CLIENT ALERT

The Rise of Protections in Credit Agreements and Indentures Against "Net Short" Strategies

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Recently, several provisions have appeared in credit agreements and indentures that limit the ability of creditors who stand to benefit from an obligor's default or bankruptcy by triggering restructuring events.

In the restructuring and corporate debt markets, there is a growing concern about the activism of "net short" creditors, who despite holding "long" positions in an obligor's corporate loans or bonds may be more motivated by their significant "short" positions in reference to the credit quality of the obligor or of such loans or bonds. To the extent that a creditor's "net short" position, rather than its interests as a debt-holder, drives its decision-making, some commentators and market participants have argued that these positions have made work-outs and restructurings of distressed companies more complicated and unpredictable, if not impossible. Over the last several weeks, corporate obligors have decided proactively to take the steps necessary to curtail the potential for such disruption in a work-out or restructuring.

The most prominent (suspected) example of this strategy may have been employed by Aurelius Capital Management ("Aurelius") against Windstream Communications ("Windstream"). Aurelius accumulated the requisite percentage of a series of Windstream bonds and, in September 2017, delivered a default notice asserting that a spin-off transaction consummated by Windstream in April 2015 (two years prior to the default declaration) constituted an unpermitted "Sale and Leaseback Transaction" within the meaning of the operative indenture. On February 15, 2019, after a long and highly publicized trial on the merits of the default notice (and subsequent attempts by Windstream to cure the default), Judge Jesse Furman of the Southern District of New York ruled in favor of Aurelius, following which Windstream filed for Chapter 11 bankruptcy protection. The market speculated that Aurelius had profited from this strategy as a "net short" creditor due to its position as a holder of credit default swaps ("CDS") that paid out upon the occurrence of certain "credit events," including a Windstream bankruptcy.

Historically, the syndicated loan market offered some protection to obligors in the form of "disqualified lender" lists, which prohibit certain identified institutions and their affiliates from holding the applicable loan. However, in the aftermath of the Windstream bankruptcy and other situations where market participants believed that creditors utilized their CDS position to drive corporate debt recovery strategies, some obligors are proactively taking additional steps to curb the potential for similar strategies in the future:

- One approach, seen in Charter Communications' recent $750 million issuance of 2029 senior notes,[1] is to include a restriction that "a notice of Default may not be given with respect to any action taken, and reported publicly or to Holders, more than two years prior to such notice of Default." This provision effectively imposes a "statute of limitations" on creditors' rights to declare defaults so long as the underlying transaction was reported either publicly or to the holders of the applicable bonds, thereby preventing creditors from opportunistically "sitting on" a challenge to a transaction.

- Another approach seen in several recent credit agreements is to provide that any lender with a "net short position" will be prohibited from voting with respect to any amendment, waiver or direction in circumstances where it would otherwise be permitted to do so and will be deemed to have voted its holdings in the same proportion as the other lenders. These credit agreements set forth certain parameters for determining whether a lender has a "net short position" and imposes an obligation on each lender to promptly notify the administrative agent that it is a "net short lender" (subject to the assumption that, absent any such notice, each lender will be deemed to represent that it is not a "net short lender"). This provision is subject to certain exceptions, including for "bona fide market making activities," for revolving lenders at closing and for certain regulated banks.

We anticipate that the same or similar provisions will appear with increasing frequency in the future. As the market evolves, participants on all sides of this issue will need to consider the wisdom and efficacy of these provisions:

- For obligors, are these provisions effective in protecting against "activist investors" (i.e., are they susceptible to some "workaround")? What is the enforcement mechanism and what is the remedy if a "net short lender" has breached its deemed representation? Will these provisions stand up in court if they are challenged (e.g., is the statute of limitations "unreasonably short")? Will the presence of "net short lender" provisions have unintended consequences (such as making it more difficult in certain circumstances to obtain requisite lender consents for amendments)?

[1] See https://www.sec.gov/Archives/edgar/data/1091667/000119312519161294/d753026dex42.htm.

- For creditors, should their positions be aggregated with those of their affiliates (who may operate independently) and is it feasible to capture the net position of a complex financial institution on an ongoing basis? Should the magnitude of the “net short” position have some relevance? Should sophisticated parties be excused from breaches of negotiated contracts based solely on the passage of time, and should creditors accustomed to keeping confidential their trading strategies be required now to divulge their positions?
- And from the perspective of the broader market, will these provisions impact overall liquidity or discourage investors from acquiring loans or bonds with these provisions? Will these changes discourage the use of CDS and other derivative instruments, which many market participants employ for legitimate purposes? Do these provisions eliminate a “restructuring catalyst” and thereby make it more difficult to force obligors to engage in restructuring discussions with their creditors? Will these changes mitigate the inherent informational asymmetry that parties with CDS positions wield and help obligors and other market participants better understand creditors’ “true” motives?

We anticipate that these and other related questions will be debated in the coming weeks and months as these provisions inevitably spread throughout the market.

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