

Structuring Anti-Net Short Provisions in Syndicated Credit Facilities

Determining When a Net Short Position Exists: Divestment, Voting, and Other Limitations

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December 17, 2019

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Agenda

1	<p>Introduction</p> <ul style="list-style-type: none">– What are “anti-net short” or “Windstream” provisions generally?– What is their intended purpose?– Why Now? - The Windstream case– How prevalent in the market?
2	<p>Anti-Net Short Provisions in Syndicated Loans</p> <ul style="list-style-type: none">– Who are Net Short Lenders and how are their affiliates treated?– Are any Lenders excluded from the provisions?– What representations must Lenders give?– What are the Consequences under the Credit Agreement?– How is “net short” defined?
3	<p>Anti-Net Short Provisions in High Yield Bonds</p> <ul style="list-style-type: none">– To what actions do they apply?– What representations and covenants must bondholder give?– What are the Consequences under the Indenture?– How is “net short” defined?
4	<p>Quick explanation of CDS and other shorting tools</p>
5	<p>Investor/Lender Concerns vs. Issuer/Borrower/Sponsor Perspectives</p>
6	<p>Questions</p>



“NSL” or “Windstream” Provisions Generally



- Intended to fend off and discourage “net short debt activist” investors
- Began to be proposed in May of 2019 by certain sponsors in the U.S. after the Windstream case in February of 2019.
- Generally targets any Lender or Noteholder who, because of its (or its affiliates’) other financial positions (normally CDS), would stand to benefit from a default of the company.
- Consequences may include:
 - Disenfranchisement
 - Limits on the ability of creditor to call a default
 - Restrictions on transfer
 - Forced sale
- Primary promoters of these provisions have been certain borrowers, issuers and their sponsors
- Lenders, Noteholders and other “normal” “net long” creditors might also benefit
- While the language hasn’t “matured,” its prevalence seems to be increasing
 - Have become fairly common in Term Loan B transactions in the US
 - Have appeared in a few high yield bond deals
 - Have just begun migrating to the UK / European market
- Many lenders and investors have raised concerns about the practicality of these provisions and their potential impact on liquidity of the obligations (particularly in a distressed scenario).
- Both the provisions themselves and market participants’ level of acceptance of them continue to evolve

The Windstream Case

- On April 24, 2015, Windstream Services LLC (**Windstream**) completed a transaction in which:
 - it contributed certain telecommunications network assets to Unity Group Inc. (**Uniti**) in exchange for a combination of cash, all the common stock and debt securities of Uniti and
 - its parent entity Windstream Holdings (**Holdings**) entered into a master lease in which it leased back from Uniti the network assets in exchange for annual rent payments, stating that the lease was for the direct benefit of Windstream and its subsidiaries and that Windstream would be involved due to retaining regulatory obligations associated with operating the network assets
- Aurelius (a subsequent note purchaser) claimed the Transaction violated the Indenture governing its 6³/₈% Senior Notes due 2023 (the **Notes**) because (i) it caused Windstream to fail its leverage ratio test triggering an event of default and (ii) it was a sale and leaseback transaction requiring it to use proceeds thereof to repurchase the Notes, which it did not do
- On September 21, 2017, Windstream received a notice of default under its Notes (**Default Notice**)
- On October 12, 2017, the trustee under the Notes filed a declaratory judgement seeking affirmation that (i) defaults relating to the Transaction occurred and were continuing under the indenture, (ii) the Default Notice was valid and (iii) an Event of Default would result under the indenture if the default was not cured within 60 days. Because of discovery requirements, the judge tolled expiration of the cure period to December 7, 2017
- On October 18, 2017, Windstream held an exchange and consent offer seeking a waiver of the defaults specified in the Default Notice
 - Bondholders of multiple other series of Windstream's outstanding bonds exchanged their bonds for newly-issued Notes of the series held by Aurelius
 - As part of the exchange, holders of the newly-issued Notes agreed to vote to waive the default – now possible because Aurelius would no longer hold more than 50% of the Notes

The Windstream Case (cont'd)

