The Bottom Line:™

- Beginning in October 2016, some law firms and private equity firms started sneaking a new sentence into indentures which would upend some of the longstanding ability of bondholders to enforce their bond covenants.
- We saw this problem grow rapidly in the new year, and lawyers have now attempted to sneak these types of provisions into no fewer than 18 deals.
- We see this as a crisis of major importance. We published a report last week called “The End of Covenants” urging bondholders to raise a ruckus and kill these provisions off before they take root. That effort has been successful so far. The offending provisions have been removed from each of the 6 offerings they appeared in last week. Early indications are that new deals with this provision will be unsellable.
- Late on January 11th, after the buyside uprising, Davis Polk published a client memo titled “No, Not the End of Covenants.”
- We explain some points on which the Davis Polk views are wrong factually, wrong analytically, and wrong for the health of the bond market and the millions of ordinary people who rely on safe bond income for their retirement and pension funds.
- We also take this opportunity to give some general remarks on the War on Covenants. We share some of our many experiences with threatened and actual covenant breaches, and we give real examples of where the “no premium on default” language would have caused bondholders to lose considerable amounts of money.
- Trigger warning: this report includes facts, analysis, opinion, light sarcasm, and occasional hyperbole.

Our Prior Reports and Davis Polk’s Response

Recently, lawyers have been attempting to sneak language into bond deals that would deprive holders of a prepayment premium upon a voluntary covenant breach. We have published two reports discussing these “no premium on default” provisions at length. When the provisions first started to appear, we published a November 7, 2016 report, “Beware of Language That Deprives Bondholders of the Prepayment Premium upon a Covenant Breach.” Despite our warning, these provisions began to spread rapidly. On January 9th we published a report, slightly updated for new facts on January 11,

Adam B. Cohen is the Founder of Covenant Review and its parent company, Fulcrum Financial Data. He graduated in 1997 from Georgetown University Law Center, where he was on the Georgetown Law Journal. He has been a corporate finance attorney with Latham & Watkins and an investment banker with Lehman Brothers, working in New York and Hong Kong, where he represented banks and sponsor-backed issuers in debt, equity, and M&A engagements. Adam has reviewed and discussed with investors thousands of credit documents. He has served as the Vice President of the Fixed Income Analyst Society, co-authored two chapters in Frank Fabozzi’s Handbook of Fixed Income Securities, regularly lectures on covenant issues, and has been cited by the Delaware Chancery Court on indenture matters.
2017, with the more incendiary title, “The End of Covenants: The ‘No Premium on Default’ Language is Spreading Like Wildfire – Your Future Covenant Enforcement is Being Destroyed.” Once the market was alerted to this drastic new language, the buyside response was swift and certain: all five deals being marketed (Broadcom, Fibria, General Motors Financial, Novolex, and Raízen) had to pull the offensive language. Further, one that had already priced (Marsh & McLennan) removed the language in a prospectus supplement as some buyers didn’t want the bonds to settle with that provision. We make no apologies for a crisp headline that finally brought the necessary attention to a very important issue.

In our “The End of Covenants” report, we pointed out that Davis Polk was the law firm with the most deals driving this War on Covenants. Of the 18 deals that have been marketed with the offensive language, Davis Polk was involved in at least 9. After the market responded to our report, Davis Polk published a client memo titled, “No, Not the End of Covenants.” That memo is available here.

In this piece, we go through some of Davis Polk’s main contentions and explain why they are wrong. The buyside has taken the right action here by flatly refusing to accept any form of the “no premium on default” language. Investors shouldn’t let law firms suck them into a maze of confusion where bondholder protections will be picked apart by gradual language erosion.

**Davis Polk Point #1: The Market’s Traditional Understanding**

Davis Polk’s primary contention is that the common market understanding prior to the Cash America decision was that, in general, no prepayment premium would be available as a remedy upon enforcement of a covenant breach. Davis Polk’s argument is that bondholders should therefore be fine with the “no premium on default” language because it merely restores the rule that was understood to prevail prior to Cash America.

