"The Net Short": U.S. and European High-Yield Covenant Trends in Response to Net Short Activism

Background

On February 15, 2019, the U.S. District Court for the Southern District of New York issued its ruling in the case of Aurelius Capital Master, Ltd. ("**Aurelius**") against Windstream Services, LLC ("**Windstream**"). The origins of the case date back to April 2015, when one of Windstream's affiliates spun off and, subsequently, leased back some of its real estate and other assets. Two years after that transaction, Aurelius, a fund that purchased a controlling position in Windstream's 6.375% Senior Notes due 2023 (the "**2023 Notes**"), challenged the transaction, alleging that the sale and leaseback was not permitted under the 2023 Notes indenture, and issued a notice of acceleration related to the 2023 Notes. The district court ruled in favor of Aurelius, stating that the transaction resulted in an event of default under the 2023 Notes indenture and that Aurelius' notice of acceleration was valid. This meant that Windstream was consequently in default under a number of its other debt instruments, by virtue of cross-default or cross-acceleration provisions in those instruments, and faced an immediate liquidity crisis with no access to financing to fund its business operations. As a result, on February 25, 2019, Windstream filed for Chapter 11 bankruptcy, despite the fact that at the time it had no operational failures.

It has been generally understood that, at the time it brought its suit against Windstream, Aurelius held credit default swaps ("**CDS**"), creating a net short position in Windstream's debt. For a typical noteholder with a net long position in a note[1], especially one that is structurally-, lien- or payment-subordinated in the capital structure, the issuer's bankruptcy would generally be viewed as undesirable because of the risk that potential recoveries under the note could be significantly lower than par (or the amount the holder paid to purchase the notes). In contrast, noteholders with a net short position in a note would arguably operate under an opposite set of economic incentives because the CDS would pay out if the reference entity (such as Windstream, in the case of CDS protection on the 2023 Notes) experiences an adverse credit event (such as, among others, a payment default or bankruptcy filing, as in the Windstream case). As such, a net short noteholder may not be interested in negotiating with an issuer and its group to find ways to avoid bankruptcy if any issues arise during the term of the notes.

The use of CDS-driven investment strategies by certain credit investors that benefit from an issuer's credit event has the potential to upend the historically aligned incentives of all noteholders in a particular class of an issuer's debt. Windstream was only the latest in a number of CDS-driven debt defaults by corporate issuers, from the Spanish gaming company Codere in 2013 to the homebuilder Hovnanian in 2017 (which also resulted in litigation that was finally settled in 2018).[2] Consequently, there has been a growing awareness among participants across the loan, high-yield and derivatives markets of the need to effectively address the potential impact of CDS, or similar instruments, on both issuer-creditor and intercreditor relationships and on the credit markets, generally.

On September 19, 2019, the Chairmen of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission, along with the Chief Executive of the U.K. Financial Conduct Authority, issued an Update to June 2019 Joint Statement on Opportunistic Strategies in the Credit Derivatives Market, where the agencies outlined concerns about continued pursuit of various opportunistic strategies in the credit derivatives markets, including "manufactured credit events", and their potential adverse impact on the "integrity, confidence and reputation of the credit derivatives markets, as well as markets more generally".[3] The agencies emphasized that they "expect firms to consider how the aforementioned opportunistic strategies may impact their businesses and to take appropriate action to mitigate market, reputation and other risks arising from these types of strategies". The agencies "look forward to further

1 A noteholder's hedging strategy with respect to a specific bond or an issuer may employ short positions in CDS or another type of security, and this type of hedging activity has generally been viewed as standard by the market.

2 Note that, unlike Windstream, Codere and Hovnanian involved a "manufactured default", whereby net short activists cooperate with, and encourage the issuer, which is an otherwise solvent company, to deliberately default on its debt, thereby triggering a credit event and pay-out under CDS purchased against the reference security.

3 *See* Update to June 2019 Joint Statement on Opportunistic Strategies in the Credit Derivatives Market, *available at* https://www.sec.gov/news/public-statement/update-june-2019-joint-statement-opportunistic-strategies-credit-derivatives (Sept. 19, 2019). *See also* Joint Statement on Opportunistic Strategies in the Credit Derivatives Market, *available at* https://www.sec.gov/news/press-release/2019-106 (June 24, 2019).

industry efforts to improve the functioning of the credit derivative markets and welcome continuing engagement with market participants".[4]

While potential legislative responses to the issue remain possible, loan and high-yield bond market participants have presently endeavored to address the issue by introducing two main types of contractual restrictions in debt documentation:[5]

(1) a **net short disenfranchisement ("NSD") provision**, which prohibits a noteholder from exercising its voting rights if it effectively holds a "net short" position in a specific instrument; and

(2) a **sunset on covenant enforcement provision**, which prohibits default notices following a certain period (typically, two years) after the triggering action or event was originally reported to noteholders or publicly.

