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The Rise of the Net-Short Debt Activist

The market for corporate debt does not immediately lend itself to the same kind of "activism" found in equity markets. Bondholders, unlike shareholders, do not elect a company's board or vote on major transactions. Rather, their relationship with their borrower is governed primarily by contract. Investors typically buy corporate debt in the hope that, without *any* action on their part, the company will meet its obligations, including payment in full at maturity.

In recent years, however, we have seen the rise of a new type of debt investor that defies this traditional model. As we previewed here, this investor buys "long" positions in corporate debt not to make money on those positions, but instead to assert defaults that will enable the investor to profit on a larger "short" position. We call this investor a "net-short debt activist."

The playbook of the net-short debt activist starts with the investor identifying a transaction, no matter how old, that it can claim did not comply with a covenant in an issuer's debt documents. Next, the investor amasses *both* a short position in the company's debt (in some cases through a credit default swap that collects upon a default) *and* a long position in the debt, albeit one that is smaller than the short position, so the investor is "net short." The investor, finally, asserts the alleged default, often in a public letter; and if its long position is large enough (usually 25 percent of a bond tranche), it can also serve a formal default notice, triggering a high-stakes litigation.

Net-short debt activism can be highly effective, in part because of the asymmetric risk that it presents to the target company. Even without a formal notice of default, a public letter asserting a covenant violation can by itself increase the value of a short position and affect the target company's ability to transact in the markets. And once a notice of default is served, the company has the burden of going to court to demonstrate that no default has occurred. Unless and until that ruling is obtained, the company faces the risk not only that the activist will be able to accelerate the debt it holds, but also that other financial debt will be subject to cross defaults and that other counterparties of the company — such as other lenders, trade creditors, or potential strategic partners — may hesitate to conduct business with the company until the cloud is lifted.

The highly publicized dispute between Windstream and Aurelius Capital Management is a prominent recent example of net-short activism. Aurelius holds bonds issued by Windstream and, reportedly, also holds a short position through credit default swaps. Starting in 2017, Aurelius used its position as a bondholder to assert that, in connection with a spin-off of certain assets more than *two years prior*, Windstream violated the "sale and leaseback" covenant in its bond indenture. Windstream has vigorously contested that assertion, and it has also undertaken a series of debt exchanges and consent solicitations to waive the claimed default. Although widely supported by Windstream's "long-only" bondholders, the exchanges and consents have been challenged as well.

The Windstream situation, regardless of how it is resolved, exemplifies the risks that net-short debt activism can pose to companies. Aurelius has publicly questioned Windstream's financial position and threatened Windstream with an outcome — defaults on its bond debt — that could cause significant damage to Windstream's other stakeholders, including other creditors, shareholders and employees. While short sellers in the equity markets might "talk down" a stock, they have no similar legal mechanism to inflict such wide-ranging harm on a target.

In the current environment, companies should be aware of the risks presented by net-short debt investors and, where possible, take steps to limit those risks. At the debt issuance stage, companies are well-advised to avoid covenants that lend themselves to "technical" breaches based on notice and delivery obligations and to draft covenants as precisely as possible, with due regard for anticipated transaction structures. After issuance, it is important for companies to cultivate relationships with long-term debt investors, whose support may be essential in addressing any claims brought by net-short investors. In all events, preparation is critical, and companies that may be vulnerable to covenant-default claims, including by net-short investors, should be ready to address those claims quickly and decisively both in the markets and, if necessary, in court.

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