Here’s the quote from Davis Polk:

> Based on the language in traditional capital markets indentures and the clear difference in how payments on acceleration and payments on redemption are treated, we believe that many market participants and practitioners have traditionally understood that upon default or bankruptcy involving capital markets notes, holders would have a claim for principal and accrued interest on their accelerated notes and no more.

We disagree on this statement of the supposed traditional understanding. Although there may be some understanding that a premium is not due upon a bankruptcy, that’s a different issue – and it seems that the legalese confusion around this issue has been the conflation of covenant default vs. bankruptcy default.

Whenever we hear subscribers ponder what happens if a covenant is breached, those views are premised upon the assumption that either a consent fee or a redemption premium will be paid if the covenant is violated. Covenant Review has been serving the buyside for 11 years and analyzed thousands of indentures, and so we can say with confidence that we have a better understanding of how bond buyers view covenants than the lawyers that manufacture them. We spend much of our time each week analyzing a mix of consents, tenders offers, and hypothetical, threatened, and actual covenant breaches.

We even decided to poll our subscribers about Davis Polk’s statements last week. Many of them disagreed with what Davis Polk posited as the common market understanding. Here are some of the comments from actual bond traders and analysts – the market participants that really have something at stake here:
• “No, that is not what I have traditionally understood. [On DPW’s comment that] ‘We believe that market participants and practitioners have generally understood that an issuer’s right of redemption, including at a stated premium or make-whole, exists to provide flexibility for the benefit of the issuer.’ This is patently false.”

• “Davis Polk’s memo seems to simply equate default and bankruptcy. Having been in the HY market for a long time, that is a naïve, foolish or incorrect assumption (take your pick)… there are numerous situations where companies could or would be in default on an indenture but not in bankruptcy. Assuming they are one and the same would create many bad situations for bondholders.”

• “Clear answer is ‘no.’ We have [held] bonds numerous times [where there had to be] a make-whole [based on covenants.]”

• “Davis Polk is trying to pretend this covenant narrowly applies to the MW debate in bankruptcy (which if it did then they might be right) when it has farther reaching consequences as you note.”

It is true that many of our subscribers would be hard pressed to give a technical explanation as to why a redemption premium is available as an enforcement remedy, even though the acceleration provision seems to govern enforcement and may not include an explicit reference to a redemption premium. But since when are non-lawyers expected to understand all the technical reasons why indentures work the way they do and how boilerplate provisions have been interpreted over time via case law? That sort of expertise is what justifies the hefty fees of BigLaw.

We doubt that many bond investors have ever focused on the fine distinction between (1) what they get if an issuer is about to breach a covenant and seeks to avoid a default versus (2) what they get if the issuer goes ahead and defaults. Thus, it may be the case that there does not even exist any common market understanding of what the remedies are upon enforcement. Rather, there may only be a less precise understanding of what happens in general when a company breaches a covenant. Since a consent fee or a redemption premium is paid almost every time that an issuer is about to breach a covenant, of course the general market understanding is that a fee or premium will accompany a covenant breach.

So, how do capital markets lawyers at BigLaw get an idea of what the actual “market participants” think of these provisions? Well, that’s a bit hard to say, because in the years I worked as an associate at Latham & Watkins, it was pretty rare that I would talk to a real life bond investor, and that is pretty typical for BigLaw. The associates at Cahill, Simpson, etc. are not having some regular daily discussions with buyside credit analysts, and so their view of market participants is a bit of a funhouse mirror where opposing counsel reflect back on each other, and maybe the occasional banker’s second-hand explanation of what the bond salesman heard from the trader slips in there.

