Proskauer

The Long and Short of It: Anti-Net Short Provisions in NDAs

Reorg on **August 5, 2020**

Introduction

COVID-19's continued impact on the US economy has led to a substantial increase of both in and out-of-court restructuring activity for companies already in financial distress, and otherwise healthy companies significantly impacted by the pandemic. For less affected companies, many borrowers and sponsors have incurred PPP loans and/or drawn down on existing revolving credit facilities and delayed draw term loans to cover short-term liquidity needs. Yet with such additional sources of readily available capital tapped and visibility still uncertain, many private equity sponsors are proactively seeking to enter into negotiations with their portfolio companies' significant debtholder groups to address potential capital structure issues long before a comprehensive in or out-of-court restructuring becomes necessary.

When a company with publicly traded debt desires to enter into such negotiations, it typically will negotiate a confidentiality or non-disclosure agreement (an "*NDA*") requiring the participating debtholders to acknowledge that they may receive material nonpublic information ("*MNPI*"), receipt of which limits the debtholders' ability to trade under federal securities laws. In addition to trading restrictions, most NDAs will impose certain other contractual restrictions on the participating debtholders to encourage focused negotiations, such as a restriction on the ability of the debtholders to share or discuss MNPI or other confidential information with parties not subject to confidentiality undertakings with the company and a standstill prohibition on engaging in discussions with any other creditor groups or parties in interest. The delicate balance between the company's desire to achieve a minimally invasive restructuring outcome and the debtholders' inclination to be bound by as few additional non-credit agreement restrictions as possible often leads to intense negotiation between a company and its debtholders over the terms of the NDA at the outset of a restructuring.[1]

Adding fuel to the fire, in the past year, a handful of leveraged finance transactions introduced a new suite of provisions ("*Anti-Net Short Provisions*") seeking to curtail opportunistic conduct by lenders that have a "net short" position with respect to a borrower or its debt ("*Net Short Lenders*") following Windstream Holdings Inc.'s fight with one of its reportedly "net short" bondholders and its subsequent bankruptcy filing. Notwithstanding that post-COVID-19 sponsored lending deals are showing early signs of more lender-friendly documentation and enhanced pricing, proactive sponsors seeking preventive restructuring solutions are increasingly pushing to include Anti-Net Short Provisions in their NDAs to ensure that the participating lenders do not use MNPI to engage in net short debt activism. As the motivations of Net Short Lenders may sometimes diverge from the interests of "net long" lenders, there may be more willingness on the part of participating lenders to agree to an NDA that includes Anti-Net Short Provisions applicable to all participating lenders. However, participating lenders should take care to ensure that any Anti-Net Short Provisions are appropriately limited to both render them commercially feasible for their institutions and maintain sensible enforcement flexibility.

Brief Background: Net Short Debt Activism and Windstream

Net Short Debt Activism

A Net Short Lender is a lender that stands to benefit economically from a bankruptcy or loan default of a particular borrower by achieving an outsized "short" position with respect to the borrower or its debt through the purchase of credit default swaps or other derivative instruments. A Net Short Lender may be incentivized to utilize its position as a lender to attempt to call defaults (including latent historical or technical defaults) and otherwise cause distress and/or insolvency at the borrower for the purpose of triggering payouts under its credit default swaps or other credit derivative positions that presumably outweigh any loss incurred by the Net Short Lender due to its "long" position as a loan holder. While a lender's motivations for holding a "net short" position are not necessarily nefarious and may simply reflect a prudent hedging strategy, the priorities of Net Short Lenders may be perceived to, and may actually, conflict with those of the borrower, its equity holders, other tranche lenders and other creditors, which could lead to comprehensive disagreements in restructuring negotiations.

Introduction of Anti-Net Short Provisions to the High Yield and Leveraged Loan Markets

Anti-Net Short Provisions first began to appear in the spring of 2019 following the *Windstream Holdings Inc.* bankruptcy, which followed the company's significant loss in litigation with a bondholder seeking to call a complicated debt covenant default under the company's bond indenture.[2] The Anti-Net Short Provisions resulted from the sponsors' post-Windstream attempt to protect their portfolio company borrowers from net short debt activism. Representative examples of Anti-Net Short Provisions that have cleared the US leveraged loan market often treat Net Short Lenders as "Disqualified Lenders" and/or "Defaulting Lenders." As a result, many iterations of the Anti-Net Short Provisions (i) restrict a Net Short Lender's ability to vote solely to sacred rights amendments that by their terms affect the Net Short Lender more adversely than other affected lenders; (ii) limit a Net Short Lender's access to confidential borrower information; and (iii) prohibit the assignment of loans to Net Short Lenders. More onerous examples of Anti-Net Short Provisions also allow for forced divestment of Net Short Lenders' loans through the "yank-a-bank" provisions. [3]

