Client Alert

Milbank

Net Short Lender Disenfranchisement: Is the New Anti-CDS Vaccine Safe and Effective?

Sirius Responds to "Net Short Debt Activism" after Windstream

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Windstream Holdings, Inc.'s ("**Windstream**") chapter 11 bankruptcy filing following its contentious litigation with Aurelius Capital Management LP ("**Aurelius**")[1] has rekindled market participants' concerns over the effects of so-called "net short debt activism" – the efforts of creditors who, despite holding a borrower's debt, seem motivated to push the borrower into distress over covenant or other defaults. *Bloomberg*'s Matt Levine succinctly summarized these concerns in a recent column, writing that net short debt activism is "the idea that someone who is betting against a company will acquire some of its debt and use that position to call defaults, make trouble, and generally try to drive an otherwise healthy company into bankruptcy over a minor technical default. It seems bad."[2]

Borrower concern about the identity and motivations of potential creditors has long been an issue in the negotiation of credit agreements, and the practice of explicitly disqualifying certain entities, such as the borrower's competitors, from becoming lenders under the credit agreement is a familiar one. The recent move by Sirius Computer Solutions, Inc. ("**Sirius**") to try to protect itself against "net short debt activism" more generally is perhaps the first publicly reported[3] use of a provision to target a lender's ability to vote

[1] The Windstream-Aurelius saga has many twists and turns, but a brief summary is that Aurelius, after purchasing some of the company's bonds, alleged in December 2017 that Windstream had – over two years earlier – violated a covenant by entering into its sale-leaseback transaction with Uniti Group Inc. After Windstream arranged, though a larger bond exchange transaction, for many of its other bondholders to waive the default, the company argued that the covenant had not actually been breached and took Aurelius to court over the dispute. After over a year in court, Judge Jesse Furman of the US Southern District Court of New York held that Windstream had indeed violated the covenant and that the subsequent waivers of that default were not valid. Facing a $310 million judgment in favor of Aurelius, Windstream filed for bankruptcy shortly thereafter. Given that Aurelius's action had the foreseeable effect of reducing the expected recovery on the bonds it owned, market participants have assumed that Aurelius was primarily pursuing a larger payout on credit default swaps ("**CDS**") referencing Windstream.

[2] Matt Levine, *Maybe Companies Will Get Rid of CDS*, Money Stuff, May 23, 2019.

[3] *See* Bakewell, Sally & Natarajan, Sridhar (May 23, 2019), Buyout Firm Uses Unusual Ploy to Keep Haters at Bay in Loan, *Bloomberg News*; see also Matt Levine, *The Wild Frauds are the Good Ones*, Money Stuff, May 24, 2019, and

based on its other economic interests beyond the loan itself.[4] The Sirius net short lender provision therefore serves as a useful example of the challenges and limitations inherent in any such effort.

As we discuss below, however, this new proposed cure may not always be as effective as borrowers would like, while also having potentially unhealthy effects on the credit ecosystem. As a result, while it is understandable that borrowers will seek to deter individual lenders from taking actions that would be uneconomic for a pure creditor,[5] we expect that parties will find it difficult to draft a net short lender provision that effectively protects the borrower from the risk of mis-aligned incentives without imposing restrictions that are untenable for most lenders.

The Sirius Net Short Lender Provision

The Sirius net short lender provision (as reported in Covenant Review) provides that:

> *…any Lender (other than (x) any Lender that is a Regulated Bank and (y) any Revolving Lender as of the Closing Date) that, as a result of its interest in any total return swap, total rate of return swap, credit default swap or other derivative contract (other than any [such swap] entered into pursuant to bona fide market making activities), has a net short position with respect to the Loans and/or Commitments shall have no right to vote any of its [loans] and shall be deemed to have voted its interest as a Lender without discretion in the same proportion as the allocation of voting with respect to such matter by Lenders who are not [net short lenders].*