- Aurelius claimed the exchange violated the bond indenture and the waiver was therefore invalid because the principal amount of outstanding debt had increased by \$40 million in the exchange while the indenture only permitted an exchange if the outstanding principal did not increase
- On December 7, 2017, Aurelius delivered an acceleration notice declaring the Notes due and payable
- Windstream challenged the validity of the Default Notice on the basis that the original transaction was not a sale/leaseback of the type prohibited by the Indenture.
- In addition, the litigation was expanded to determine whether the waiver in consent and exchange offer was valid and whether the notice of acceleration issued by Aurelius was valid.
- Trial was held in July 2018 and judgement was issued on February 15, 2019, in which the court determined that:
 - the original transaction violated the indenture of the Notes
 - the exchange offer violated the indenture and was therefore invalid
 - the acceleration notice was valid and
 - all principal and interest became due on December 7, 2017
- The court also issued a default judgment in favor of Aurelius for \$330 million
- Ten days later, on February 25, 2019, Windstream filed for Chapter 11 bankruptcy
- The Chapter 11 filing constituted the Credit Event trigger under standard CDS contracts.
- The normal CDS settlement auction occurred on April 3, 2019, resulting in payments to buyers of protection equal to 70.5% of their notional amounts. Approximately \$416 million in obligations were traded in the CDS settlement auction. Market participants have assumed that Aurelius held a material portion of this position.

Net Short – Net Short Lenders

01

Net Short Lender: any lender or participant that would stand to benefit economically (by way of a short position created by purchasing CDS or similar derivative instruments) from a default by the borrower in respect of its debt, including due to bankruptcy.

- This is divergent from, and largely in opposition to, the incentives of the borrower, the borrower’s equity investors (including any financial sponsor) and the other creditors of the borrower (including the other lenders in the same syndicate as the Net Short Lender)

02

Net Short Determination: a lender’s net short position, as of a date of determination, is the net positive position, if any, held by such lender that is remaining after deducting the aggregate amount of the lender’s “long” debt exposure from the aggregate amount of its “short” exposure to the borrower and its indebtedness.

Note: Windstream Provisions do not differentiate based on the underlying rationale for any particular lender’s net position or other factors that mitigate the risk of a Net Short Lender actually becoming a “net short debt activist”.

Net Short – Lender Affiliates



Should a lender's net position take into account the exposure of the lender's affiliates (i.e., entities that the lender controls, is controlled by or is under common control with)?

Could a lender evade the Net Short Restrictions by booking a CDS at a related entity that is not technically the lender of record under the credit agreement (and thus not itself subject to the Net Short Restrictions)?

Requiring institutional investors to be aware of or control the activities and positions of their affiliates may be unrealistic or prohibited.

Net Short – Lender Affiliates (cont'd)

Compromises in the market

1

Approach #1: Carve out

- Where a lender's affiliates are included in the Net Short Determination, their "**Screened Affiliates**" (also referred to as "**Ethically Screened Affiliates**") should be explicitly carved-out.
- Screened Affiliates: Affiliates of a lender
 - (a) that are managed as to day-to-day matters independently from the lender itself;
 - (b) that have in place customary information screens (or "walls") between themselves and the lender; and
 - (c) whose investment policies and decisions are not influenced by the lender or its investment decisions (whether directly or indirectly through another affiliate that is not a Screened Affiliate).
- In some formulations, lenders are required to make a good faith inquiry with their Screened Affiliates to ascertain their positions, but need not take further steps if such Screened Affiliates fail to respond (which is the most likely result).

2

Approach #2: Exclusion of Lenders' Affiliates

- Outright omission of the lenders' affiliates from the Net Short Determination.
- May instead include an additional element in Net Short Representation whereby a lender confirms that it is not knowingly and intentionally acting in concert with any of its affiliates for the express purpose of creating the same economic effect with respect to the credit group as though such lender were a Net Short Lender.
- In other words, lenders confirm they are abiding by not only the letter, but also the spirit, of the Net Short Restrictions.

Approach #2 is more in line with the operational realities for most financial institutions, and more likely to gain broader acceptance in the market, as it is simpler, easier to manage, and more controllable for the wide range of lenders that participate in the U.S. syndicated loan market.

Unrestricted Lenders

1

Net Short Restrictions usually apply to all credit facilities under a particular credit agreement, but should they?

- Primarily aimed at syndicated Term Loan B tranche (natural habitat of net short activist creditors)
- Less concerned about Revolving Credit Facility lenders and regulated entities (i.e., banks, registered swap dealers, etc.)

2

Credit agreements containing Net Short Restrictions typically carve-out “Unrestricted Lenders”

- Regulated entities (including registered swap dealers and commercial banks)
- Revolving credit facility lenders
- Lead arrangers and bookrunners
- All of their respective affiliates

Net Short Representations

- Net Short Representations:
 - Confirmation by a lender that it is not a Net Short Lender (plus affiliates prong described above)
 - Typically required to be made (or deemed made) by lenders (other than Unrestricted Lenders) in connection with:
 - loan or participation purchase by new lenders;
 - amendments and waivers;
 - notices of default from a lender to the administrative agent/borrower; and
 - lender instructions to administrative agent to accelerate the debt and/or exercise remedies.
 - Net Short Representation is made as of a moment in time, with reference to the facts and circumstances at such time
 - Any language to the effect that a Net Short Representation continues, or is deemed repeated daily until the underlying triggering event ceases to exist, effectively converts the Net Short Representation into an ongoing restrictive covenant.

