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The End of Covenants: The "No Premium on Default" Language Is Spreading Like Wildfire - Your Future Covenant Enforcement Is Being Destroyed

By Adam B. Cohen, J.D., Founder of Covenant Review

The Bottom Line:™

- Bondholders have long rightfully expected that if an issuer wants to take an action that is not allowed under its bond covenants, then a consent or make-whole redemption would be required.
- For example, if a high yield bond issuer wants to pay a dividend that is greater than its Restricted Payments capacity, then it has to either pay a consent fee to amend its indenture or redeem the bonds under the make-whole redemption or call schedule.
- Last year, the high yield bond issuer Cash America argued in court that even if a major asset spin-off was in breach of its indenture, it did not need to seek any consent nor pay any premium – instead, bondholders should just choose to accelerate and only get par, or suffer in silence as their credit eroded.
- In September, the Southern District of New York court ruled against this ridiculous argument and said that the redemption premium was due.
- And now we are at a crisis – as of today, we know of 18 deals that have been marketed with new language that works to basically "opt-out" of the court's ruling. This terrible language will vastly embolden issuers to consider breaching covenants, and lead to more risk for bondholders and fewer premium redemptions.
- With due understanding of how alarmist all this sounds – if investors do not rapidly start rejecting these deals, it is the beginning of the end of bond covenants. This is by no means just a debate about potential make-whole premiums in bankruptcy.
- Since the first version of this report, Broadcom and General Motors launched new deals with this terrible language! *Investors must rapidly fight this!*
- But, good news! Bondholders have scored the first official victory with the elimination of this language from the Novolex deal, and as of the publication of this report we have multiple sources conveying that the language is being removed from Broadcom, Fibria, GM, and Raizen!

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Note: This is a slightly updated version of Covenant Review's January 9 report with the same title. In this version, we have updated the table of deals that have this defect and report on the first bondholder victories! The legal analysis remains unchanged, and so if you have read the prior report, you may simply want to revisit pages 3 and 4.

What happened in Cash America?

In brief:

- Cash America issued $300 million of high yield bonds in 2013. The bonds did not have a Restricted Payments covenant, but did have a Mergers covenant that limited some kinds of asset dispositions. In 2014, Cash America spun off 80% of its valuable Enova subsidiary to its shareholders.
- The Southern District of New York concluded that "Cash America breached the indenture" by spinning off that value.[1]
- The bondholders' trustee argued that "It is a fundamental tenet of any debt agreement that, if an issuer wants to effect a corporate transaction that would otherwise violate the agreements governing its debt, it must first repay its debt or obtain waivers or amendments to those agreements."
- Cash America argued that, regardless of the indenture breach: "Cash America did not send a notice of redemption pursuant to Section 3.02 of the Indenture….Nor has Cash America otherwise attempted to redeem the Notes at issue...As a result, there is simply no basis under the Indenture for the Trustee's claim that Cash America must redeem the Notes and pay the redemption price…. And the Indenture certainly does not require redemption for a default. The Indenture's prescribed remedy for an Event of Default is acceleration… The plain text of the Indenture thus squarely forecloses the Trustee's second claim for specific performance of the Optional Redemption provision."
- In other words, Cash America – through its law firm, Jones Day – was saying "an issuer can ignore its covenants and if bondholders don't like it, then the bondholder can accelerate and sue for par…. We will pay any dividend we like, we will issue any debt we like…and par is the ceiling."

As we are ringing the alarm bell about the new "no premium on default" language, our subscribers are calling us and saying things like "well, an issuer can't just lever up in an LBO and pay off the shareholders and leave us with a damaged credit, and get away with it by not paying us the make-whole" – but that is EXACTLY what Cash America and the Jones Day law firm effectively argued.[2] We invite subscribers to see for themselves the inanity of the arguments by reviewing select files on the Covenant Review website alongside this report; you can also review all the filings at PacerMonitor's Cash America filing docket.

What happened next in Cash America?

