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# Private Credit and Secured Hedges — Drafting Issues to Avoid

Client Advisories

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**Sept. 3, 2025 –** This article addresses numerous drafting issues identified in New York-law governed direct lending transactions that have either caused borrowers to seek amendments or the presence of which have caused secured hedge providers to walk away from potential trades.

Trading desks are busy! Many leading financial institutions act as principals in trading activities, providing liquidity and credit quality for counterparties (Hedge Providers). These institutions have sophisticated teams that have long assisted their clients and customers in engineering cutting-edge hedging solutions in physical and financial trades. When seeking to execute a trade, time is of the essence. As one trader told the author, "All it takes is one social media post for the market to shift by 10 basis points between the morning and the afternoon." If a credit agreement is not properly drafted to permit secured hedges, significant time and expense may be incurred by a borrower to amend its credit documents, during which time the market may shift by 50 basis points or more (and during that amendment process, the borrower may need to make additional concessions to its lenders).

Market participants execute all kinds of trades, both secured and unsecured. This article is directed to participants in the middle market that are utilizing direct lending facilities and assumes that the stakeholders are aligned on providing secured swaps that are pari passu with the lenders, both in priority of payments and with respect to liens. As noted above, this article addresses drafting issues identified in New York-law governed middle market direct lending transactions. Addressing such issues will benefit (i) borrowers, as having a clear pathway to secure hedges under direct lending credit facilities will foster a competitive environment among counterparties, leading to better pricing; (ii) direct lenders, as having a clear pathway to de-risking movements in interest rates will allow borrowers to manage cash and interest payments in a credit-positive way; and (iii) trading counterparties, who will have greater certainty that not only are trades permitted by their clients' credit facilities but also that the trades are secured on a pari passu basis with the repayment of principal to the senior-most lenders thereunder.

**Renewed Interest in Interest Rate Hedging**

Recently, private equity fund managers have increasingly focused on interest rate and currency risks. As reported by Investec in its Private Equity Trends 2024, most respondents (58%) said they had less than a quarter of their portfolio hedged against adverse moves in interest rates.[1] As Investec noted, interest rate hedging had been less of a priority for private equity managers than in other classes for a variety of reasons, including the benign interest rate environment following the global financial crisis. As a result, "many managers viewed interest rate hedging as an afterthought — if they concerned themselves with it at all."

Fast-forward to 2025 and we are in a changed world. Interest rates have soared across most of the developed world. Borrowers have numerous challenges — increased costs for their products and services, tariffs, geopolitical uncertainty, and of course, higher interest rate problems that need to be managed. As one head of capital markets bluntly noted, "Not many folks were worrying about this, and a lot of businesses have been burnt really badly." [2] For example, when Envision Healthcare's interest rate hedges expired in 2021, the company was unable to find counterparties willing to take on the credit risk without incurring a prohibitive expense. Accordingly, leading up to Envision Healthcare's bankruptcy filing, billions of dollars of floating-rate debt and related interest payments were unhedged.

**The Rise of Private Credit and the Blurring of Terms**

Since the global financial crisis, the market for private credit has grown tenfold and is projected to hit $3.5 trillion by 2028. [3] Such explosive growth, combined with an unprecedented flurry of closings in 2020 and 2021, and a hiatus between the second half of 2022 and the end of 2023 in the broadly syndicated loan markets (BSL markets), led to a blurring of terms between the direct lending markets and BSL markets. In a competitive landscape where private equity sponsors had all the leverage, direct lenders increasingly underwrote deals using the private equity sponsors' preferred forms, many of which were originally written for deals in the BSL markets. Concurrently, private credit providers increasingly underwrote the use of a borrower's collateral to secure hedging obligations and cash management obligations of the borrower.

Practically speaking, such blurring of terms resulted in secured hedge provisions from credit agreements originally written for the BSL markets being copied and pasted into credit agreements for use in the direct lending markets. Such copying and pasting has caused significant challenges to borrowers and swap providers seeking to trade on interest rate swaps without first reopening the credit agreement to appropriately permit such secured swaps.