The provision then goes on to describe that a lender's "net short position" will be determined using the following rules (with certain provisions summarized in brackets below):

1. *derivative contracts with respect to the Loans and Commitments and such contracts that are the functional equivalent thereof shall be counted at the notional amounts thereof…;*
2. *[notional amounts will be converted to dollars];*
3. *[derivatives referencing an index will be disregarded] so long as (x) such index is not created, designed, administered or requested by such Lender and (y) [the borrower's or any other loan party's obligations account for less than 5% of such index]; and*
4. *[standard CDS contracts will be deemed short positions if, under such contract] (A) such Lender is a protection buyer and (B) (x) the Loans or the Commitments are a "Reference Obligation", (y) the Loans or the Commitments would be a "Deliverable Obligation", or (z) [the borrower or any other loan party] is a "Reference Entity."*

Challenges Illustrated by the Sirius Net Short Lender Provision

While we lay out below several unresolved issues in the Sirius net short lender provision, we acknowledge at the outset that its goal is difficult (if not impossible) to achieve and therefore the provision's shortcomings are to be expected (and may be unavoidable) given the concerns one would expect potential lenders to

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Covenant Review (May 28, 2019), *"Net Short" Lender Disenfranchisement: A Response to Windstream* (reporting on a no-names basis on what we have inferred is the Sirius provision).

[4] As discussed in more detail below, the relevant provision in the Sirius credit agreement would strip voting and consent rights from any lender that has a "net short position with respect to [loans under the credit agreement]." We refer to this type of provision in this note as a "**net short lender provision**," and we use the term "**net short lender**" to mean a lender whose overall economic position, despite its position as a lender, is short the credit of the borrower. While this typically occurs when the lender purchases more CDS protection than the debt it holds, there are other circumstances that could put a lender in this position.

[5] Indeed, some creditors may also favor some form of protection against net short debt activism, as its results can sometimes be against their interests as well, as the Windstream case demonstrated.

raise. Indeed, it may be that some of the issues we outline below were the direct result of requests made by potential lenders in the negotiation of the agreement.

What about affiliates of the lender?

One of the more difficult problems to address in a net short lender clause is the treatment of the lender's affiliates: should an affiliate's positions in the company's debt or credit derivatives be considered when determining whether a lender is net short? If so, how broadly should "affiliates" be defined? If not, how can the borrower ensure the provision will work as intended? The Sirius approach to this issue seems to have been to exclude lenders' affiliates from the scope of the provision entirely. The problem with this approach, however, is that it allows a sister company, subsidiary or parent of a lender to hold CDS or other credit derivatives while the lender itself remains in compliance with the provision (provided the lender doesn't acquire the benefit of its affiliate's short position through a back-to-back contract of the same type). Presumably, Sirius found it necessary (reportedly as a result of negotiations with lenders)[6] to exclude affiliates because including them would, at the very least, be extremely onerous to any lender with credit fund affiliates, as the lender likely would not have the ability or desire to constantly monitor[7] its affiliates' positions and may not want to risk being prohibited from exercising remedies or voting as a result of the positions held by its affiliates at the time.[8] Nevertheless, a lender that wants to maintain the ability to establish "net short" incentives should have little trouble structuring around this provision. The Sirius example may demonstrate that the exclusion of affiliates from the reach of the provision is commercially necessary for lenders, but it likely will be fatal to its effectiveness for borrowers.

A more recent iteration of this net short lender provision in a credit agreement for a different borrower[9] reportedly attempted to address this problem by extending the application of the provision to affiliates, but permitted positions of any affiliates managed separately from the lender to be excluded, only if those positions are not ascertained by the lender after good faith inquiry. While this iteration of the provision would do more to protect borrowers than the original Sirius provision, its application to the more general universe of creditors is likely to raise many questions (including, for example, whether a particular affiliate is considered separately managed, and whether an inquiry is considered reasonable) and meet with more resistance.