In brief:

- Thankfully, the Court concluded that "As in *Sharon Steel*, the Indenture has both a redemption clause that requires payment of a make-whole premium as well as an acceleration clause that is…explicitly permissive and not exclusive of other remedies…And Cash America's default, like the default in *Sharon Steel*, was not due to bankruptcy, but to the company's 'voluntary actions'… — namely, the Enova spin-off. Thus, Wilmington Savings may seek, pursuant to Section 6.03 of the Indenture, 'to enforce the performance of a…provision of the… Indenture' — namely, the prepayment provision. In light of the Indenture's permissive, non-exclusive

[1] The Mergers covenant had been custom-crafted to specifically contemplate, and limit, the potential disposition of the Enova business line which was spun off. There was no Restricted Payments covenant.
[2] Cash America had argued that it did not breach its indenture, and it lost that argument also.

acceleration clause and Cash America's voluntary breach, there is 'no bar' to that relief... If anything, Wilmington Savings's claim to specific performance is even stronger than the claim of the noteholders in *Sharon Steel*, as the Indenture here expressly grants Wilmington Savings the right to pursue such a remedy. Accordingly, in this case, as in *Sharon Steel*, 'the redemption premium must be paid.'….. Cash America's position is the inequitable one: It seeks to place itself in a better position by breaching the Indenture than it would have occupied had it honored the parties' contract."[3] *Translation: bondholders are not limited to receiving par upon acceleration upon a covenant breach, but may also pursue specific performance and enforce the prepayment provisions of the Indenture. This was a good ruling for bondholders that simply endorsed the understanding that almost everyone in the market already should have known.*

- But then, the Court basically invited the future destruction of bond covenant enforcement: "Moreover, when negotiating the Indenture itself, Cash America could have foreclosed the possibility of *Sharon Steel* applying to a voluntary breach of the Indenture… 'Under New York law, the parties to a loan agreement are free to include provisions directing what will happen in the event of default of the debt, supplying specific terms that supersede other provisions in the contract if those events occur.' For example, Cash America had — as future parties have — 'the ability . . . to draft acceleration provisions that would be self-operative.'" *Translation: issuers can put a clause in their indenture to limit the remedy for a breach to par redemption.*

<u>And now the destruction of your covenant enforcement has begun.</u>

In October, Rackspace was LBO'd by Apollo. And the then-existing bondholders were paid a 115 make-whole redemption because the Restricted Payments covenant would have been breached by the proceeds of the new debt incurrence being used to pay off shareholders. For the LBO to proceed, Apollo had two options: obtain a consent from the existing bondholders for the transaction, or call the bonds at the then-applicable make-whole price.

When Apollo marketed the LBO bonds, it deployed the new "no premium on default" language. We told investors at the time: "Apollo has slipped in a sentence that could arguably deprive bondholders of the right to a call premium upon a covenant breach. This is outrageous and, as far as we know, unprecedented." Sadly, the provision remained in the deal, and some subscribers told us "maybe it's just an Apollo thing." Then we reported that Service Master did it, and some subscribers said "maybe it's just a sponsor thing." But the provision has even jumped to high grade issuers like FedEx and Marsh & McLennan.

<u>Tainted bonds with the no premium on default language.</u>

Below are the 18 deals we know of as of January 10, 2017 that have been marketed with some variant of the terrible "no premium on default" language. The table below shows by the numbers that the driving law firm is Davis Polk (and we make the fascinating observation that the original law firm that inserted this provision for EP Energy and Rackspace – Paul, Weiss – is the same law firm that bondholders paid to fight for them in the Cash America litigation).[4] As to the banks, it seems to us that this is spreading rapidly just because lawyers are starting to pull the idea into their deals, and not because any bank is really trying to spread this around, and in fact we believe many on the sellside are unaware that this language is in their deals.

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[3] *Sharon Steel* is a critical Mergers covenant indenture case from 1982 that is commonly cited in indenture litigation; it is all explained in the filings. Note: we are liberally using ellipses to condense and simplify the text of the Cash America documents and we are replacing some double quotations with single quotations, but a review of the source documents will reflect substantive fidelity.

[4] We primarily blame the issuer law firms for putting this language in. The underwriter law firms are somewhat less culpable for failing to stop it.