**The Universe of Hedge Banks**

As an initial matter, a Hedge Provider needs clarity that it is a "Hedge Bank" under the borrower's credit agreement and, accordingly, that it is afforded the benefits of the application of payments specified in the post-default waterfall, any guarantees and the collateral arrangements. Historically, in the BSL markets, Hedge Banks were limited to the administrative agent, the lead arrangers, the lenders and their affiliates. In such transactions, at least one of the lenders would have a regulated affiliate that could provide swaps to the borrower. Limiting the universe of potential secured swap counterparties ensured that the relationships ancillary to lending (and the related fees!) would stay within the group. [4] The secured hedging provisions evolved to include a "designation notice" pursuant to which a Hedge Provider affiliate of an agent or lender would become a Hedge Bank entitled to pari passu treatment upon delivery thereof and agreeing to be bound by the provisions of the credit agreement as if it were a lender thereunder.

In the direct lending markets, a borrower should assume that its agent and lenders do not have an affiliate that can provide swaps. Even though many regulated financial institutions have affiliated private credit funds, such private credit funds are often not "Affiliates" (as defined in the relevant credit agreement). In addition, there may be internal policies at such financial institutions that prohibit trading entities and private credit funds from being described as affiliates. Accordingly, from a best-practices perspective, borrowers should ensure that the definition of Hedge Bank permits, subject to delivery of a designation notice, "any Person" or "any Person reasonably satisfactory to the Administrative Agent [5] and the Borrower" to act as a Hedge Bank.

An example definition is below:

"Hedge Bank" means (x) any Person that is an Arranger, an Agent or a Lender or an Affiliate of any of the foregoing (or was an Arranger, an Agent or a Lender or an Affiliate of any of the foregoing at the time it entered into a Secured Hedge

Agreement), in its capacity as a party to a Secured Hedge Agreement, or ***(y) any other Person that has been designated by the Borrower in writing to the Administrative Agent as a "Hedge Bank" [pursuant to a Designation Notice in the form of Exhibit [ ]] for purposes of this Agreement and the other Loan Documents***; provided that if such Person is not an Agent or a Lender, such Person executes and delivers to the Administrative Agent and the Borrower [a letter agreement in form and substance reasonably satisfactory to the Administrative Agent, the Collateral Agent and the Borrower pursuant to which such Person (a) appoints the Administrative Agent and Collateral Agent as its agent under the applicable Loan Documents and (b) agrees to be bound by Sections [ ], [ ] and [ ] and ARTICLE [ ] as if it were a Lender] [a Designation Notice in the form of Exhibit [ ]].

By including the italicized language above, the borrower has a clear pathway to designating non-agent, non-lender Hedge Providers as Hedge Banks. [6]

**Hedging Obligations Are Not Pari Passu**

In a lien-secured hedging arrangement, Hedge Providers ordinarily require that hedging obligations be pari passu with the obligation to repay principal to the senior-most lenders in the post-default waterfall. [7] Given that amendments to the post-default waterfall are typically affected lender (i.e., 100% lender) voting matters, it is critical that borrowers carefully evaluate the waterfall when documenting credit facilities. Examples of drafting issues to avoid include the following:

1. Payment of hedging obligations is junior in the waterfall to repayment in full of the principal.
2. Hedging obligations that are entitled to pari passu treatment are hedging obligations payable to "Lenders," "Affiliates of Lenders" or "Revolving Credit Lenders" to the exclusion of third-party Hedge Providers.
3. Application of proceeds is limited "to Obligations consisting of principal on the Loans, Hedging Obligations [and Secured Hedging Obligations]," and the definition of "Obligations" does not include Hedging Obligations. There is inherent ambiguity as to whether the words "to Obligations" governs the application of payments, or whether there are two (or three) categories of obligations included in the application of payments. In deals where this ambiguity has appeared, the term "Secured Obligations" appears, which is inclusive of obligations under the loan documents, secured hedges and secured cash management obligations. The term Secured Obligations appears in the catch-all step of the waterfall prior to the last step, in which proceeds are permitted to be distributed to the borrower.
4. The lead-in of the waterfall provides that the agent applies proceeds in accordance with the waterfall to "Agents and Lenders" and thus to the exclusion of third-party Hedge Providers.
5. In deals where there is a super-senior or first-out revolver, hedging obligations are not pari passu with the super-senior or first-out tranche.
6. The loan documents do not have a post-default waterfall at all! [8]