Indeed, we’ve watched the lawyer understanding of certain provisions mutate over the years, even though the literal language – and the understanding of the real market participants – does not change. For example, when I was a kid lawyer at Latham (and the “older” guys at Covenant Review remember this too), we generally believed that the purpose of an Unrestricted Subsidiary was to give the issuer a little side pocket - say, $10 million or so – to invest in some new business line. Most of us back then (circa the 1997-2002 period at least) were pretty sure that putting assets into an Unrestricted Subsidiary was not a way to get around the Restricted Payment covenant’s prohibition against “directly or indirectly” paying a dividend or refinancing junior debt. But somehow over time, the sponsors and law firms came increasingly to believe that abusing Unrestricted Subsidiaries was a great way to wrangle value away from bondholders. For a recent example of this problem, see our reports on J. Crew and Claire’s Stores playing these games.

1 See our November 7, 2016 report for a technical explanation of why the redemption premium is an available enforcement remedy.
And so we wonder: should the understanding of “market practice” and what is allowed under indentures change, when the language has not changed, just because lawyers with no personal skin in the game imagine it to be so?

Davis Polk Point #2: The Scope of Sharon Steel

The Davis Polk memo also seems to mischaracterize the Sharon Steel holding. After saying that, as a general rule, no premium is due upon a covenant breach, Davis Polk then said:

> A few courts, including the U.S. Second Circuit in Sharon Steel (1982), have recognized a narrow exception in the case of an issuer that intentionally triggers acceleration with the goal of avoiding a redemption premium, with the courts requiring such an issuer to pay the redemption premium.

The problem with this statement is that the Sharon Steel appellate court decision was not limited to “the case of an issuer that intentionally triggers acceleration with the goal of avoiding a redemption premium.” The Sharon Steel opinions is available here.

In the Sharon Steel case, UV Industries, Inc. had engaged in a piecemeal liquidation of its assets, and attempted to assign its public debt to Sharon Steel, the purchaser of the last piece of the UV assets. The court found that the issuer had violated the indentures, and then the court concluded that the redemption premium was due. The Sharon Steel court made no finding that the issuer had intended to cause acceleration. There is no reference to any “bad faith” element on the part of the issuer. Further, we don’t see how the actions at issue in Sharon Steel circa the 1979 dates of the events could be construed as being intended to cause acceleration. Sharon Steel circa 1979 had a plausible argument that the piecemeal liquidation followed by the assignment to Sharon Steel was in compliance with the indentures. (This was in an age before indenture covenants became commonly litigated.) Just because the court ultimately rejected that argument doesn’t mean that the issuer somehow “intentionally” defaulted with the goal of avoiding a redemption premium.

There are a couple of cases that suggest that the Sharon Steel holding includes some bad faith element. But the statements made in those cases appear to be merely statements made in passing, which lawyers refer to as “dicta.” Those statements are not essential to the holdings of either case, and there’s nothing to indicate that a great deal of consideration went into making them. The Cash America court properly declined to give significant weight to this dicta.

Here is what the Cash America court said about the idea that the Sharon Steel holding includes a bad faith element:

> Cash America is arguably on firmer ground in contending (somewhat inconsistently) that Sharon Steel “requires bad-faith conduct,” if only because it can point to dicta suggesting as much in subsequent cases. … But that requirement finds no support in Sharon Steel itself; indeed, the Second Circuit did not purport to make, and as an appellate court would have been in no position to make, a factual finding on an issue the district court did not have an occasion even to reach.[fn] Instead, the Court’s analysis turned on the distinction between defaults arising from “voluntary” actions (e.g., liquidations or spinoffs) versus involuntary actions (e.g., bankruptcies).

Here’s the footnote referred to in the above quote:

> Nor is it obvious that the Second Circuit could have made a finding of bad faith on the facts of the case. For one thing, the debtor’s successor-in-interest indicated that it was prepared to honor the indentures. See 691 F.2d at 1046-47 (describing Sharon Steel’s “attempt to formalize its position as successor obligor” through the delivery

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of executed supplemental indentures to the trustees). For another, the debtor had a non-frivolous argument based on the indentures’ successor obligor clauses that it did not breach the indentures at all. The Second Circuit rejected that argument, but only after a lengthy analysis of the issue (in stark contrast to the Court’s fairly peremptory discussion of the redemption premium issue).