Credit Agreement Implications

1 Consequences and Constraints

- a) New and nuanced terms and definitions
- b) Ignores motivation of Net Short Lenders
- c) Mechanics are untested

2 Vote Stripping

- a) Disenfranchisement is the most prevalent Net Short Restriction
- b) Net Short Lenders stripped of rights to approve or disapprove any amendment, waiver or consent, and votes are disregarded or dragged along proportionally with non-Net Short Lenders
- c) Net Short Representations required in conjunction with voting

3 Silencing

- a) Net Short Lenders are barred from instructing the administrative agent to exercise remedies

4 Disqualification

- a) “Disqualified Lender” terms prohibit assignment of loans and disclosure of information to a defined universe of entities
- b) Disqualified Lender definitions now explicitly include Net Short Lenders
- c) Net Short Lenders (or any prospective lender/participant that would be a Net Short Lender) barred from buying into credit facility
- d) Prospective assignees/participants required to make Net Short Representations
- e) Selling lenders entitled to rely conclusively on counterparties’ Net Short Representation without inquiry

5 Removal

- a) Net Short Lenders may be subject to forced divestment (“yank-a-bank”)
- b) Borrower could force Net Short Lenders to assign loans to another eligible lender willing to purchase loans

Credit Agreement Implications (cont'd)

6 Prepayment

- a) Some credit agreements go further and allow the borrower to repay Net Short Lenders on a non-pro rata basis
- b) In a distress scenario, if loans are trading below par, repayment of Net Short Lenders (i) might result in a *more favorable* outcome for Net Short Lenders and (ii) reduces cash available to an already distressed credit group
- c) Recent deals set the “price” of repayment as the lesser of (i) the par amount of the loan and (ii) the amount the Net Short Lender paid to acquire the loan

7 Paradigm Shift

- a) Net Short Representations present a new area of potential liability for lenders
- b) Risk of misrepresentation, coupled with need to carefully track lenders' (and, in some cases, affiliates') overall net exposure
- c) Market participants to keep a close eye on Windstream Provisions to carefully monitor scope, details and potential unintended consequences

Defining “net short position”

01

Derivative positions measured by notional amounts

02

Includes all shorts referencing the Loans/Commitments OR the Borrower

03

“Long” positions usually include only the Loans/Commitments

04

Credit Indices are excluded unless the Borrower makes up more than 5% of the Index or the Index was put together by the Lender

Additional Windstream Provisions

In any particular deal, the borrower (or their equity investors or financial sponsor) may seek to include some or all of the Windstream Provisions. Two often proposed provisions are the “Time Bar” and “Early Warnings”

Time Bar

- a) Often proposed, but seldom accepted; never < two years
- b) Imposes expiration date (a “sunset”) on lenders’ ability to call defaults and take remedial steps with respect to certain historical events that gave rise to a default
- c) Effectively creates a contractual deadline for any default resulting from an action (or inaction) reported publicly or directly to the administrative agent or lenders

Early Warnings / Advance Notice

- a) A requirement for the administrative agent to provide the borrower with longer than usual advance notice prior to acting on a default (excluding bankruptcy)
- b) Notice period (of anywhere from one to three business days) allows the borrower time to evaluate whether to challenge the default notice on the basis of the applicable Net Short Restrictions, or assess the veracity of the Net Short Representations (and, if applicable, activate the Verification Covenant)
- c) Curbs lenders’ ability to act quickly and decisively in exercising contractual and legal remedies against a defaulted borrower

Anti-Net Short Provisions in High Yield Bonds

- How is “net short” defined?
 - Value vs Notional. Typically net short calculation in indentures is based on “value” as opposed to “notional”.
 - Holder or beneficial owner is “net short” if, as of any date of determination,
 - the value of its Short Derivative Instruments exceeds the sum of the value of its notes and Long Derivative Instruments as of such date of determination; or
 - it is reasonably expected that such would have been the case were a Failure to Pay or Bankruptcy (each as defined in ISDA CDS Definitions) to have occurred with respect to the issuer or any guarantor immediately prior to such date of determination.
 - Whether a derivative position is considered “Long” or “Short” is based on whether its value increases or decreases with change in certain Performance References (e.g., the value or performance of the underlying notes or the creditworthiness of the issuer or any guarantor).
 - Net Short analysis can be limited to just notes being issued, or can take into account other debt or equity of the issuer.
 - Calculation of value can be complicated and could be the sources of disputes if issuers disagree with noteholder certifications.
- To what action do they apply?
 - Typically net short holders are excluded from delivering notices of default or acceleration.
 - Could be expanded to exclude participation in any other vote/action of noteholders without Issuers consent.