**Covenants Do Not Permit Secured Hedges**

Historically, many lenders affirmatively required their borrowers to obtain interest rate protection for a portion of the term loans. Although such affirmative requirements exist today in financings in certain industries or asset classes (such as project financings), a typical middle-market credit agreement will include limitations on the ability of a borrower (and the restricted group) to incur indebtedness, grant liens, dispose of assets, make distributions, prepay junior indebtedness, enter into agreements with restrictive covenants that would impact debt service and enter into transactions with affiliates. Accordingly, Hedge Providers need clarity that the covenants included in a borrower's credit agreement and ancillary guarantee and collateral documentation do not block the borrower's ability to enter into a secured swap.

Most credit agreements contain a restriction on the incurrence of indebtedness and granting of liens on property. Some credit agreements, however, do not include a clear exception for the incurrence of secured obligations under swap contracts entered into between the borrower and a Hedge Provider. Examples of well-intentioned, but technically inaccurate, debt and liens covenant exceptions include the following:

1. The debt and liens covenants include an exception for "Obligations," but Obligations is not defined to include obligations payable to Hedge Providers under secured swap contracts.
2. The debt and liens covenants include an exception for "Obligations under the Loan Documents," where "Loan Documents" is not defined to include secured swap contracts or explicitly excludes secured swap contracts. The exclusion of swap contracts from the term Loan Documents relates back to the introduction of benchmark transition language (to address the discontinuation of LIBOR and, thereafter, future benchmark replacements). As noted in the footnotes to the model credit agreement provisions published by a major loan trading association, if the term Loan Documents includes swap contracts, parties should consider explicitly excluding such swap contracts from the operative provisions of the benchmark replacement section, further noting that "[e]xcluding 'swap agreements' may result in differing fallback rates applicable to Loans under the Credit Agreement and the swap documented in such swap agreement." [9] Practically, that resulted in many sophisticated credit agreements excluding swap contracts from the definition of Loan Documents without building in a parallel exception to the debt covenant and liens covenant for obligations under swap contracts.

Many credit agreements have a so-called no-lender-action provision that prohibits action by individual lenders to exercise rights and remedies under the Loan Documents and clarifies that the sole person vested with authority to exercise rights and remedies on behalf of the Lender Parties (defined to mean the Lenders and related indemnitees) is the Administrative Agent, acting at the direction of the majority lenders. [10] The expansion of a no-lender-action provision, whether intended or otherwise, to apply to all Secured Parties, or to apply to any and all actions (and not just enforcement of rights and remedies) may trigger a request from Hedge Providers to clarify that enforcement of rights and remedies under a swap contract is not prohibited by such no-lender-action provision.

**Junior Capital or Pari Passu Capital Structures**

Given the adaptation of credit agreements from the BSL markets to direct lending transactions, it is not surprising that many such credit agreements include mechanics to incur pari passu debt and junior priority debt, including helpfully attaching forms of intercreditor agreements that may be used if such debt is incurred by the borrower. Such intercreditor agreement exhibits, if not appropriately drafted, may introduce barriers to the borrower entering into trades with Hedge Providers. Hedge Providers need certainty that (i) the incurrence of pari passu debt will not inadvertently prime the Hedge Providers' recovery in the waterfall and (ii) the "first lien" or "senior debt" cap included in any junior priority intercreditor agreement appropriately permits secured swap obligations (subject to any negotiated cap that the Hedge Provider underwrites prior to entry into a trade).

Examples of issues seen in documents include the following:

1. Secured swap obligations are not appropriately included in the definition of "senior obligations" or "first lien obligations" (or such similar term utilized in the relevant intercreditor agreement).
2. Hedge Providers are not appropriately captured in the relevant definition of secured creditors, and the intercreditor agreement does not appropriately provide that the first lien or senior debt representative acts as the representative for all secured parties under the credit agreement where the Hedge Provider intends to receive pari passu lien priority.
3. The intercreditor agreement imposes a cap on the amount of secured swaps that constitute senior obligations or first lien obligations (or such similar term utilized in the relevant intercreditor agreement), despite no such cap appearing in the underlying credit agreement.
4. The defined terms are inherently inconsistent or contain drafting glitches that prevent obligations to Hedge Providers from constituting senior obligations or first lien obligations (or such similar term utilized in the relevant intercreditor agreement) or having the priority afforded to Hedge Providers in the underlying credit agreement.