**Davis Polk Point #3: The make-whole provision is just for the benefit of the issuer.**

Davis Polk’s third point is also puzzling to many bond buyers. Here’s a quote:

Not all capital markets notes include an optional right of redemption. We believe that market participants and practitioners have generally understood that an issuer’s right of redemption, including at a stated premium or make-whole, exists to provide flexibility for the benefit of the issuer. It would be odd, to say the least, if when an issuer defaults on notes without this feature, the issuer only has to pay principal and interest, but if that additional feature is included – for the issuer’s benefit – the issuer must pay a premium.

Well, yes, technically it is true that “not all” bonds have an optional redemption provision. But probably something like 99% of U.S. fixed rate straight corporate bonds do. More importantly, it is not the market understanding that the make-whole provision is only for the benefit of the issuer, and not for the benefit of the bondholders. What that provision does is to pre-determine what price the issuer will need to pay should it need to pay off bonds prior to maturity. Prior to the prevalence of make-whole provisions and call schedules, the parties had to engage in extensive negotiations to determine the payoff price.

Baking the prepayment provisions into the document avoids the negotiation costs. Using a make-whole formula ensures that bondholders will have a known compensation formula for the interest payment stream that they won’t receive if the bonds are repaid prior to the time when the call schedule begins. It is the bondholders who are “made whole” by the make whole provision, not the issuer. So it’s baffling that Davis Polk would suggest that this provision is only for “the issuer’s benefit.”

Again, let’s hear from actual bond buyers:

- “No to Davis Polk. While a make-whole premium does provide the issuer flexibility, I view the purpose as guaranteeing me a return for doing the work…I do not view the make whole as just giving flexibility to the issuer, far from it.”
- “The Davis Polk argument that companies without a make whole redemption option would be penalized in some way is confusing or absurd…Issuer and bondholder have entered into a contract for fixed payments over a certain period of time. If the issuer wishes to (or is forced to by pending default) exit this contract early, there is an economic cost to break that contract. The make whole redemption as the name suggests is supposed to make bondholders ‘whole’ for their economic value (payment for risk of receiving interest payments until maturity) lost when a company redeems a bond prior to maturity.”

**Davis Polk Point #4: Companies supposedly don’t intentionally default anyway.**

Actually, companies DO default on their covenants intentionally

Davis Polk states “companies rarely intentionally default.”
We say, companies do intentionally default their bond covenants.

First, while “rarely” may be a relatively true statement, when a bond manager has $50 million of bonds trading at 110, and the issuer breaches a covenant but claims it didn’t and the bonds fall down to par, we guarantee that the loss of $5 million (10 points on $50 million) doesn’t feel any better because it is “rare.”

Second, issuers don’t tend to declare, “Hey, we breached our covenants.” They just do so and profess ignorance. Or they tell their bankers that “we got an opinion from counsel,” and then when the investor asks the banker to see that legal opinion, the story comes back as “oh, it was just an oral opinion.” Big difference!

Third, the biggest reason why relatively few issuers default on their covenants is because today they know they will be sued for breach — if the “no premium on default” language spreads, then it is logically obvious that more issuers will breach! And, alongside that increased propensity to breach, when a breach occurs for covenants that trade down due to diminished creditworthiness, but are still trading above par, then the economic rationale for enforcing the covenant is stolen away. For someone to say “this potential change is not much of a change at all” is sort of like saying, “removing the traffic lights and stop signs from this road isn’t going to change anything, because people stop at intersections already.”