Covenant Review's Tainted Bond List			
Issuer	**Issuer Law Firm**	**Underwriter Law Firm**	**Left Lead Bookrunner**
Broadcom*	Latham & Watkins	Simpson Thacher & Bartlett	Barclays
CF Industries	Skadden, Arps, Slate, Meagher & Flom	Davis Polk & Wardwell	Morgan Stanley
Communications Sales & Leasing	Davis Polk & Wardwell	Cravath, Swaine & Moore	Citigroup
EP Energy	Paul, Weiss, Rifkind, Wharton & Garrison	Latham & Watkins	Goldman, Sachs & Co.
Fedex	Davis Polk & Wardwell	Simpson Thacher & Bartlett	Wells Fargo Securities
Fibria*	White & Case	Skadden, Arps, Slate, Meagher & Flom	BNP Paribas
GM Financial*	Hunton & Williams	Davis Polk & Wardwell	Credit Agricole
Green Bank	Skadden, Arps, Slate, Meagher & Flom	N/A	Cincinnati Insurance Company
Honda	O'Melveny & Myers	Sidley Austin	Barclays
Marsh & McLennan	Davis Polk & Wardwell	Willkie Farr & Gallagher	BofA Merrill Lynch
Metro De Santiago	White & Case	Davis Polk & Wardwell	BofA Merrill Lynch
Nike	Goodwin Procter	Davis Polk & Wardwell	BofA Merrill Lynch
Novolex - FIXED AT PRICING	Latham & Watkins	Cravath, Swaine & Moore	Credit Suisse
Rackspace	Paul, Weiss, Rifkind, Wharton & Garrison	Cahill Gordon & Reindel	Deutsche Bank Securities
Raizen*	Davis Polk & Wardwell	White & Case	BofA Merrill Lynch
Roper	Davis Polk & Wardwell	Simpson Thacher & Bartlett	J.P. Morgan
ServiceMaster	Debevoise & Plimpton	Simpson Thacher & Bartlett	Credit Suisse
Toyota Motor Credit	N/A	N/A	BNP Paribas
* =removal pending confirmation			

We call these securities "Tainted Bonds" because they will forever trade with the risk that the bonds will be trading above par when some corporate action occurs – such as an LBO or spin-off – where people *think* they should get a consent or make-whole redemption because of covenant constraints – but then the issuer may just choose to breach in the belief that bondholders' only remedy will be to accelerate at par. Buying any of these bonds will subject investors to very significant, non-compensable event risk for the life of these bonds. At the request of many of our subscribers, and in order to better assist investors that wish to identify any deals with this terrible provision, Covenant Review is maintaining a list of the Tainted Bonds. Any of these deals where the odious provision is removed in the final terms will be removed from this list when we have confirmed that the offending language has in fact been removed.

Since we published the first version of this article on January 9, bondholders secured their first public victory – the no premium on default language has been removed from the Novolex deal because people who read the report acted to protect their investors. This victory is important especially as Novolex was not some struggling deal – the provision is so

manifestly wrong that the buyside should prevail on being "right", and adding on to that the "might" of passing on the deal. In the midst of writing this report, we have multiple sources telling us that Broadcom, Fibria, GM, and Raizen are also removing the language; we will remove them from the list when there is sufficient confirmatory evidence. *Some on the sellside are beginning to hear about and understand this issue – keep talking it up and rejecting deals!*

The destruction of covenant enforcement is going to cost your clients money and increase their risk.

In a typical year, bondholders are collectively paid hundreds of millions of dollars a year in consent fees and premiums on make-whole redemptions. These payments occur in both high yield and high grade, with a few random examples spanning across the last decade including ITT (conglomerate; redemptions as high as 153 due to Mergers covenant), JC Penney (retail – redemption drove bonds from 85 to 145 due to Debt covenant), TXU (utility; redemption of two tighter covenant bonds in the LBO due to Debt and Liens covenant), Rackspace (IT; redemption at 115 due to Restricted Payments covenant), and Rhiag (European auto parts dealer; redemption due to sale to LKQ where Rhiag credit support was needed to finance the deal). There are *dozens* of such examples – and every portfolio manager reading this article has undoubtedly had their returns enhanced by receiving such payments. This upside – or more properly, this compensation for your enhanced risk in a consent or your need to be compensated for the loss of expected future interest payments in a repayment – may be obliterated by the new "no premium on default" language being included in the indenture.

And more importantly, there are the many hundreds of risky, bad things that didn't happen because covenants mean something today. Think of all the times you worried about questions such as "can this issuer just put on another $2 billion of secured debt?" or "can this company just sell assets and buy back stock to calm its investors?" Imagine what will happen if every issuer, regardless of financial health, could just breach covenants and say "well, worst case, we have to redeem at par?"

