Indenture Restrictions Applicable to "Net Short" Investors and Related Provisions

Recent litigation involving the telecommunications company Windstream Services, LLC and Aurelius Capital Master, Ltd. has heightened market focus on noteholders that, through derivatives, take an economic interest in the negative performance, or even failure, of a bond issuer and actively pursue that result. In response to the *Windstream* decision[1] and other recent examples of "net short debt activism," private equity sponsors and corporate bond issuers have sought to introduce a variety of protective contractual provisions in bond indentures with an aim to limit the damage that can be caused by a net short investor.

In this memorandum, we discuss the principal terms of these protective provisions, with a focus on the differing scope, remedies and mechanics of two examples that recently have cleared the market. While these examples share broad similarities, there are a number of nuanced differences. We also discuss a few other contractual provisions that bond issuers have added to address related issues raised by the Windstream decision.

I. Background

The Windstream litigation began in October 2017 when Aurelius, which owned more than 25% of Windstream's senior notes due 2023, directed the trustee to file suit against Windstream, alleging that Windstream had breached the indenture governing the senior notes as a result of a sale and leaseback transaction that occurred in March 2015. In February 2019, the district court ruled in favor of the Trustee and Aurelius, following which Windstream filed for Chapter 11 bankruptcy protection.

II. Net Short Provisions

Although a number of different formulations of "net short" mitigation language recently have been introduced to the bond market, for illustrative purposes we discuss two examples in this memorandum that have recently cleared the market, which will be referred to as "Example A" and "Example B".

Both of these examples are directed at limiting the ability of investors with net short positions to take adverse action against the issuer, particularly as it relates to amendments, waivers and actions upon defaults or Events of Default. However, they differ in a number of important ways, including as to how they define "net short", the scope of holdings covered, the scope of actions covered, the certifications required from noteholders, related voting calculations and the remedies for addressing net short noteholders.

Defining "Net Short"

Although neither example defines what "net short" means in great detail, they take fundamentally different overall approaches – value vs. notional amount. In Example A, the definition focuses on whether the "value" of the derivative instruments held by the noteholder exceeds the "value" of its notes. Conversely, Example B defines "net short" to be when a noteholder "has a net short position with respect to the Notes" and, in determining whether

[1] *U.S. Bank National Association v. Windstream Services, LLC*, No. 17-CV-7857 (JMF), 2019 WL 948120 (S.D.N.Y. Feb. 15, 2019).

or not this is the case, derivative contracts with respect to the notes are to be counted at the notional amount thereof. In addition to this fundamental difference, Example A goes a step further and provides that, even if a noteholder does not have a net short position based on the current values as of the date of determination, a noteholder would be considered to have a net short position if it is reasonably expected that this would have been the case were a Failure to Pay 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. Thus, in Example A, the calculation of value must take into account what would happen to the values of the notes and derivative instruments if such a default occurred. It should be observed that both Examples A and B limit the net short analysis to positions in respect of the applicable notes being issued. Issuers and noteholders may consider if long or short positions in other debt or equity of the issuer should be included in the determination of a "net short" position.

Each of these determinations could be complex and technical – *e.g.*, valuing swaps, including those held in foreign currencies, may not be straightforward. Example A will result in more subjective determinations in light of the "value" calculations and the assumed default events. And although Example B gives some guidance with respect to matters such as currency conversion, holding through indexes, etc., neither approach will result in simple, straightforward calculations. This complexity is part of the reason that both Example A and B rely in part on the noteholder certifications discussed below.

Scope of Holdings/Affiliates

Issuers generally have insisted that the net short determination should include the holdings of a noteholder and its affiliates as a whole, rather than just the holder itself. This is due to a concern that short positions could be held in affiliated entities, allowing a noteholder, acting together with its affiliates, to avoid the net short limitation while achieving the same economic effect.

Both Example A and Example B address this concern, but limit the scope to the holdings of affiliates that are "acting in concert" (Example A) or "coordinating or acting in concert with" (Example B) with the noteholder in the determination of whether such noteholder has a net short position. These limitations would prevent intentional avoidance of the net short limitations while allowing holdings by affiliates who hold short positions without an activist intention. This is particularly important for noteholders who may be part of a large, complex institution where other parts of the business hold short positions in unrelated transactions.