Again, issuers don’t tend to admit breach, but here are just a few of the types of covenant breach scenarios we have seen over the years:

The Captain Renault breach – I am shocked – shocked – to find that you think a covenant breach is going on in here!3

Sometimes we see a covenant default that may not be readily apparent to investors or lawyers who haven’t read the case law, but it beggars belief to us that an issuer advised by knowledgeable counsel would both think they are in the right initially and then persist in professing that belief once presented with the correct analysis. One example was when First Quantum acquired the high yield issuer Inmet in 2013. First Quantum formed a shell company called Akubra solely for the purpose of making a tender offer for Inmet’s equity, which was executed primarily via a $2.5 billion loan facility. The loan included provisions for Akubra to complete a merger with Inmet. The end game was that all this Akubra debt would be loaded onto Inmet and paid off with Inmet cash, and the Akubra debt would be used to pay off Inmet shareholders. That was to us an obvious breach of the Restricted Payments covenant’s limitation against “directly or indirectly” acquiring the shares of an issuer with debt loaded onto that issuer, which should have been conceded. However, First Quantum acted as if there was no covenant breach. The Inmet 2020s fell from a high of about 111 to a low of about 103 due to the leveraging up of the credit enough to push the bonds down significantly but not below par — the classic example of where there would have been no economic rationale to accelerate at par.

We published a report explaining how two covenants had been breached, and then bondholders challenged to enforce their covenant rights and only then received an exchange offer that restored the values of the bonds for the damage done. Each $1,000 in face amount of 2020s received an offer to exchange into $1,150 in face amount of new First Quantum bonds, and each $1,000 in face amount of 2021s received an offer to exchange into $1,130 in face amount of new First Quantum bonds. There was approximately $2 billion of Inmet bonds involved between the Inmet 2020s and 2021s, and bondholders would have lost approximately $290 million in value if they had not challenged the breach. This is real money! When we sounded the alarm last week, it was exactly with these kinds of cases in mind – this is definitely not some theoretical exercise.

3 Before the youngsters Google it, Captain Renault was the prefect of police in the movie Casablanca, and this clip explains the relevance: Casablanca clip.
Even the most “credible” names try such things. Another such moment was when Bank of America decided not to offer a redemption of $2 billion of Countrywide Series B Floating Rate Convertible Senior Debentures due 2037 when it acquired that company in 2008. There, too, we knew that the Change of Control put right had been triggered. However, when Countrywide sent out a Fundamental Change notice, its description of the Change of Control language was a twisted version of the actual language that seemed like a furtive and guilty gesture – with some language cleverly omitted – and no put right was offered. Bondholders who trusted the issuer interpretation would have lost out, but instead bondholders retained counsel to enforce that one. We recall that the bonds that had fallen to 92 were taken out at a negotiated 98 – that was 6 points on $2 billion, for a $120 million value differential. Real money! See our report, Bank of America’s Countrywide Financial Corporation: Covenant Default on $4 Billion of Bonds: Investors Must Act.4

*The “really, is that how an indenture works?” breach*

This is where the issuer announces an intention to effect a transaction that would breach the covenants, but then does not complete the transaction after bondholders object. A real example is when Elan Pharmaceuticals was selling its Tysabri assets to Biogen in 2013 and would have left its bonds outstanding and reinvested the proceeds in new research and development. Of course, creditworthiness declines when a steady cash-producing asset that is almost the entire business is converted into cash to be used for speculative purposes, and the company’s bonds slipped down some points to 105–but were still above par – so again, investors would have just been stuck with an unfair loss if their recourse was limited to par. We published on why the Mergers covenant would have been breached by the proposal, subscribers took our findings to the company, and within a month Elan reversed its position and the bonds were redeemed at 118 – a full 13 points on $600 million, which worked out to nearly $80 million. Again, this is real money. With a mere three examples we have named nearly $500 million that would have been unfairly spirited away from bondholders if the bonds at issue had included the “no premium on default” language!