Anti-Net Short Provisions: Negotiating Points for NDAs

The argument by private equity sponsors for inclusion of Anti-Net Short Provisions in restructuring NDAs follows from the generally offered rationale for inclusion in syndicated loan documentation: to align informational access and voting power with economic interest so that participating lenders that are invited "under the tent" with the borrower are incentivized to maximize the value of the loans. At first blush, participating lenders may be hesitant to agree to Anti-Net Short Provisions, particularly if none are included in the underlying credit agreement. Noted market concerns surrounding Anti-Net Short Provisions include operational feasibility for restricted lenders and the potential for borrowers to exploit already permissive credit documentation. However, as seen in *Windstream* and other cases, net short debt activism can materially erode the long only positions of other tranche lenders. Depending on the investment thesis and operational ability of the individual participating lender and the make-up of the participating group, it may actually be sensible for a participating lender to agree to have a sponsor include Anti-Net Short Provisions in the participating lender group's NDA, as long as such provisions are appropriately limited in time, applicability and scope.

Termination Date

A fundamental aspect of the restructuring NDA is the "cleansing" mechanic whereby the NDA requires the company to publicly disclose the MNPI shared pursuant to the NDA at, among other triggering events, an outside cleansing date so that the restricted lenders can trade again for purposes of federal securities laws. Participating lenders will want the Anti-Net Short Provisions to terminate on the cleansing date along with the trading and other contractual restrictions to ensure that if restructuring negotiations fail they can pursue appropriate enforcement, and if necessary, hedging strategies to mitigate downside recovery scenarios.

Key Takeaway*:* The length of an outside cleansing date depends upon a number of factors, but if Anti-Net Short Provisions are included, participating lenders may want to consider a length of time that balances downside flexibility with a desire to discourage net short debt activism within the group.

Unrestricted Lenders

A participating lender should always consider whether it is feasible from an institutional perspective to subject itself any Anti-Net Short Provisions. Indeed, when the Anti-Net Short provisions were first proposed in the syndicated loan market, arrangers and financial institution investors quickly pushed back on the basis that applying Anti-Net Short Provisions to such lenders would be impracticable, as certain regulated institutions do not use separate legal entities for their various business units. An institutional investment vehicle, therefore, may hold a wide variety of positions with respect to a particular borrower at any given time for which individual investment teams may have little or no ability to monitor. As a result, credit agreements commonly exclude "Unrestricted Lenders" from the purview of any Anti-Net Short Provisions, comprised of regulated entities (including commercial banks and registered swap dealers), the closing date revolving credit facility lenders and the lead arrangers, and often, their respective affiliates.

Key Takeaway*:* Participating lenders should think carefully before agreeing to Anti-Net Short Provisions in their NDAs that fail to include exclusions generally required by the market, or if such exclusions are otherwise included in any Anti-Net Short Provisions in the underlying credit agreement.[4]

Calculation of Net Short Position: Lender Affiliates

Whether a lender's net position should take into account the holdings of such lender's affiliates remains an unsettled issue in the development of Anti-Net Short Provisions. Omitting a lender's affiliates from the net short calculation presents a fairly obvious work-around to the Anti-Net Short Provisions for a restricted lender: simply book the applicable credit default swaps or other derivative instruments at an affiliate entity that is not technically the lender of record under the credit agreement (and thus itself not subject to the Anti-Net Short Provisions). However, the Anti-Net Short Provisions initially appeared in the syndicated loan market, which caters predominantly to asset managers, mutual funds, insurance companies, CLOs and other fund investors that are often housed within large financial institutions operating multiple business units that have their own individual investment strategies and/or fiduciary duties. In most cases, such lenders will simply be unable to assume the risk of unintentionally breaching the Anti-Net Short Provisions that include affiliates in the net short calculation where they cannot adequately ascertain, or, if internal information barriers exist, are prohibited from knowing, the positions of their sister funds and affiliates. As a result, early iterations of the Anti-Net Short Provisions that cleared the syndicated loan market excluded affiliates from the net short calculation entirely, with no additional stipulations. The following compromises on this issue have made their way into a few syndicated credit agreements and could be used in the context of a restructuring NDA depending on the make-up of the participating lender group:

- In one approach, "Screened Affiliates" (lender affiliates that (i) are managed independently from the lender itself, (ii) have customary information walls between themselves and the lender and (iii) whose investment policies and decisions are not influenced by the lender or its investment decisions) are excluded from the net short calculation. In certain credit agreement formulations, lenders are required to make a good faith attempt to ascertain their Screened Affiliates positions (which would seem futile given the customary information wall requirement).
- In another approach, the Anti-Net Short Provisions exclude affiliates from the net short calculation, but include one or more of the following representations (or covenants) from the participating lender: (i) it has customary information walls between it and its affiliates; (ii) it will not share MNPI or any other confidential information with its affiliates and/or (iii) it is not knowingly and intentionally acting in concert with any of its affiliates for the express purpose of creating the same economic effect to the credit group as if such participating lender was a Net Short

Lender.

