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THE NET SHORT NOTEHOLDER PREDICAMENT

Summary

In the wake of bondholder activism in the Windstream case, certain issuers and borrowers have taken documentary steps to protect against action by so called "Net Short Investors".

In this newsletter we propose to take a look at the high yield bond market response, including the inclusion of certain new provisions in indentures and some of the potential consequences thereof.

Windstream

In 2015, Windstream entered into a sale-leaseback transaction which, more than two years later, an investor holding certain notes issued by Windstream alleged created a covenant breach. The bondholder was an activist investor that, after making a determination that the sale-leaseback transaction violated the indenture, purchased in excess of 25% of the outstanding principal amount of the notes along with credit default swap protection in respect of the credit in an amount greater than their holding of notes thereby creating a net short position. After the bondholder accelerated the notes (as holder of greater than 25% of the outstanding principal amount of such notes), litigation ensued and the court found that the sale-leaseback transaction did indeed violate the covenants. Ultimately, Windstream filed for bankruptcy after the court determined that the principal amount of the notes, plus interest and additional amounts, became due and payable as a result of the covenant breach.

The Windstream case gave rise to a debate over whether an issuer group should be afforded protection from investors who might be financially incentivized to act in a manner adverse to the interests of the issuer group (and potentially other investors) The risk arises not so much around actions leading to a default (as these remain within the control of the issuer group), but rather around the exacerbation of such defaults caused by activist noteholders who benefit from the deterioration of the credit due to short derivative instruments.

Documentary Responses to Net Short Investors

In response to the Windstream case, we have observed certain provisions added to financial instruments, including high yield bonds, intended to curtail the activities of net short investors. Two limitations currently being tested in the market are the contractual shortening of the applicable statute of limitations on the timing to call a past default and the disenfranchisement of net short noteholders. While as of the date of this article these provisions have been included in certain high yield transactions in the U.S. market, we are also seeing these included in the latest deals in the European loan market and, therefore, expect to see them promulgated internationally as well.

Shortening of Statute of Limitations

The shortening of the statute of limitations is the most prevalent limitation on net short noteholder activities as well as the most straightforward one we have observed in the market to date. This change provides for a two year time limit on the period during which a notice of default may be given after an action is taken. Without specifying the statute of limitations, a suit could usually be brought until the maturity date. In simple terms, this limits the threat of an open-ended notice of default and gives the issuer group peace of mind after the statute of limitations has elapsed.

Over the past few months we have observed the shortening of the statute of limitations in high yield bond offering transactions in the U.S., including five deals in June 2019. One example of this language is to include a proviso in the Event of Default covenant in the following form:

> *"However, a Default... will not constitute an Event of Default until the Trustee or the Holders of 25% in principal amount of the outstanding Notes notify the Issuer of the Default and... the Issuer does not cure such default within the time specified... after receipt of such notice; <u>provided 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</u>."*

Though this limitation may have been specifically added as a consequence of net short investors raised by the specific facts and circumstances in the Windstream case, it effectively imposes a statute of limitation on all bondholders, regardless of intent and doesn't directly address the issue but simply limits the risk. This seems to be the sledgehammer solution to the issue as it imposes restriction across the board which may overreach by limiting remedies for undiscovered historic defaults where such remedies would be appropriate but it does not in our view resolve the issue at hand.

Disenfranchisement of Net Short Noteholders

Another restriction on net short investors has been disenfranchisement from the ability to participate in an enforcement action under the indenture. This limitation is more technical as it requires defining the scope of net short investors captured.

The disenfranchisement of net short investors is also generally included in the Event of Default covenant in the following form:

> *"Any notice of Default, notice of acceleration or instruction to the Trustee to provide a notice of Default, notice of acceleration or take any other action (a "Noteholder Direction") provided by any one or more Holders must be accompanied by a written representation from each such Holder to the Issuer and the Trustee that such Holder is not Net Short, which representation, in the case of a Noteholder Direction relating to a notice of Default shall be deemed repeated at all times until the resulting Event of Default is cured or otherwise ceases to exist or the Notes are accelerated."*

This restriction revolves around the definition of Net Short which is assessed based on the underlying value of short derivative instruments compared to the value of notes held and any long derivative instruments. This provision has not yet been tested in practice, but potential issues may arise in the valuation of derivative instruments and the variance of such valuation over time (which may be exacerbated by repeating representations as to Net Short status). A collateral concern here is that certain noteholders who hedge investments in the ordinary course (as opposed to debt-activist funds who are weighted more on the short side) may be caught and their rights limited because of these provisions (in the loan market this risk is somewhat mitigated by excluding regulated banks and day one revolving facility lenders from disenfranchisement, although arguably this unfairly benefits banks over bona fide fund investors). Due to the fact that Net Short investors are generally only excluded from the numerator, as opposed to the standard affiliate disenfranchisement mechanic which excludes affiliates from both the numerator and the denominator, one could theoretically arrive in a situation in which there are not sufficient non-disenfranchised Holders to deliver a notice of Default. Though only theoretical, in a situation in which the credit had significantly deteriorated to the point where the notes lost most of their value, any investor holding a short instrument may well be Net Short at that point. The flip side of this is that if the denominator were also adjusted (a position we see in the loan market where net short lenders are deemed to have voted in the same proportion as lenders who are not net short), some minority Noteholders may be disproportionately represented in these potential default situations which may in turn lead to other problems.

In addition, the effectiveness of these provision relies on self-policing by the noteholders requesting acceleration and accountability of affiliates in order to avoid structuring around these restrictions. When affiliates are accounted for, this may incidentally impose overly burdensome monitoring requirements (especially on larger institutional investors) but if they are not taken into consideration structuring loopholes may be exploited to circumvent these restrictions.

Should investors be concerned about such issues, an unintended consequence of these new provisions may be that investors reduce or even discontinue entirely their purchase of credit default protection instruments relating to high yield credits in which they hold or intend to hold a position leading to a commensurate pricing premium to reflect the uncovered risk and/or reduced liquidity.

A recent development we have observed in the market has been a mandatory transfer provisions with regard to net short investors. This goes one step further than simply disenfranchising these investors as, on its face, it requires net short investors to transfer their notes at market price.

Where to next?

Short-selling and conflicting financial incentives are not new phenomena in the international financial markets and have been a long topic of debate, and in some circumstances, preventative regulatory action. The Windstream case presents a set of facts and circumstances that market participants believe can be addressed by specific covenant changes, which is a new development in the issuer-investor dynamic. Whether these changes are effective in practice, or become commonplace in the market, we expect will be an evolving process and, although we have focused on bond covenants here, we have also observed such responses in the loan market.

As market standard provisions are being fleshed out, key points to monitor are (i) accountability of affiliates, (ii) transferability and liquidity repercussions (whether mandatory or collateral to onerous monitoring requirements), (iii) determination of net short positions and (iv) international regulatory responses with regard to potential market abuse, manipulation or investors taking uncovered risk positions in high yield bonds. What is certain is that net short activist investors are out there and issuers and borrowers are reacting to limit actions which they can take.

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