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Default Activism in the Debt Markets

We have recently seen an increase in contentious disputes, some public and many not, between companies and their debt investors. Clashes between borrowers and their lenders are as old as debt itself, but what we are seeing now is something different. In these situations, debt investors are not merely seeking to enforce their contractual entitlement to payment, or to challenge transactions that will impair the borrower's ability to pay. Rather, they are purchasing debt on the theory that the borrower is *already* in default and then actively seeking to enforce that default in a manner by which they stand to profit. Call it *Default Activism*: default as opportunity rather than risk.

In our recent memo [The Rise of the Net-Short Debt Activist](#), we discussed one type of default activism: namely, a “net-short” strategy under which an activist amasses a large “short” position in a company together with a smaller “long” position, and then uses the long position to assert that the company is in default on its debt, so that it can reap gains on its short position.

Default activism, however, is not dependent on having a short position. In other recent situations, default activists have asserted that a default on bonds entitles them to collect not only principal and accrued interest on those bonds, but also a significant *premium*. Historically, “call” protection payments payable upon an “optional redemption” were thought not to be payable when debt was accelerated following default. But recent case law — in particular, the widely discussed *Cash America* case from the Southern District of New York — has held that covenant defaults are the equivalent of an *indirect* optional redemption, and that recovery of a “make-whole” premium can be pursued as an alternative to acceleration. While the *Cash America* decision has been criticized in some quarters, it has enabled default activists to buy bonds at prices at or only slightly below par but still seek to profit handsomely by asserting that a default has occurred and that the holders should receive a large premium.

Critical to the default activist's playbook is a willingness to dig deep, poring over transactions and applicable indentures and credit agreements in hopes of excavating a colorable default claim. Because debt documents almost never include an express time bar for defaults, the acquiescence of debtholders to a corporate transaction when it actually occurs (at a time when the company's financial condition may be strong and its debt valued at or above par) does not necessarily prevent a default activist from asserting defaults based on the same transaction years later (when circumstances may differ). Call this tactic *Default Archaeology*. To cite a recent example, bondholders of Safeway have asserted

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defaults arising from the company's acquisition by Albertsons, first announced in 2014. Although analysts differ on the merits of the bondholders' claim, the nearly four-year gap between the closing of the Albertsons deal and the default allegations is remarkable. Safeway has recently sued to obtain a declaration that it is not in default and, notwithstanding *Cash America*, does not owe any make-whole premium.

Importantly, default activists do not need to go to court to score a pecuniary victory. In our experience, default activism is as apt to begin with a private letter to the borrower as it is with a public default notice. The letter will simultaneously assert that the borrower is in default and offer to drop the assertion in exchange for an accommodation like a fee or a buyout. The corporate borrower, faced with the risk of costly, distracting and high-risk default litigation, often finds it easier to negotiate a quiet settlement. Whatever its status in the equity markets, greenmail is alive and well in the debt markets.

Default activism is the product of at least two important trends, one driving demand and the other supply. First, as increasingly large and numerous investment funds compete for limited opportunities in the debt markets, some have sought to distinguish themselves through active, non-correlated strategies, much as equity-focused funds have increasingly pursued stockholder activism strategies. Second, as corporate debt structures, and the documents that govern them, have become ever more complicated (from multi-page EBITDA definitions to new technologies for unrestricted subsidiaries), the opportunities for disagreements have significantly increased.

In light of these market developments, companies should assume that debt investors are monitoring their transactions, assessing potential breach claims, and seeking creative ways to profit from them – and that they have long memories. As a result, it is more important than ever for companies to be deliberate when negotiating debt agreements, and to be thoughtful when engaging in transactions that may implicate their debt covenants. Taking “aggressive reads” of debt covenants has simply become more risky than it once was. In the current environment, companies should also seek to cultivate constructive relationships with their traditional long-term debt investors, who can be allies in the face of default claims. And companies that have reason to believe they are specifically vulnerable to default activism claims should be prepared to make their case in the event of an activist approach.

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