

KEY POINTS

- During 2019 anti-net short provisions were introduced to the US leveraged loan market by financial sponsors seeking to limit the rights of lenders that hold a net short position in loans.
- Anti-net short provisions in the US leveraged loan market primarily comprise disenfranchisement of net short lenders and restrictions on transfers to such lenders but can also include a limitation period on taking action following a default and an extended cure period.
- This recent development in the US leveraged loan market is starting to migrate to the European market but, in these early days, there is no settled position on anti-net short provisions in the European leveraged loan market.

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Anti-Net Short Provisions: emergence and migration to the European market

One notable development in the leveraged loan market in 2019 was the inclusion by financial sponsors of “Anti-Net Short Provisions”, which are designed to provide financial sponsors with greater control over the composition of their portfolio companies’ debt investors and to curtail net short debt activism. While these provisions have, to date, primarily been limited to the US leveraged loan market, such terms are now migrating to its European counterpart. This article discusses the different approaches taken to Anti-Net Short Provisions in the US leveraged loan market and provides insight as to what market participants can expect in Europe.

“NET SHORT LENDER” AND “NET SHORT DEBT ACTIVISM”

First of all, who is a “net short lender” and what is “net short debt activism”? A lender will be considered a “net short lender” when its long position in a loan is outweighed by its short position in a credit default swap or other derivative. What this means is that, in the right circumstances (for example, where a borrower is in default under its loan documentation), a net short lender will benefit from the bankruptcy or insolvency of a borrower because its pay-out under the credit default swap or other derivative will be greater than any losses it suffers in connection with its long position in the syndicated loan. Net short debt activism is a term used to describe net short lenders who take net short positions with a view to calling a default under the relevant loan documentation to force a pay-out under a credit default swap or other derivative.

ORIGIN AND FINANCIAL SPONSOR RESPONSE

Net short debt activism is not necessarily a new concern for financial sponsors. Certain borrowers have been alive to the (sometimes unconventional) consequences of working with entities that have net short positions

with widely-known examples including Codere’s 2013 restructuring and the recent events involving Hovnanian Enterprises.

However, in February 2019, Windstream entered into Chapter 11 bankruptcy after a holder of certain of its bonds, who was believed to be a net short lender, alleged that Windstream had breached one of its covenants as a consequence of a transaction that Windstream had undertaken two years prior to the date on which that holder acquired its bonds.

Upon seeing the implications of the Windstream case, financial sponsors were quick to react by introducing Anti-Net Short Provisions in an attempt to protect their portfolio companies from the motivations of net short lenders which are perceived not to be fully aligned with the interests of the company, equity stakeholders and, perhaps also, lenders who hold long positions.

EVOLUTION OF ANTI-NET SHORT PROVISIONS

At the time Anti-Net Short Provisions first appeared in the market, leveraged loans and high yield bonds took quite different approaches. The leveraged loan market typically incorporated provisions disenfranchising net short lenders whereas

the high yield bond market included language which prohibited bondholders from exercising their rights with respect to an event of default that was more than two years’ old. These contrasting approaches are continuing to evolve and, in respect of leveraged loans at least, it is now not uncommon for financial sponsors to propose Anti-Net Short Provisions that comprise a combination of both approaches and also extensions thereof.

ANTI-NET SHORT PROVISIONS IN THE US LOAN MARKET

In US syndicated loan documentation, Anti-Net Short Provisions are generally found in the sections governing amendments and waivers, successors and assigns and/or remedies upon event of default. While the drafting of these provisions is far from settled, it is typical that language in leveraged loans purports to implement one or more of the following:

- **Disenfranchisement of net short lenders:** language is included in the amendments and waivers section to provide that net short lenders shall have no voting rights with respect to any amendment, waiver or any other instruction to the agent to undertake (or refrain from taking) any action under any loan document. This would include, for example, the issuance of a default or acceleration notice under the loan document and the right to approve or disprove any amendment, waiver or consent request made by the borrower to its lenders. In addition to being disenfranchised with respect to their position, for the purpose of determining the votes of the “required lenders”, net short lenders are also

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deemed to have voted their interests as a lender without discretion in the same proportion as the allocation of voting by lenders who are not short lenders.

- **Extension of Disqualified Lender list:** the disqualified lender list is extended to include any lender that has made an incorrect representation or warranty or deemed representation or warranty with respect to it not being a net short lender. If a net short lender is considered a “disqualified lender” for the purposes of loan documentation, in addition to losing its right to vote and to certain remedies as discussed in the disenfranchisement provisions above, the borrower can require that the net short lender assign and delegate all of its interests, rights and obligations under the loan documentation to an assignee and require that such net short lender be prepaid and its commitments cancelled.
- **Contractually shortened limitation period:** language is included in the events of default section whereby the parties to the loan documentation agree to shorten the period in which the lenders may take action (including, for example, issuing a default notice) in relation to a specific default to two years after that default. This feature is more prevalent in the US high yield bond market than in the leveraged loan market. Note, however, that this has also started to appear in certain loan documentation in addition to the foregoing elements.
- **Extension of cure period:** language is included in the events of default section providing that any cure period with respect to any actual or alleged default or event of default may be extended or stayed by a court of competent jurisdiction. This feature usually accompanies the contractually shortened limitation period mentioned above and therefore is more prevalent in the high yield market than in the leveraged loan market.