Anti-Net Short Provisions in High Yield Bonds (cont'd)

- What representations and covenants must bondholder give?
 - Written representation by holder that it is not Net Short; Deemed covenant to provide info reasonably requested by Issuer to verify accuracy of position representation (see next slide).
 - For bonds held through DTC, either DTC or its nominee must provide a written representation that it is not being instructed by any beneficial owners that are net short.
 - DTC can rely on reps/deemed covenants of beneficial owners in giving directions to indenture trustee; DTC will need procedures to implement this.
 - In connection with notice of default, continuing representation is typical until the relevant Event of Default is cured or otherwise ceases to exist, or the underlying notes are accelerated.
- What are the consequences under the Indenture?
 - Net short holders not allowed to vote, and votes of any holders that misrepresent position will be disregarded.
 - Different approaches to whether net short holders should be disregarded for purposes of counting required thresholds for action/voting.
 - Abstaining versus non-existing.
 - Other remedies (e.g., forced sale) similar to those in credit agreements can also be used.

Verification Covenant

- Emerging development not yet in market-clearing syndicated loans
 - lenders required to furnish to the borrower such information as the borrower reasonably requests in order to verify the accuracy of such lender's Net Short Representation.
 - If either (x) the lender fails to timely comply with the Verification Covenant or (y) the borrower initiates legal proceedings challenging the veracity of the Net Short Representation, any instruction from such lender (and the required remedial action) will be **stayed** until the lender complies with the Verification Covenant or a court adjudicates the borrower's legal claim.
- Lender considerations for Verification Covenant:
 - Individual lender direction at issue vs. the collective lender direction
 - Consider requiring limitations on the disclosure obligations for:
 - information subject to third-party confidential arrangement;
 - commercially sensitive or proprietary information;
 - information protected by attorney-client privilege; and
 - instances where disclosure may be prohibited or restricted by any applicable law.

CDS and other “shorting” instruments

1

CDS transactions can reference a single borrower or a credit index

2

Transactions are typically on standard terms, reliant on centralized, market-wide decisions as to whether a trigger has occurred and what the payout will be.

3

Protection buyers pay an upfront amount to purchase the contract and then pay a standard semi-annual premium payment (typically 500 bps)

4

Standard CDS contracts are triggered when a “Credit Event” (“Failure to Pay” or “Bankruptcy” for US entities, plus “Restructuring” for non-US entities) occurs in respect of any “Obligation” (usually “Bonds” or “Loans” but may include other “Borrowed Money”) of the “Reference Entity”.

5

Payouts are determined in specially designed auctions where the payout is normally set to equal the discount applicable to the cheapest “Deliverable Obligation” trading in the auction.

6

CDS contracts are usually only traded by dealers on entities with significant debt outstanding (though in some legacy cases these amounts may be lower)

6

Other “shorting” instruments, such as bond shorts and equity shorts, also exist

Good, Bad or Ugly? Investor/Lender vs. Borrower/Sponsor Perspectives

1

Some aspects may be favorable

- Disenfranchisement of net short lenders for defaults thwarts motives that would be antithetical to normal creditor behavior
- Time bar may allow creditors and borrower greater certainty regarding treatment of past events
- Generally helps keep lenders' incentives aligned with each other

2

Some aspects may increase risks for lenders/investors

- Provisions restricting eligible assignees may constrain exit options, particularly where the borrower is distressed
- Provisions threatening forced sale or repayment may be too draconian
- Because they are untested, they may give rise to additional litigation risks, making it harder for lenders or noteholder to enforce their rights

3

Some aspects may be unworkable

- Treatment of affiliates is challenging
- Some investors may not know their client funds' net position
- Mechanism for receipt of representation remains untested for bonds

The Definition of “net short position” is evolving



“Net short position” should take account of **all** debt obligations and undrawn commitments of the loan parties, rather than just the loans and/or commitments under the facility

Derivatives transactions defined as any transaction for which:

- (i) any loan party is the Reference Entity or
- (ii) any Covered Obligation is an Obligation or Reference Obligation (or any functional equivalent)

Index exclusion can be refined to apply when Covered Obligations or **loan parties** represent less than 5% of the index (collectively)

Unclear how equity shorts should be addressed.

Questions?

Thank You

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