Both examples also include exclusions for the holdings of screened affiliates. Example A is a flat carve-out for the holdings of all "Screened Affiliates" from the net short calculation. In order to be a "Screened Affiliate", an entity must be subject to customary information screens between it and any non-Screened Affiliate, and make investment decisions independently from any non-Screened Affiliate. Similarly, Example B includes a concept of "Ethically Screened Affiliates". The mechanic is similar to the "Screened Affiliates" construct in Example A, but in this formulation, noteholders have an affirmative obligation to "reasonably inquire" of such entities whether they hold any interest in the notes or any related derivative instruments. Only the responses received as a result of this inquiry are included in the net short determination. This approach leaves open the question of whether the noteholder would receive fulsome responses (or any at all) from entities separated by an information barrier.

Similar to the "acting in concert" construct, the intention of the screened affiliate carveout is to avoid capturing entities within the same institution that hold short positions for reasons unrelated to holding of the notes

by another entity in the same institution. It is debatable whether the "Screened Affiliates"/"Ethically Screened Affiliates" carveouts are necessary where the "acting in concert" limitation is already included, as screened affiliates are, by definition, unlikely to be coordinating or acting in concert with the noteholder. Each of the screened affiliates approaches adds a level of complexity to which it may be difficult to comply, while adding perhaps marginal protections.

In addition to the foregoing, Example B also includes additional carve-outs to the net short limitations for (1) "Regulated Banks", defined to generally apply to U.S. banks or bank branches with capital of at least $5.0 billion (or affiliates thereof) and (2) derivatives entered into for bona fide market making activities. These additional carve-outs may provide additional comfort to banks acting as underwriters or initial purchasers.

Scope of Actions Covered

In the Windstream case, the underlying action at issue was an alleged default. In Example A, the net short limitations address only that issue by excluding net short noteholders from the submission of notices of default or acceleration. Example B takes a more expansive approach – by providing that no net short noteholder is permitted to vote on any amendment, supplement, waiver or modification, take any other action that would require consent, or make any request, demand or notice under the indenture unless, in each case, the issuer allows such net short noteholder to participate. While the Windstream case resulted from a notice of default, it is of course conceivable that net short noteholders could vote against the interests of the issuer and "long" noteholders with respect to amendments, waivers and other actions. Issuers and noteholders will need to make their own determination of whether the negative effect of the voting power of net short noteholders in actions beyond defaults justifies the imposition of the net short limitations on those actions.

Certifications by Noteholders

The net short provisions rely, in part, on noteholders to certify as to their holdings. In Example A, the certification must be made explicitly in writing with the delivery of a default notice. In Example B, the certification is not required to be explicit, but instead is deemed to be made by virtue of the noteholder taking action. In Example A, where the scope of the provision is limited to defaults, a notice requirement may not be too difficult to comply with or enforce (although it can be tricky when dealing with beneficial owners of notes). It is questionable whether explicit certification is practical in the context of a broader net short provision like Example B, which is applicable to amendments, waivers, etc., in addition to defaults.

Vote Calculation

In the event that a noteholder has incorrectly or falsely represented that it is not a net short noteholder, and exercised a prohibited right to submit a notice, provide consent, etc., its action/vote will be disregarded. However, Examples A and B differ in their treatment of the notes held by a disregarded noteholder for purposes of calculating the applicable required threshold for noteholder action/voting. Example A provides that the notes of such disregarded net short noteholders are still considered outstanding for purposes of determining whether the particular notice of default was given by the required percentage of noteholders. The effect of this approach is that a net short noteholder is treated as having abstained from the giving of notice, and their notes are still counted in the "denominator" of the outstanding notes calculation, making it more difficult for the remaining "long" noteholders

to reach the required notice threshold. By contrast, Example B provides that notes owned by net short noteholders are deemed not to be outstanding at all for purposes of the vote count. Instead of treating net short noteholders as abstaining voters, Example B treats them as non-existing. This approach avoids the negative dilutive effect for "net long" noteholders that is inherent in Example A.

Additional Remedies

In addition to the limitation on voting rights described above, Example B goes beyond disregarding the vote of net short noteholders and allows issuers to remove them from their position as a noteholder. Similar to remedies with respect to disqualified lenders often found in credit agreements, a net short noteholder can be forced to transfer its notes to any transferee, which may include the issuer or a subsidiary of the issuer, at a purchase price equal to the lesser of the market price and par, in each case without accrued interest. Importantly, the noteholder could receive a price well below par (and well below the price paid by the noteholder) and would not receive the make-whole price or any other call premium on its notes in connection with this removal. Example A does not include a comparable provision.