5. The intercreditor agreement imposes requirements on the incurrence of hedging obligations that are not contemplated by the underlying credit agreement.
6. The junior lien priority intercreditor agreement does not contain the requirement that the secured swaps be terminated prior to a junior priority lien agent or representative having access to the collateral.

**Agent's Role**

It is worth noting that many direct lending transactions are being originated with an independent, noncreditor provider of loan agency services functioning as the administrative agent (Independent Agent). One Independent Agent noted to the author that it is equipped to remit payments to secured swap counterparties, but that any such secured swap counterparties would need to be onboarded by the Independent Agent in a process separate from the onboarding of the lending entities. In addition, credit agreements often include explicit language that any provision in the credit agreement purporting to provide discretion to the administrative agent will instead be vested in the direct lending institution that has an anchor position (Lead Lender). Market participants should carefully evaluate any discretionary provisions that relate to Hedge Providers and work with the Independent Agent's legal counsel to clarify which discretionary provisions related to Hedge Providers should remain with the Independent Agent and not be vested in the Lead Lender.

**Conclusion**

Given the increasing importance of interest rate hedging in the middle market, market participants should carefully evaluate credit agreements to ensure that such credit agreements effectively permit the borrower to trade with Hedge Providers. By addressing the above drafting issues at origination or in connection with an amendment, borrowers will be able to approach the trading markets and concentrate on the economics and terms of the trade. For more information, contact Dev Ghose.

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1. Investec, Why should Private Equity managers focus on interest rates and currency risks?, INVESTEC (Mar. 18, 2024), https://www.investec.com/en_gb/focus/private-equity-trends/2024/why-should-private-equity-managers-focus-on-interest-rates-and-currency-risks.html. ↩
2. Silas Brown & Abhinav Ramnarayan & Paula Seligson, Hedging Failure Exposes Private Equity to Interest-Rate Surge, BLOOMBERG L.P. (June 20, 2023, 7:00 AM), https://www.bloomberg.com/news/articles/2023-06-20/private-equity-firms-exposed-by-unhedged-risk-interest-rates-surge. ↩
3. Peter Madigan, The Inexorable Rise of Private Credit, THE BANK OF NEW YORK MELLON CORPORATION, AERIAL VIEW (June 27, 2024), https://bk.bnymellon.com/Aerial-View---Long-Read-The-Inexorable-Rise-of-Private-Credit.html. ↩
4. Notably, some agreements further provided that secured Hedge Bank status is contingent upon the affiliated financial institution continuing to be a lender to the borrower. ↩
5. As discussed later in this article, many credit agreements in direct lending transactions provide that discretionary actions of the administrative agent are instead vested in a representative of the direct lending institution with an anchor position. To the extent such discretionary actions relate to satisfactory on-boarding of the Hedge Provider, market participants should consider whether such discretionary actions should explicitly remain with the administrative agent. ↩
6. Some borrowers have taken the position that the presence of the proviso alone (without the additional bolded language in clause (y)) is sufficient to facilitate non-agent and non-lender trading entities as being "Hedge Banks". Hedge Providers may not agree to such interpretation. ↩
7. Some lenders may wish to cap the obligations that may be paid on a pari passu basis with the principal on the loans. Any cap in the waterfall will be evaluated by credit officers at a potential Hedge Provider and may limit the notional amount of the debt subject to the trade. ↩

8. Yes! This has happened! Some historic forms included the post-default waterfall in the security agreement. There are instances where the credit agreement historically originated on one bank's form (contemplating the post-default waterfall to be included in the security agreement), and the security agreement utilized in the deal originated with another bank's form … resulting in a deal being executed without any post-default waterfall. ↩
9. LSTA, Daily Compounded SOFR Concept Document 43 n.43 (Aug. 3, 2023). ↩
10. Whether such "no lender action" provision includes exceptions for exercising rights of setoff and/or filing proofs of claims and pleadings during a bankruptcy proceeding is a negotiated point between the borrower and its lenders. ↩

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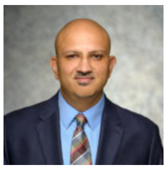

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