As the former formulation still requires the participating lender to attempt to monitor non-Screened Affiliates, which may be unrealistic, the latter formulation in one of its various forms is likely a more readily agreeable compromise for most institutional investors given the restrictions apply solely to the conduct of the lender of record.

***Key Takeaway**:* Generally, participating lenders in multi-strategy enterprises should be reluctant to agree to Anti-Net Short Provisions that include any or all affiliates' holdings in the net short calculation, unless they can be assured of operational monitoring feasibility and a compelling justification exists to subject the entire group to such restrictions.[5]

Additional Windstream Provisions to Look Out For

In addition to the Anti-Net Short Provisions, sponsors have attempted to import other post-Windstream contractual deterrents to net short debt activism into their loan documents and bond indentures. While the breadth and variety of such provisions remain unsettled in syndicated loan market, institutional investors should be on the lookout for the following oft-resisted provisions in the NDAs proposed by sponsors and borrowers.

Additional Default Warning

One of the post-Windstream provisions that has been proposed, but often rejected, in conjunction with the Anti-Net Short Provisions is a requirement for the administrative agent to provide the borrower with additional notice prior to acting on any non-bankruptcy default. The intent of this extended notice period (we have seen as long as three business days proposed) is to give the borrower time to determine whether to challenge such default action in accordance with the Anti-Net Short Provisions by evaluating whether the administrative agent acted at the direction of the requisite non-Net Short Lenders. From an enforcement perspective, this provision reflects a significant constraint on the lenders' ability to act decisively to enforce their rights under the credit documents against a defaulted borrower. However, sponsors seeking to engage in proactive discussions with their portfolio companies' lenders may attempt to include a similar provision in their NDAs. For instance, the sponsor could include a provision in the NDA requiring the participating lenders to agree to provide advance notice to the borrower beyond what is required in the credit agreement before directing the administrative agent to act upon a default.

Stipulated Default Time-Bars

Another relatively controversial post-Windstream provision that has cleared the market in a few leveraged loan transactions is the imposition of a contractually shortened limitation period, which restricts the lenders' ability to take remedial action with respect to publicly or privately reported historical defaults after a specified period of time. We have most often seen two years proposed, although no prevailing market standard has emerged to date given the overall reluctance on the part of syndicate investors to agree to this provision. As sponsors generally try to organize ad hoc groups of lenders that comprise the "Required Lenders" under the applicable credit agreement, the inclusion of such a provision in the NDA would result in a material weakening of the syndicate's ability to enforce upon historical defaults while such provision remains in effect.

Looking Ahead

In the current market, prudent sponsors will continue to focus on making proactive adjustments to the profile of their portfolio companies' capital structures in order to best position them to survive the economic fallout caused by the COVID-19 pandemic. The best solution for many of these companies will be out-of-court, consensual restructurings well in advance of any financial distress. Private credit lenders and other institutional investors that purchase leveraged loans likely will be major constituents at the negotiating table and should closely monitor and evaluate whether, to what extent, and in what form Anti-Net Short Provisions should be included in an NDA at the outset of a restructuring with an ad hoc group of participating lenders.

[1] While we have limited our discussion to restructurings of leveraged loans, much of our commentary applies to high yield bonds as well.

[2] The bondholder in the Windstream case was reported to be economically "net short" Windstream through credit default swap positions, and thereby stood to profit from Windstream's default and bankruptcy, as each are customary triggering events for payouts under credit default swaps.

[3] We do not cover here the various forms of Anti-Net Short Provisions that have appeared in market-clearing financings, however, the general foundation of all Anti-Net Short Provisions is the disenfranchisement of Net Short Lenders.

[4] Participating lenders relying on such exclusions should be prepared to provide representations as to their status as an Unrestricted Lender.

[5] The determination of a lender's net short position as included in any Anti-Net Short Provisions should also be reviewed by derivatives counsel to ensure appropriate calculation mechanics, including carve-outs for bona fide market-making activities and index-based derivative instruments for which the borrower or other members of the credit group (or their respective obligations) are included as a de minimis component of the underlying index.

Related Professionals

- **Vincent Indelicato**
  Partner