Corporate Hedging, Contract Rights, and Basis Risk*

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ABSTRACT

A hedging contract can be terminated by a counterparty following a firm's event of default, such as a credit downgrade, covenant violation, or bankruptcy. This right is often exercised. Our model shows that although the termination right reduces hedging costs, it can reduce firm value because the counterparty exercising it does not consider the externality imposed on the firm. Consequently, firms hedge less, especially when facing high bankruptcy costs, and are more likely to enter liquidation. Using detailed hedging data, we confirm the model's predictions and provide an explanation for low hedging during financial distress.

JEL codes: G30, G32

Keywords: hedging, risk management, derivatives, event of default, counterparty, basis risk, distress, contract, ISDA

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