Here is how we imagine it might play out:

- Healthy issuers / LBO targets, or bonds trading well above par: Just breach, and pay off at par if needed – rather than pay a consent and / or make-whole. Or just send a 101 tender and consent offer ahead of the closing because "you might as well take an extra point now, because you can only sue for par anyway."
- Issuers with bonds trading a couple points below par: Well, just breach, because maybe no one will really accelerate or bother to enforce if there is no upside to it.… Who will hire counsel to litigate a big dividend that breaches a Restricted Payments covenant for a bond trading at 98, when the upside is par? Instead, you as a bond buyer will be stuck lamenting "the good old days" when you would have gotten a nice 110 redemption.
- Stressed issuers / bonds well below par: Hopefully the new language doesn't make much impact here. Except…imagine a company where secured bonds trade above par, and the unsecureds trade well below par. The issuer decides to exchange in the unsecureds, which will dilute the secureds' collateral in breach of the Liens covenant, and that knocks the secured bonds down to 98. Then what?

The "no premium on default" language is the single worst change to ever emerge in corporate bond indentures. It is a looming disaster for bondholders, and it will greatly encourage aggressive issuers (and especially sponsor-controlled issuers) to make a mockery of the restrictive covenant protections by engaging in actions that are recklessly accretive to equity, regardless of what the covenants provide.

How can this disaster be stopped?

The only hope to save the market – and your investors – from this unfolding tragedy is for bond investors to pass on deals with any form of this new language.

For anyone managing a corporate bond portfolio where the investors will continue in the asset class, it would seem prudent to protect those investors by pushing back against an attempt to establish a very risky market precedent. Similarly, it would seem prudent to pass on any deal where the issuer is essentially signaling with this language that "we will honor or ignore covenants as we please."

This is the time for each investor – for YOU – to say, yes, I am going to pass on a deal that might trade up a point or two because some other manager bought the deal – because I have to protect my investors from the spread of this precedent.

We specifically recommend to each of our subscriber firms that the key CIO / DOR / PMs / traders independently determine that their firm will have to pass on any deal that has this provision. When that person(s) is identified, please let us know. Then, every time Covenant Review sees this provision, we would be happy to assist you by informing the point(s) of contact at your firm that the new deal has this problem. Then, your firm can tell the selling broker / salesperson: "We have decided as a firm policy that we are passing on any deals that have the no premium on default language."

If your firm would like to protect its investors in this way, please email Adam Cohen at acohen@covenantreview.com. You can also call me on 1-212-716-5781. I am speaking with buyside participants throughout the day to address this provision.

Asset managers should come to their own conclusions on an individual basis to protect their client interests – we are not suggesting that different firms act together in any way. *We are not identifying subscribers but we have already confirmed with some buyside players that they are already rejecting these deals* – and the more that do so, the quicker this covenant change will vanish.

Rapid negative market feedback to covenant changes like this have worked before, such as the demise of the 110% Change of Control call option and preventing the spread of Change of Control portability in the U.S (vs. it being rampant in Europe). It is time to act!

A note on nuance and the tone of this report.

We originally wrote on some aspects of this problem more in depth in the report "Beware of Language That Deprives Bondholders of the Prepayment Premium upon a Covenant Breach"; click here for that report.

We are fully aware of how "alarmist" this report sounds. Please pardon us for this tone, but we know of no other way to adequately communicate the seriousness of the problems raised by this provision.

We are also aware of how this report may appear a bit presumptive in recommending to buyside market participants how they should respond. Please pardon us for any imposition in this regard. We are passionate about this topic at Covenant Review. I started this firm because I really wanted to protect bondholders and that mission has never been more urgent than at this moment.

We are also aware of how this report and its arguments might make its way into the hands of lawyers and bankers who could debate all kinds of nuance… like how the deals have some varying language…how we could debate an intentional vs. unintentional default…. the possibility of specific performance in some cases… how deals needs to close with a "no conflicts" opinion….how missing a premium in a bankruptcy isn't part of the tail risk of high yield…how maybe we could bring back the Minstar provision….blah blah blah. This report isn't for the sellside to pick apart – it is for the buyside to understand a clear and present danger and to act. Some people on the sellside are already giving mangled

responses (even if perhaps well intentioned) to some of our subscribers that can almost make some of this language sound OK (like supposedly this language is just about premiums in bankruptcy). It isn't, so don't fall for these "explanations of what was really intended."

As some law firms and issuers are wielding a sledgehammer against your right to enforce bond contracts, the buyside needs a simple, blunt response to end this attempt.

— Adam Cohen, Founder, Covenant Review

Your contract with Covenant Review generally forbids redistribution of our reports – but this one is different – please DO share this report with your friends on the buyside, and with your friends at broker-dealers who need to understand why this issue is important to you. (But no sharing with research firms or the general public please.)

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