*The “can’t herd cats” breach*5

Sometimes an issuer breaches and there just isn’t the right assortment of bondholders to do anything about it. We recall a situation where an issuer had engaged in asset sales and dividends that seemed a clear breach to us, but one very large holder was an insurance company that doesn’t like to litigate, and another holder had a big CDS position that made him indifferent, so a challenge just couldn’t come together. In another situation, a very long-standing debt issue had been distributed over time in little pieces to so many buyers who had put the debt away as a museum piece that it was too hard to get enough people to do anything about it.

*The “I’ll make you an offer you can’t refuse” breach*

Some years back, there was another indenture breach involving a serial acquirer kind of character.6 We had never figured out why bondholders had gotten together at some level to organize, and then didn’t follow through. We eventually learned that the acquirer had told creditors essentially, either you drop this argument or don’t get to be a lender in any of our future deals. Again, real money!

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4 Of the $4 billion, there were two series of $2 billion each and the enforcement economics were different between them.

5 This is just some fun lingo. Our customers are tigers!

6 No, it was not one of the PE firms you would likely guess.
The “oopsy” – such as the really unintentional, debatable, or hard to avoid breach

The classic example here is when several bond issuers couldn’t file their S.E.C. reports on time because they had to restate their financials due to accounting for options. In those cases, the issuers were basically stuck and did not want to breach their indenture but surely did not have any ability to file properly (and in some cases the courts wound up saying there was no breach anyway).

**Davis Polk Point #5: The consequences are too dire for companies to intentionally default anyway.**

Davis Polk’s memo says that:

[C]ompanies rarely intentionally default. Doing so triggers any number of negative consequences for the issuer, including cross defaults in other debt, cross defaults in hedges, leases and other financial obligations, supplier retraction of credit, going-concern qualifications in financial statements and loss of shelf registration statement eligibility.

This sounds real at first blush, but actually it is not so simple. There is a big difference between an event that factually is a covenant default vs. a declared default vs. a payment default. Payment default is indeed a bad thing! But it is sometimes a different story for a covenant default, and isn’t that the real issue here anyway? If the issuer knows that some action would be a covenant default, then with the no premium on default language, it may have an economic incentive to try to get away with it. And, if the bondholders declare a default, it can try to challenge that claim of default. And, even if there is a default, other creditors may not want to declare a default under their documents anyway. It would be foolhardy to imagine that one’s bond rights are protected because maybe one day a lender might be able to accelerate – it is more likely that a lender group with a money good position may want to ignore the default or take a small consent fee. Even companies that get into real troubles tend to be able to get waivers from lenders for breaches, because lenders generally don’t like to see their borrowers get pushed into default on their loans.

**Davis Polk Point #6: We can always wordsmith the “no premium on default” language.**

*Beware, this is a trap!*

Davis Polk contends that the one potential change that the “no premium on default” language makes to the pre-Cash America understanding of covenant breach enforcement remedies is to eliminate what it characterizes as the narrow Sharon Steel exception. In other words, according to Davis Polk, the one change is that if an issuer intentionally defaults in order to avoid the make-whole, then under the new language no premium is due.

It looks to us like Davis Polk is angling to see some more nuanced version of the “no premium on default” language sneak into indentures in some future attempt. We urge investors to reject this now. As you know, if you give a law firm an inch, they will take a mile. This happens again and again in bond covenants:

- Remember back when the equity claw was invented to narrowly redeem 35% of a bond issue with the proceeds of *bona fide* underwritten public common stock offerings? And then, the law firms started to slip into the definition of what is a “Public Equity Offering” the sham of “private” stock offerings, which let cash-rich investment grade companies buy high yield issuers and take out the bonds with a blended equity claw / make-whole redemption by manufacturing a phony stock offering? And then they nudged 35% to 40% on some deals? And more recently, a law firm has purportedly blessed the ability of TeamHealth and Blackstone to use the equity claw in a regular LBO. (To learn about that travesty, see “Lawyers and P.E. Are Trying to Subvert the Equity Claw Provision –
And Bondholders Should Challenge Them.”)