In this note, we examine the key terms and mechanics of these provisions and provide an overview of the trends and changes in their formulations over 2019 in the U.S. and European high-yield bond markets. These formulations continue to develop and have not yet been widely tested on the U.S. or European markets.

Net Short Disenfranchisement

In 2019, the NSD provision was included in the final terms of a small, but growing number of U.S. high-yield offerings, generally those involving private equity sponsor-owned companies. This provision was also introduced in the preliminary terms of a couple of European high-yield offerings during 2019, although it was retained in the final terms of only one of the offerings (i.e., following the completion of the marketing process and discussion of the proposed terms between the issuer and investors).[6]

The NSD provision may include several important variations, which drafters should be aware of to ensure that the provision, if incorporated in high-yield bond deals, strikes the right balance between protection of the issuer and net long noteholders against net short activism without overreaching in its scope such that the overall liquidity in the notes is negatively affected.

4 We briefly note that there have already been certain changes in the derivatives markets aiming to address some issues with the so-called "narrowly tailored credit events" or "manufactured defaults". Specifically, on July 15, 2019, the International Swaps and Derivatives Association ("**ISDA**") published the 2019 Narrowly Tailored Credit Event Supplement (the "**NTCE Supplement**") to the 2014 ISDA Credit Derivatives Definitions.
The NTCE Supplement amends two key definitions relating to the "narrowly tailored credit events", which are events that are significant enough to trigger credit events under a CDS contract leading to its settlement, but narrow enough to avoid actually impairing the creditworthiness or financial condition of the company on which the credit event is determined (the "**Reference Entity**"). In particular, the NTCE Supplement amends the definition of a "Failure to Pay" by introducing a "Credit Deterioration Requirement". If this requirement is specified as applicable in the relevant CDS contract then a failure to make due payment "shall not constitute a Failure to Pay if such failure **does not directly or indirectly either result from, or result in, a deterioration in the creditworthiness or financial condition of the Reference Entity**". *See* 2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions, *available at* https://www.isda.org/book/2019-narrowly-tailored-credit-event-supplement-to-the-2014-isda-credit-derivatives-definitions.
CDS parties can effectively apply the NTCE Supplement to their existing contracts by adhering to the ISDA 2019 NTCE Protocol, which was published on September 16, 2019. *See* ISDA 2019 NTCE Protocol, *available at* https://www.isda.org/protocol/isda-2019-ntce-protocol.
The NTCE Supplement will apply to uncleared CDS (except where the transaction references a sovereign Reference Entity) that are entered into on or after the implementation date (set for Jan. 27, 2020). Cleared trades are not covered by the NTCE Supplement and are instead addressed by equivalent amendments to the central clearinghouse's rulebook.

5 While comparable structures have also been introduced in the U.S. and European loan markets, this publication primarily focuses on the trends seen in the U.S. and European high-yield markets.

6 We have already seen the NSD provision appearing in the preliminary terms of at least one European high-yield offering in January 2020.

(1) Scope of Application

Drafters must carefully consider the scope of activities and voting rights affected by the NSD provision. So far, there have generally been two main approaches to this so-called "net short" position representation ("**Position Representation**"):

(1) a provision stating that **any notice of default, notice of acceleration or instruction to the Trustee to provide a notice of default, notice of acceleration or to take any other action** provided by any one or more holders must be accompanied by a written representation that the applicable beneficial owners of the notes are not "net short" ("**Default Notice Position Representation**"); and

(2) a broader provision stating that **each amendment, supplement, waiver or modification of the indenture or the notes, as well as any other request, demand, authorization, direction, notice, consent or waiver under the indenture** must be accompanied by a written representation that the applicable beneficial owners of the notes are not "net short" ("**General Amendment Position Representation**").

In the high-yield offerings containing the NSD provisions in 2019, the Default Notice Position Representation was more prevalent, and it arguably more directly addresses the Windstream scenario, where the underlying issue was an alleged uncured covenant default. However, there is some concern that net short activists could block the adoption of proposed amendments, waivers or other modifications of the indenture that are intended to "defuse" or forestall potential covenant breaches or other events that could potentially result in an event of default under the governing indenture and are, therefore, viewed as beneficial from the perspective of the issuer and net long noteholders, by refusing to vote in favor of such amendments, waivers or other modifications. Accordingly, certain issuers have sought to include the more comprehensive General Amendment Position Representation in their high-yield bonds.