In order to give effect to the disenfranchisement of net short lenders and the extension of the Disqualified Lender list, representations are typically included in

the loan documentation to require lenders to disclose their net short positions to the borrower and the agent. To the extent a lender does not notify the borrower and the agent of its net short position, it is deemed to have represented that it is not a net short lender. Lenders are required to make this representation at various times throughout the life of the credit, including at the time the lender buys into the loan through the form of assignment and assumption (or participation agreement), at the time of voting on any amendment or waiver, and at the time of issuing a notice of default (or instruction to the agent to do so).

Recent credit agreements have also proposed that, in determining a lender's net short position, lenders should also take into account the positions of their affiliates to prevent lenders from structuring their short positions in a manner that would circumvent the purpose of the Anti-Net Short Provisions. While this affiliate aggregation addresses the simple structuring work-around, it creates issues for lenders and in particular large financial institutions who may have difficulty in monitoring their overall exposure to a particular credit at all times across their various affiliates and business lines. Indeed, certain regulated banks do not use separate affiliated legal entities for their different business units. This has resulted in various carve-outs to the definition of net short lender in loan documentation, including, exceptions for affiliates behind information barriers and regulated banks.

EMERGENCE IN THE EUROPEAN MARKET

As you would expect, once the Anti-Net Short Provisions cleared the market in the US, financial sponsors sought to implement similar provisions in the European leveraged loan market, particularly in European leveraged loan deals that have both dollar and euro tranches. Notwithstanding this, Anti-Net Short Provisions are still very much in their infancy in Europe and therefore, while they have been proposed in an increasing number of term sheets, it is not uncommon for these provisions to fail to make it through to the long form documentation.

In these early days, a range of different approaches has been proposed in term sheets for transactions backed by financial sponsors including the following:

- **Disenfranchisement (only):** Disenfranchisement language is included that tracks the position now seen in some US leveraged loan documentation (as detailed above) with carve-outs for day-one revolving credit facility lenders, regulated banks and derivative transactions entered into pursuant to *bona fide* market making activities. This is supported by a requirement that each lender shall promptly notify the agent if it is, or becomes, a net short lender and that such lender is otherwise deemed to have represented to the agent and the borrower that it is not a net short lender, but without any amendment to the usual European market transfers and assignments provisions nor the inclusion of any contractual limitation period or extended cure period.
- **Disenfranchisement plus transfer restriction:** Disenfranchisement language is included as per the above bullet and, in addition, lenders are prohibited from assigning or transferring commitments to lenders that have made an incorrect representation or warranty (actual or deemed) in respect of not being a net short lender. However, there is no contractual limitation period nor any extended cure period.
- **Contractually shortened limitation period (only):** Although it is still considered uncommon in the European leveraged loan market, financial sponsors have been known to request, at least at the term sheet stage, that lenders adopt the contractually shortened limitation period of two years as is often seen in the US high yield bond market and some US leveraged loans.

TRANSFERABILITY AND THE EVOLUTION OF ANTI-NET SHORT PROVISIONS IN THE EUROPEAN MARKET

As we look forward to where the European market may settle on Anti-Net Short

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Provisions, one factor to consider is the inherent differences in the transfers and assignments provisions between the US and European markets and, in particular, in what circumstances an existing lender can transfer or assign its position following an event of default.

In the US syndicated debt market, investors typically agree not to transfer or assign their interests in any loan to an entity that is a “disqualified lender”. This restriction on transfers applies at all times, even during an event of default. The European leveraged loan market deals with assignments and transfers in the inverse; it prohibits lenders from transferring or assigning their positions in a loan without borrower consent other than: (i) to those entities that are specified on a pre-agreed “white list”; or (ii) while certain “material” events of default are continuing.

In addition, this is typically subject to a prohibition on lenders transferring or assigning their positions to a distressed debt or loan-to-own investor, however, this restriction falls away while certain “material” events of default are continuing.

As usual, one of the critical features for primary debt investors is how easily they can exit the trade – for example, how big is the pool of investors that a primary investor can transfer or assign their position to in

the secondary market? How quickly can a primary investor execute the transfer or assignment? Is borrower consent required to the transfer or assignment?

In addition to affecting each of the questions above, the introduction of the Anti-Net Short Provisions to European documentation terms in the same form that currently exists in the US leveraged loan market, is likely to be a particularly sensitive issue for European primary debt investors as the US formulation limits transfers and assignments notwithstanding the continuation of any event of default whereas, the European market is more accustomed to having the flexibility to transfer or assign loan positions while certain material events of default are continuing.

CONCLUSION

As with many new developments in the European leveraged loan market that have been imported from the US leveraged loan or high yield markets, there will be an adjustment period after which the position will settle and Europe’s market position with respect to Anti Net Short Provisions will be established. In particular, it will be interesting to see where the European leveraged loan market will land on each of the following:

- **Alignment:** Will Anti-Net Short Provisions in the European market align fully with the US leveraged loan market or will the alignment be partial in the same way that most-favoured nation protections and soft call provisions retain certain differences?
- **Extent:** Will Anti-Net Short Provisions traverse the market into mid-market transactions in the same way that EBITDA-growth baskets migrated from large cap deals to mid-market transactions?
- **Syndication:** How will primary debt investors weigh up the potential limitations on their ability to transfer or assign their positions as against their interests as a net long lender in ensuring a consensual work-out if difficulties arise in the credit? ■

Further Reading:

- Lender transfer rights: the long and short of it (2019) 11 JIBFL 750.
- The new breed of transfer restrictions in leveraged lending transactions: a new paradigm or just a sign of the times? (2018) 4 JIBFL 222.
- LexisPSL: Banking & Finance: Practice Note: Key issues in loan transfers.