III. Related Provisions

Sunsets on Default

Because the default at issue in Windstream was based on an event that occurred years prior to the date the default was alleged to have occurred, certain issuers have pushed to include sunsets on the ability of noteholders to call a default more than a specified number of years after the occurrence of the underlying event. This could prevent opportunistic activism by limiting activists' ability to search out and act on defaults long after they have occurred. Noteholders need to be attentive to this provision to avoid unduly limiting their ability to call defaults. Without such a contractual limitation, the statutory limitation for contract claims would govern. Under New York law, which governs most high yield indentures in the U.S. markets, the applicable statute of limitations is six years (N.Y. C.P.L.R. § 213(2)). The limitation that has been included in several recent bond transactions states that "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 essentially shortens the six-year statute of limitations to two years from the date the action is reported. Although two years may seem like sufficient time to provide a notice of default, disclosure of a particular event may not clearly indicate to noteholders that the event was a default. For example, disclosure of an investment or asset sale could be included but not prominently featured in an issuer's 10-K or 10-Q, and presumably the action would not be identified as impermissible. And in light of the myriad of basket exceptions in high yield indentures and the lack of an affirmative requirement for issuers to detail basket usage, it could take time for noteholders to become aware that such event caused a default. As a result, by the time noteholders are prepared to take action, a sunset on the ability to call the default could prevent it.

Contractual/Judicial Extension of Cure Period

Early in the course of the Windstream litigation, Windstream moved for an expedited adjudication by the court, citing the 60-day cure period provided for in the indenture. If the cure period were allowed to expire without either a cure of the default by Windstream or a determination by the court that a default had not occurred, the noteholders would be entitled to accelerate. The plaintiffs recognized the issue as well and asked the court to toll

the 60-day cure period to provide for sufficient time for them to conduct discovery. Against this backdrop, the court was compelled to question whether it had authority to toll the cure period in the indenture.

Courts had examined this issue before. In *Metropolitan Life Insurance Co. v. RJR Nabisco*, 906 F.2d 884 (2d Cir. 1990) ("*Metlife*") the trial court order ordered that a cure period could be tolled pending an adjudication of whether an alleged default had occurred. On appeal, the Second Circuit reversed. The court expressed a reluctance to modify contractual terms and provided that the cure period could be tolled only for such time as the plaintiffs required for discovery (but noted that the court should limit and expedite discovery in this case). In Windstream, the court followed *Metlife*, providing that the cure period could be tolled only so long as to allow for limited discovery.[2]

The *Windstream* decision has prompted contractual provisions in recent indentures to provide that "Any time period in this Indenture to cure any actual or alleged Default or Event of Default may be extended or stayed by a court of competent jurisdiction to the extent such actual or alleged Default or Event of Default is the subject of litigation." This language would now permit a court to stay a cure period without having to alter the terms of the contract. Importantly, the stay could be granted for any reason and is not limited to extensions to permit discovery or extensions requested by the noteholders. In theory, the cure period could be stayed for the duration of the litigation through final judgment (which could be years). It remains to be seen whether this language will, in fact, be sufficient to overcome courts' demonstrated hesitation to modify contracts. Further, it will be interesting to see how long parties (particularly noteholders) are willing to accept an extended cure period. Given that litigation can drag on for years (perhaps even beyond the maturity of the notes at issue), noteholders may demand a speedier adjudication.

IV. Concluding Thoughts

The field of contractual responses to net short debt activism is varied and new. As the market continues to address this issue, we expect further evolution of these provisions and perhaps a market standard to develop which appropriately balances an issuer's desire to exclude bad actors with noteholders' concerns to not unduly impair their rights under an indenture.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Helene R. Banks at 212.701.3439 or hbanks@cahill.com, Michael A. Sherman at 212.701.3747 or msherman@cahill.com, Ariel Goldman at 212.701.3398 or agoldman@cahill.com, or Mark E. Loftus at 212.701.3175 or mloftus@cahill.com.

[2] *U.S. Bank National Association v. Windstream Services, LLC*, No. 17-CV-7857 (JMF), 2017 WL 5054726 (S.D.N.Y. Nov. 1, 2017).

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