(2) *"Net Short" Definition and Treatment of Affiliates*

In the NSD provisions with the Default Notice Position Representation, "Net Short" is generally defined along the lines of the following example:

"Net Short" means, with respect to a Holder or beneficial owner, ***as of a date of determination****, either (i) the* ***value*** *of its* ***Short Derivative Instruments*** *exceeds the sum of (x) the* ***value*** *of its Notes plus (y) the* ***value*** *of its* ***Long Derivative Instruments as of such date of determination*** *or (ii) it is reasonably expected that such would have been the case were a* ***Failure to Pay***[7] *or* ***Bankruptcy Credit Event*** *(each as defined in the 2014 ISDA Credit Derivatives Definitions) to have occurred with respect to the Issuer or any Guarantor immediately prior to such date of determination.*

"Derivative Instrument" is generally defined as follows:

"Derivative Instrument" with respect to a Person, means ***any contract, instrument or other right to receive payment or delivery of cash or other assets to which such Person*** *or any Affiliate of such Person that is acting in concert with such Person in connection with such Person's investment in the Notes (other than a Screened Affiliate)* ***is a party*** *(whether or not requiring further performance by such Person),* ***the value and/or cash flows of which*** *(or any material portion thereof) are* ***materially affected*** *by the value and/or performance of the Notes and/or the creditworthiness of the Issuer and/or any one or more of the Guarantors (the "Performance References").*[8]

Instead of "value", some examples of the "Net Short" definition refer to the "notional amount" (particularly in the NSD provisions with the General Amendment Position Representation).[9] It is generally not explicitly stated in the "Net Short" definition whether the use of the term "value" means "fair value", "notional amount" or some other measure. However, consistent with market and accounting practice, "value" should be deemed to refer to "mark-to-market value" or "fair value" and not "notional amount".[10] Notably, the Default Notice Position Representation is typically deemed to be provided on a "continuing basis" (i.e., it is deemed a continuing representation until the date the event of default at issue is cured, waived or otherwise ceases to exist). The calculation of "value" for many derivative instruments, therefore, is difficult, as the derivative instrument's value could fluctuate during the life of the contract due to market movements and other factors, making it difficult to monitor the ongoing position. On the other hand, since "notional amount" is a "notional" figure, it may not accurately capture the economic value and power held by the noteholder and not account for fluctuations in such value.

Furthermore, in assessing whether it has a "net short" position, a noteholder would typically also need to include its affiliates that are "acting in concert" with respect to a specified investment. For some noteholders, such as financial institutions, additional internal tracking systems may need to be put in place in order to include affiliates in the determination of whether they have a "net short" position. Although "screened affiliates"[11] are generally excluded for purposes of the calculation, the NSD provisions with the General Amendment Position Representation typically provide that "screened affiliates" can only be excluded after the noteholder's "reasonably inquiry" as to whether that affiliate has any interest in any notes and/or any applicable short instrument.

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7 *See supra* note 4 for discussion of the recent amendments to the "Failure to Pay" definition.

8 "Short Derivative Instrument" is generally defined to mean a "Derivative Instrument (i) the value of which generally decreases, and/or the payment or delivery obligations under which generally increase, with positive changes to the Performance References and/or (ii) the value of which generally increases, and/or the payment or delivery obligations under which generally decrease, with negative changes to the Performance References". Conversely, "Long Derivative Instrument" is generally defined to mean a "Derivative Instrument (i) the value of which generally increases, and/or the payment or delivery obligations under which generally decrease, with positive changes to the Performance References and/or (ii) the value of which generally decreases, and/or the payment or delivery obligations under which generally increase, with negative changes to the Performance References".

9 See a general example below:
"Net Short Holder" means **any Notes Beneficial Owner** *(alone or together with its Affiliates (but subject to clause (vi) below)) (other than any Notes Beneficial Owner that is a Regulated Bank)* **that***, as a result of its (or its Affiliates' (but subject to clause (vi) below)) interest, whether held directly or through any intermediary, in any total return swap, total rate of return swap, credit default swap or other derivative contract (other than any such total return swap, total rate of return swap, credit default swap or other derivative contract entered into pursuant to bona fide market making activities),* **has a net short position with respect to the Notes***. For purposes of determining whether a Notes Beneficial Owner (alone or together with its Affiliates (but subject to clause (vi) below)) has a "net short position" on any date of determination: (i)* **derivative contracts with respect to the Notes** *and such contracts that are the functional equivalent thereof* **shall be counted at the notional amount thereof** *in Dollars; " . . . "*

10 Fair value is defined under the U.S. accounting standards (Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements*, paragraph 5) and the International Financial Reporting Standards (IFRS 13) as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date".