What does "net short position" actually mean?

Another key implementation issue is that precisely defining a "net short position" is not easy. Lenders will require certainty and will therefore negotiate for a clear definition of the concept. An overly broad definition will be too restrictive for most lenders, but any approach that does not capture all methods of effecting a short position will potentially put the provision's effectiveness at risk. As a case study in the difficulties inherent in crafting an effective net short lender provision, the Sirius example (again, perhaps foreseeably) could be said to be both under- and over-inclusive in certain respects:

- Although perhaps appropriate in the context of a relatively simple capital structure such as that of Sirius, the provision itself seems clearly over-inclusive. By not addressing the "long" side of the equation, the provision would capture a lender whose overall exposure to the borrower extends

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[6] According to *Bloomberg News*, Sirius initially proposed including at least some affiliates but later narrowed the provision to exclude affiliates entirely. *See* footnote 3.

[7] Moreover, calculating the credit exposure of an affiliate is not necessarily a straightforward task. How, for example, should an affiliate's equity holding in a CLO that holds one of the company's loans be treated?

[8] We also note that the Sirius provision provides for deemed representations by lenders that they are not net short (unless the administrative agent is notified otherwise), so, to the extent that a lender voted on an issue while unknowingly being net short, there would presumably be other undesirable consequences for a lender that breaches this representation.

[9] See Covenant Review (June 6, 2019), *The Windstream-Inspired Net Short Lender Disenfranchisement Provision Undergoes Refinement.*

beyond its position in the loan (e.g., by way of its holdings of equity of the company or of debt other than the loans).

- At the same time, the provision fails to consider other ways in which a lender's position may benefit from a borrower default. For example, short positions on the equity of the borrower could provide a lender with an incentive to push for a default. Further, positions in credit derivatives that are more exotic than standard flow-traded CDS (such as options on CDS) may be difficult to compare to CDS notional or bond principal on an apples-to-apples basis.[10]

- Even with respect to the prime suspect – CDS – the provision's use of the blunt instrument of notional amounts to calculate net positions may fail where the potential payout under a triggered CDS contract upon a default is greater (on a percentage basis) than the diminution in value of the loan (as would likely be the case if another obligation was the cheapest-to-deliver for purposes of setting CDS recovery or if the loan was acquired in the secondary market at a significant discount). The provision also fails to address how a lender might utilize mismatches in the tenors of bought and sold CDS contracts of equal notional amounts.[11]

Why not banks?

Another issue implicated by the Sirius provision is the exclusion of "Regulated Banks" from the Sirius net short lender provision, leaving hedge funds or other non-market-making asset managers as the potential targets of the provision. One reason for this distinction may be that (again foreseeably) applying the provision to banks would be unworkable, as they may have a wide variety of positions with respect to the borrower at any given time on which it would be impractical to place limits. On the other hand, non-banks are also likely to object to the provision (or at least to any version that extends to affiliates). Given the current market structure in which non-banks act as an essential source of credit, these objections may make loans with these provisions materially less marketable in many cases.

What about basis holders?

Finally, it is worth noting that net short lender provisions – including the Sirius provision – do not attempt to address the "empty creditor hypothesis" long discussed in the literature with respect to basis package holders.[12] The Sirius provision, for example, explicitly allows a lender to retain its voting rights as long as it is not over-hedged with respect to its loans and/or commitments. As noted above, this position still leaves plenty of space for a lender to be incentivized to favor a borrower default.

Potential Ill-Effects of Net Short Lender Provisions on Credit Markets Generally

In one sense, settling the questions of efficacy and clarity raised by the Sirius net short lender provision are purely the prerogative of Sirius and the limited set of lenders with whom it is negotiating. However, lenders and other investors should consider the impact a profusion of net short lender provisions might have on the broader credit markets. At least three concerns occur to us.

