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Debt Default Activism: After *Windstream*, the Winds of Change

In our prior memos The Rise of the Net-Short Debt Activist and Default Activism in the Debt Markets, we discussed the phenomenon of "Debt Default Activism," in which investors purchase debt on the thesis that a borrower may *already* be in default, and then seek to profit from the alleged default, by, for example, triggering a credit default swap (or "CDS") payout or trading various interests around the negative news generated by the default allegation.

In February, the most prominent example of Debt Default Activism came to a conclusion. Aurelius, a bondholder of telecom services provider Windstream that was reported to be economically "net-short" Windstream through CDS, prevailed in litigation with Windstream over a complicated debt covenant issue.

Windstream's "long-only" debtholders, whose rights were nominally vindicated by the decision, were not happy. They had voted overwhelmingly to waive the alleged covenant default (the court concluded that those consents were not valid) in order to avoid exactly the result that ensued: Windstream's bankruptcy. The long-only creditors had good reason to aid Windstream's attempt to stave off Aurelius' challenge. With Windstream's bankruptcy, the value of their positions plummeted, illustrating that Debt Default Activism can harm not only corporate borrowers but also their creditors.

In the period since the *Windstream* decision, the winds of change have begun to blow, with signs of an emerging view that well-designed contractual limitations on Debt Default Activism can benefit both borrowers *and* lenders. We highlight several examples below, cautioning that they are untested and evolving– we expect a dynamic process over the next few years or more.

Mandatory Disclosures and Voting Restrictions. One provision to emerge in recent weeks requires debtholders to disclose if they are "net-short" and deprives "net-short" holders of the right to vote their long positions on amendments to the applicable debt agreements. The goal of the provision is to align voting power and economic interest so that those incentivized to maximize the value of a given debt instrument control relevant decisions.

Default Time-Bars. Also notable in *Windstream* was the gap between the time that Windstream completed the challenged spin-off transaction (April 2015) and the time Aurelius actually asserted a default (September 2017). An even longer gap applied to the recent objection by Safeway bondholders to the company's acquisition by Albertsons. A new provision addresses such "default archaeology" by imposing a time-bar on default claims, requiring that any default

notice be delivered within two years of the date that the challenged transaction is reported publicly. Whether two years, three years or six months emerges as a standard, it is clear that many market participants are not content with the longer limitations periods dictated by state law (in New York, six years for contract claims).

Anti-"Cash America" Provisions. In the *Cash America* case of 2016, the Court held that a borrower's covenant default may be treated as an "optional redemption" of the defaulted debt, and, therefore, that lenders may be entitled to a redemption premium from their defaulting borrowers. *Cash America* came as a surprise to many market participants, as the prevailing view had been that if a borrower did not *intentionally* breach a covenant, then the only remedy available to debtholders would be acceleration of their principal *at par*. In response, some borrowers sought to include language in debt documents stating that a prepayment premium would *never* become due upon an acceleration of debt. But investors pushed back, and this fix to *Cash America* has not taken hold. Since then, however, Debt Default Activists have advanced "premium hunting" claims in which they buy debt, allege a default under that debt, and demand to be repaid at par *plus a redemption premium*. It is possible that a milder form of the contractual fix previously proposed by borrowers might deter activist overreaches while protecting bargained-for call protection: it would echo the pre-*Cash America* consensus view and provide that no premium will be due on account of an event of default, other than in situations in which the borrower consummated the transaction with the intent to breach a covenant.

Myriad other responses to Debt Default Activism could be imagined, including such prosaic measures as increasing the size of the long position creditors have to hold to assert default, whether by raising the typical 25% threshold (a 30% threshold has gained some market traction) or by aggregating voting on common covenants across bond indentures. Evolution in inter-creditor arrangements also would not surprise us.

As debt investors evaluate contractual responses to Debt Default Activism, they will undoubtedly be concerned that limitations designed to deter opportunistic behavior by activists may provide openings for borrowers to exploit already permissive credit documentation. But recent developments suggest that borrowers and lenders may find common ground on contractual provisions that will constrain activists without unduly limiting creditor remedies.

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