11 "Screened Affiliate" is generally defined along the lines of the following example:
"Screened Affiliate" means any **Affiliate of a Holder** *(i) that* **makes investment decisions independently** *from such Holder and any other Affiliate of such Holder that is not a Screened Affiliate, (ii) that* **has in place customary information screens** *between it and such Holder and any other Affiliate of such Holder that is not a Screened Affiliate and such screens prohibit the sharing of information with respect to the Issuer or its Subsidiaries, (iii) whose* **investment policies are not directed by such Holder** *or any other Affiliate of such Holder that is acting in concert with such Holder in connection with its investment in the Notes, and (iv) whose* **investment decisions are not influenced by the investment decisions of such Holder** *or any other Affiliate of such Holder that is acting in concert with such Holders in connection with its investment in the Notes.*

One important clarification on the "materially affected" prong of the "Derivative Instrument" definition, which we have seen in a minority of the proposed NSD provisions, is the exclusion of positions that a noteholder and its affiliates may have in any general index.[12]

(3) Verification Covenant

The majority of NSD provisions which cleared the market in 2019 (particularly those with the Default Notice Position Representation) also included a covenant that holders will provide (typically, within five business days) the issuers with such other information as the issuers may reasonably request from time to time in order to verify the accuracy of such noteholder's Position Representation.

(4) Consequences of Breach and Forced Transfer

While most formulations of the NSD provision state that the vote of any noteholders who misrepresented or violated their Position Representation should be disregarded, it is important to consider whether the respective notes held by such noteholders will be subtracted only from the numerator or from both the numerator and the denominator in determining the final outcome of the vote. This is an important distinction as the second approach prevents the potential dilutive effect of the breaching noteholders' vote. The NSD provisions with the General Amendment Position Representation typically include an explicit provision that the notes owned by any net short holders are to be deemed disregarded and not outstanding for the purposes of determining whether the requisite amount of outstanding notes voted in favor of any amendment, waiver or notice.

In addition, high-yield offerings containing the NSD provisions with the General Amendment Position Representation also include another issuer-friendly provision that allows the issuer to require any noteholder that makes an incorrect Position Representation or breaches its covenant not to take any prohibitive actions to transfer the notes in question back to the issuer at the lesser of (i) the principal amount of the notes and (ii) the most recently available quoted price for such notes (as determined by the issuer in good faith).

(5) Stay on Cure Period During Litigation

Another important caveat that has been present in a number of formulations of the NSD provisions (particularly those with the Default Notice Position Representation) is the stay on cure period, which provides that if, following the delivery of the Position Representation, the issuer: (i) determines, in good faith, that there is a reasonable basis to believe that a noteholder was, at any relevant time, in breach of the Position Representation and (ii) initiates litigation seeking to invalidate any event of default on this ground, then the running of the cure period with respect to the relevant default shall automatically be stayed pending the court's final and non-appealable determination on such matter.

Sunset on Covenant Enforcement

This provision was developed in parallel to the NSD provision as another potential response to net short activism. Typically, if an event of default takes place under the indenture at any point during the term of the notes, the trustee or the holders of a certain percentage of the outstanding notes can declare the notes to be due and immediately payable, subject to certain notification requirements and the running of a grace period. The newly introduced sunset provision, however, provides 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***".

It is important to note that this provision could potentially be read as more limiting than the NSD provision as it covers the actions of all noteholders, regardless of their net short position. In 2019, the majority of high-yield offerings including the NSD provision also included the sunset on covenant enforcement provision. Moreover, there have been a few market examples where the sunset on covenant enforcement provision appeared without the NSD provision.

12 This concept is usually reflected in the "Derivative Instrument" definition through the inclusion of the following language at the end of the definition:

> *Derivative Instruments in respect of an index that includes the Issuer or one or more of the Restricted Subsidiaries or any instrument issued or guaranteed by the Issuer or one or more of the Restricted Subsidiaries* ***shall not be deemed to be "materially affected" with respect to the Notes and/or the creditworthiness of the Issuer and/or one or more of the Restricted Subsidiaries, so long as the Issuer and the Restricted Subsidiaries and any instrument issued or guaranteed by the Issuer and the Restricted Subsidiaries, collectively, shall represent less than 5% of the components of such index.***

Conclusion

While the NSD and the sunset on covenant enforcement provisions were featured only in a minority of U.S. high-yield offerings in 2019, we expect to see the drafting of both provisions to continue to evolve going forward and, potentially, see their broader adoption in future offerings as they gain further market acceptance. The European high-yield market has not, to date, actively adopted these provisions. However, as these provisions gain further traction in the U.S. high-yield market, certain types of offerings in Europe, particularly sponsor-led transactions, are likely to start pushing for inclusion of similar provisions. Furthermore, similar language is currently being introduced in some credit facilities in the U.S. (and, to a smaller extent, in Europe) and we, therefore, expect that, over time, there will be an expectation to mirror these provisions in high-yield documentation in order to align the terms of borrowers' high-yield indentures and credit facilities.

We will continue to monitor developments in this area and welcome any queries you may have.

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