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[10] For instance, if creditor A sells creditor B $1000 notional of a 1yr5yr CDS call option with a strike of 10 points upfront ("**PUF**") (i.e. the right to buy $1000 of 5 year CDS from creditor A for 10 PUF, expiring in 1 year), creditor A is long the company's credit because it wants CDS protection to decline in value so that the option it sold expires worthless. Should this option sale be counted as a $1000 long position for creditor A? What if the option is very far out of the money (i.e. the option strike is instead 50 PUF compared to a price of 5 PUF today)? Would it appropriately be counted as part of Creditor B's short position and to what extent?

[11] By way of example, a creditor could hold $100 of the loans, sell $1000 of 5 year CDS, and buy $1100 of 2 year CDS, thereby achieving a flat position on a notional basis, apparently in compliance with the test. But the creditor may still have an incentive to create a Credit Event before the 2 year CDS expires in order to lock in gains on the net amount of CDS upfront payment received (i.e. the excess of the payment received for selling 5 year CDS over the payment made to purchase the 2 year CDS).

[12] Basis package holders are debt holders that have fully hedged with CDS (but have not over-hedged), and therefore theoretically stand to recover par in all instances. A basis-package holder has sometimes been referred to as an "empty creditor" because it has no economic exposure to the company's debt, yet retains its full voting rights.

First, we note that, in general terms, covenants are included in bond indentures and credit agreements in order to induce lenders to lend, thereby improving the borrower's access to credit and lowering its cost. Any market development that serves to dilute the effectiveness of covenants generally will serve to reduce the range of contractual tools available to borrowers and their creditors to strike an appropriately priced arrangement. To the extent that net short lender provisions serve to reduce the incentive of creditors to actively enforce covenants, such covenants may tend to be less effective over time. This, in turn, may serve to reduce creditors' willingness to lend, thereby eventually raising the cost of borrowing. One could question whether the Sirius provision and others like it would ultimately have such an effect on credit markets, but market participants are right to weigh such concerns.

Second, any credit instrument provisions that make transferability contingent on idiosyncratic features of the creditor will tend to reduce the liquidity of the credit instrument, which, in turn, should tend to make it more expensive for creditors to lend in the first place. Because any net short lender provision will require a potential lender to consider its other financial positions (and possibly those of its affiliates) before proceeding to take on the loan, any loan that includes such provisions will be at least somewhat less liquid. Borrowers and lead arrangers will of course need to balance the value of the protection that the provision may provide the borrower against the potential limitations on liquidity.

Third, any credit market participants who rely on CDS generally should be concerned that the profusion of net short lender provisions will tend to make ***all creditors*** more wary of using CDS. The availability of CDS as a potential hedge has generally helped to make corporate credit markets more robust and resilient. As liquidity for many single-name CDS contracts has contracted, market participants have generally found it more difficult to find appropriate hedges, which also tends to increase the price of the credit they extend.

Looking Ahead

In the wake of the Windstream battle, borrowers have good reason to look for ways to defend themselves from the negative effects of net short debt activism, and the Sirius net short lender provision is an understandable attempt to do so. One also has to have some sympathy for the drafters of the Sirius net short lender provision – indeed any net short lender provision. The definitional task is difficult and the countervailing interests hard to balance. In the end, though, we think market participants may find that any net short lender provision that would be palatable to lenders generally will not be tight enough to prevent a determined activist from creating an economic reward for its efforts through other instruments. As this is a challenge for which half-measures likely will not produce even half the intended results, these provisions may not turn out to be widely replicated.

At the same time, lead lenders and bond underwriters need to take seriously the challenge that the Windstream saga has posed to credit markets. Arrangers will need to determine what mix of provisions, such as barring the ability to trigger a default after a certain time period, or other more traditional methods of policing the mix of lenders, such as borrower consent rights or disqualified lender lists, will provide the borrower with sufficient protection in the circumstances. The resulting balancing exercise is one that all participants in the credit markets will need to watch closely.

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