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Credit Markets Seek to Limit the Influence of Net Short Lenders

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Introduction

Over the past several months, there has been an increase in credit agreements and high-yield bond indentures with provisions designed to limit the influence of lenders whose economic interest is not aligned with their investment in the loans or bonds being issued pursuant to such credit agreement or indenture. These lenders, known as net short lenders, are ones who, generally speaking, hold a long position in a borrower's loans or bonds but, at the same time, hold a more-than-offsetting credit default swap position that allows the lender to profit, as an economic matter, from an event of default by the borrower.

This has led to situations involving "manufactured" defaults. The Commodity Futures Trading Commission, which oversees a portion of the credit default swap market, has observed 14 manufactured credit events in the past two and a half years, compared with just six in the prior 10 years.[1] The rise in such debt activism has caused both corporate borrowers and long-only credit investors to seek protection from this activity.

Disenfranchisement of Net Short Lenders

Several versions of language disenfranchising net short lenders have appeared in credit agreements and indentures over the past several months, with the language typically providing that any net short lender will have its voting rights taken away. Specifically, any voting right that a net short lender holds under the credit agreement or indenture will be automatically deemed to have been voted in the same manner as those lenders that are not net short lenders.

As we discuss below, these disenfranchisement provisions describe in detail how the lenders are required to calculate whether they are net short, and impose an obligation on each lender to notify the administrative agent if such lender is in fact net short. Some lenders are typically exempt from this provision, including regulated banks and revolving lenders, on the basis that such lenders (or their affiliates) may hold credit default swaps and other derivatives as part of their bona fide market making or related activities, and not with the intention of profiting from the borrower's financial distress.

Contractually Shortened Statute of Limitations

Another provision that has appeared in recent credit agreements and indentures limits the ability of lenders or bondholders to deliver a notice of default after a specific period of time, typically no later than two years following the occurrence (and disclosure) of the event that triggered the ability to deliver such a notice. This type of provision seeks to limit opportunistic credit investors from searching for older events that could have triggered an event of default that was not called and then, upon identifying such an occurrence, buying the loans or bonds and seeking to trigger an event of default in an effort to collect the proceeds of an outsized credit default swap position.

An example of such language, from the recent 5.75% Senior Notes issued by Avis Budget Car Rental, is as follows (emphasis in bold added and language shortened for clarity):[2]

> *However, a default under [certain clauses of the Event of Default section] will not constitute an Event of Default until the Trustee or the Holders of 30% in principal amount of the outstanding Notes notify the Company of the default and, with respect to [such clauses] the Company does not cure such default within the time specified in [such clauses] after receipt of such notice;* ***<u>provided</u>, 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.***

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1 Childs, M. (2019 August 2). *Why Hedge Funds Could Find it Harder to Push Companies in Default.* Retrieved from http://www.barrons.com.

2 https://www.sec.gov/Archives/edgar/data/723612/000072361219000112/exhibit41-indenturex57.htm.

Conclusion: Realistic Expectations and Careful Drafting

These provisions call to mind "disqualified institution" provisions, which have been commonplace in the credit markets for a number of years. Such "DQ lender" provisions give a borrower the ability to identify specific lenders by name that the borrower does not want participating in its credit facility. This provision, while perhaps comforting to corporate borrowers, is no panacea for eliminating so-called vulture investors from finding creative ways to benefit from the borrower's financial distress. A similarly realistic perspective should be taken by both corporate borrowers and credit investors when assessing the efficacy of these newer provisions.

While the goal of these net short provisions is understandable, drafting provisions to implement that goal is a difficult proposition. One key issue is identifying the manner in which the net short amount is calculated. Comparing the notional amount of the credit default swap to the face amount of the loan or bond seems to rely on the assumption that the lender in question has acquired such loan or bond at par; however, that is often not the case. In addition, using the face amount of the loan or bond ignores the right to any make-whole payment or other type of prepayment premium that a lender might be entitled to following an acceleration of the credit obligations upon the occurrence of an event of default. Further, a short position established under a credit default swap could be replicated, somewhat imperfectly, without actually requiring the purchase of a swap or other derivative. Instead, an investor could take a short position in the borrower's common stock or, if applicable, another junior security in the borrower's capital structure. Moreover, while the use of the notional amount may make some sense in the context of a credit default swap, the equation becomes significantly more complex when assessing option contracts on credit default swaps (also known as credit default swaptions). The cost to acquire such an option is influenced by a number of factors, including the expiration date of the option and, accordingly, this subjects the net short calculation to potential gamesmanship as the notional amount of the underlying credit default swap may bear little relation to the cost the investor paid to obtain such position.

Finally, a creative net short investor can likely find a way to take a long position in a loan or bond using one investment vehicle while holding a more-than-offsetting short position using a different investment vehicle that would not necessarily constitute an "affiliate" for purposes of the net short provision, but for which such investor would still receive a material benefit. This is not to say that net short provisions do not serve a purpose – only that corporate borrowers and credit investors should understand the complexity in the underlying issue and have a realistic understanding of the limitations of contractual language seeking to limit this type of behavior.

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact the authors.

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