition precedent to closing is receipt of antitrust or other regulatory approval, an event outside the control of the parties.

Commitment letters for acquisition financings most typically provide that the term of the lender's commitment to provide such financing is concurrent with the closing timeline in the acquisition agreement, including automatic extensions upon a corresponding extension under the acquisition agreement (subject to a hard outside date). To ensure similar coverage, LFCs for deal contingent hedges should be similarly structured, to accommodate the possibility of extension such that, if the end date is extended in accordance with the acquisition agreement, the deal contingent hedge – along with the acquisition financing – will be available to the buyer.

## "Phoenix Clause"

As discussed above, the primary benefit of a deal contingent hedge to a buyer is that the hedge settles – and payments are required to be made by the parties – solely upon closing of the acquisition. If the acquisition is terminated (or otherwise fails to close prior to the end date specified in the acquisition agreement), the hedge similarly terminates and no payments are due from either party. For a swap dealer, there are often real costs to providing a contingent hedge if the underlying transaction – and, thus, the hedge – does not close and settle: the swap dealer will be required to close-out an equal and offsetting derivative position. Such close-out may result in a "windfall" gain to the swap dealer, but may also be at a loss with no recourse to the buyer.

To mitigate the potential for this loss, swap dealers will deeply diligence the acquisition structure, acquisition closing conditions and likelihood of failure to close within the period prior to the outside date, and "price" their findings (together with the expected volatility of the underlying hedge position during the pre-closing period) into the terms of the LFC. One variable that swap dealers have great difficulty analysing is the possibility of a mutual termination of the acquisition by the parties (whether at or prior to the outside date), which permits the buyer to terminate the deal contingent hedge without cost. To obtain some downside protection in such circumstance, LFCs nearly always contain a "phoenix clause" that, upon any reconstitution of the transaction within a specified period following termination, requires the buyer to pay the swap dealer's earlier losses on closing-out its offsetting position (with a corresponding obligation of the swap dealer to pay any gains on such close-out to the buyer), without, in either event, an obligation on the swap dealer to provide (or even offer to provide) a replacement hedge in connection with such reconstituted transaction. In contrast, the "alternate transaction fee" ("ATF") in most acquisition financing commitment letters addresses a similar fact pattern by requiring the borrower to offer the committing lenders a "right of first refusal" ("ROFR") to provide the financing for the reconstituted transaction, with payment of the ATF – usually 50% of the applicable commitment fees – arising solely to the extent the buyer fails to provide the committing lenders with such ROFR.

Once agreed in concept, a number of the terms of the phoenix clause should be carefully considered. First, buyers seek to minimise the period during which a reconstituted deal will give rise to the mutual payment obligations. While most swap dealers will ask for up to six months, buyers may be able to reduce this period to three (or even one) month/s on the basis that sellers would never agree to delay closing for any material period *solely* to permit buyers to avoid settling an uneconomical deal contingent hedge (which is, at heart, the swap dealers' ultimate concern). Second, to the extent this payment obligation arises, the buyer should consider the basis on which the swap dealer calculates its loss (or gain) and, specifically, whether to require such calculation on the basis of the methodology specified in the LFC with respect to an early termination of the hedge. As parties often agree to make such calculations based on the objective Market Quotation measure, it would be reasonable to require that the swap dealer use that same measure in closing-out its offsetting position.

Swap dealers will also often seek to include a "Non-Compliance Event", "Buyer Event", "Party B Event" or other "bad actor" provision in LFCs requiring the buyer to pay the swap dealer's losses on its offsetting position (*without* a corresponding payment by the swap dealer of any gains) if the acquisition fails to close due to the mutual agreement of the parties or intentional breach of the acquisition agreement, or other "bad act", by the buyer. As noted above, the basis for this request is the swap dealer's concern that the buyer may terminate (or cause the termination of) the acquisition solely to avoid payment on an out-of-the-money hedge. Buyers should strongly consider the swap dealers' need for such a clause – and the plausibility of the rationale – as the (relatively low costs) of an out-of-the-money deal contingent hedge are unlikely to provide buyers with a sufficient motivation to terminate an acquisition and incur what is likely to be a significant termination fee and other material costs in doing so.

## Conclusion

As noted above, swap dealers price the significant risks they assume in deal contingent hedges into the economic terms of the transaction. Such hedges are, thus, generally materially more expensive for buyers than entering into a standard,

non-deal contingent FX or other hedge transaction. To ensure they mitigate their risks in the most cost-effective manner, prior to entering into a deal contingent hedge, corporations and private equity sponsors should closely analyse all options for addressing FX and other basis risks. In particular, swap dealers regularly provide swaptions[7] and forward-starting swaps[8] that may allow the buyer to achieve the same or a similar result. The particular tool best suited for a given buyer in a given acquisition will depend primarily on the buyer's view as to the likelihood of acquisition closing and the relative pricing among the various options.

## Endnotes

1. As it has been discussed in this chapter, this risk is heightened where, due to market conditions or preference, the committed debt financing obtained by the buyer to fund all or a portion of the acquisition consideration is likewise denominated in USD.
2. Under a simple FX derivative, the parties agree on the trade date that (x) one party pays a fixed (notional) amount in a specified currency to the other party (the swap dealer) in exchange for (y) payment by the swap dealer of such fixed (notional) amount in a second currency at the prevailing exchange rate on a specified settlement date. In the acquisition context, this transaction ensures that the buyer will receive an amount equal to the required non-USD acquisition consideration at closing from the swap dealer in exchange for payment of a specified amount of USD, independent of any FX appreciation in the second currency relative to USD.
3. For simplicity's sake, this chapter focuses on the FX risks inherent in closing a cross-border acquisition, and the ability of a deal contingent FX hedge to effectively mitigate this risk for the buyer. In practice, deal contingent hedges are also used to manage post-closing FX mismatches in revenues and expenditures as well as interest rate fluctuations of floating rate acquisition financing and commodities pricing assumptions on which the acquisition price (as well as any related acquisition financing, including any reserve-based loan) was based. While the underlying derivative instrument for each differs dramatically, the structure of the deal contingent hedge and considerations are broadly the same.
4. Where the deal contingent hedge relates to post-closing FX, interest rate or commodities pricing risk, the parties often agree to negotiate and execute a full ISDA Master Agreement and Schedule in connection with acquisition closing to ensure proper documentation for the post-closing trading relationship. Buyers should carefully consider the timing to enter into the ISDA Master Agreement and Schedule in such circumstances, as, to the extent required at or prior to closing, such requirement would introduce additional conditionality to the availability of the hedge.
5. Where the acquisition is subject to additional limitations on conditionality for regulatory reasons (e.g., to obtain the approval of the Takeover Panel in a UK "certain funds" acquisition), buyers should consider these as well in determining the appropriate scope of the LFC conditions.
6. Where the primary use of the hedge is to mitigate post-closing risks, "dis-applying" events of default and termination events will be less essential than for a closing date hedge. Of course, removing or limiting termination events in an ongoing, post-closing hedge may be important to support the assumptions made in the buyer's investment thesis, but failure to satisfy the conditions to such hedge will generally not impede closing the acquisition.
7. An option transaction pursuant to which, in exchange for payment of a premium on the trade date, the swaption "purchaser" buys the right (but not obligation) to enter into a specified, pre-agreed (interest rate, FX or other) swap on or prior to the option expiration date. In contrast to deal contingent hedges, the swaption pricing is included in the option premium and payable by the purchaser regardless of whether the acquisition closes.
8. A derivative transaction under which the parties agree to exchange (or "swap") specified payments (again, relating to interest rates, FX or otherwise) from and after a specified "start" date. As with swaptions, there is no deal contingency to a forward-starting swap, such that if the acquisition fails to close, the buyer – with no further need for the swap – will be forced to early terminate the transaction and, where out-of-the-money, pay the losses resulting from such termination to the swap dealer.

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