- Remember when secured high yield bonds started to really take off around 2003 with deals like Calpine and Reliant where there was a clear limit on secured debt – something like a 3x first lien secured leverage ratio and a 4.5x second lien secured leverage ratio, with that language sitting in an intercreditor agreement, and rules about “Permitted Priority Liens?” And then, the ratios got moved over to the Liens covenant, and then the carveouts got put on top or added to the ratio, so then the 3x or 4.5x wasn’t really the limit after all? And then we got crazy “1.5 liens” and “1.75 liens” sandwiched in.

- Remember when MFN yield protection for leveraged loans was good for the life of the loan? And then the lawyers put in 18 month sunsets… then 12 months… then on some deals they limited the protection to only certain baskets… then they added on some exceptions for acquisitions… it never ends.

In saying above “remember when,” we’re cognizant that actually many of our readers don’t remember some of this history because the private equity law firms have been throwing a lot of sawdust into the sausage for the past 15 years. The average bond covenant package used to be considerably better – and there were far fewer games and lawsuits. And increasingly, more and more of the non-sponsor corporates are having their bond covenants populated with sketchy provisions by issuer lawyers (often without any particular request by their issuer), with a shoulder-shrug response from the underwriter lawyers.

If bondholders let the law firms get away with any nuanced variations of the “no premium on default” language, then over time bondholders will lose the war. You will be stuck debating fine points of language deal by deal, and your analysts’ eyes will glaze over. We at Covenant Review live this day in and day out – trying to make someone care about such fine points as whether a certain basket can be refinanced with secured vs. unsecured debt – and we win some, and we lose some. This “no premium on default” language is too important to play “win some, lose some” by being nuanced away.

This has to be a binary yes or no answer – the language is in there and so unacceptable, or the language is not there. Covenant Review employs 16 analysts with law degrees with an average of 15 years’ experience – we came from Davis Polk, Latham, Cahill, Simpson, etc., and we used to represents plenty of sponsors and banks. And “death by a thousand cuts” in the contract is exactly what we used to do when we worked for BigLaw – but now, we work for you, and the only answer to stop this is “just say no.” Say no and pass on the deal. Don’t fall into the trap of debating this away.

In 2011, we produced a short video explaining how bonds get marketed with newfangled ideas – see here for that depiction which remains true.

**Other Considerations**

*It was the lawyers, not the underwriters, who were behind the “no premium on default” language. The banks were largely blindsided.*

Many bankers and salespersons told our subscribers that they had no idea that the “no premium on default” language had been placed in their deals. They were largely blindsided, and to their credit most of those sellside participants grasped the issue and quickly came to sympathize with their bond buyers. We think in many cases the bond issuer had no idea, either. We have tried to track “how the virus spread” and made some inquiries of issuers and lawyers, but sadly our requests for more details on the history here have been ignored thus far. Any clues are welcome!
Why would any issuer fight for this anyway?

Putting in such language is just bad for the bond market as a whole. It’s one thing to play the grand old covenant sport when people sort of expect it from some sponsors. But when lawyers start throwing bombs into respected brand name issuances like FedEx, GM, and Marsh & McLennan, who is supposed to benefit? We highly doubt that Fred Smith told any banker or law firm “next time we sell bonds, let’s make sure there’s no premium payable upon default.”

The potential net present value of such a covenant loophole is highly speculative for the issuer. Its inclusion is also a kind of black mark declaration that “we may want to breach and get away with it.” Why would any issuer like to sell new issue bonds with such a statement? And surely, what issuer is offering new bonds with the idea that “we don’t want to pay a make-whole premium in bankruptcy, either.” If an issuer is essentially making a written declaration in a new issue bond that it is thinking of a default or angling for how the pie gets split in bankruptcy, run!

Some open letter notes to our law firm friends

Occasionally, we will visit a law firm to discuss, “how does the buyside think about covenants?” But the “no premium on default” topic is getting much broader attention among law firms than usual and so we’d like to offer a few covenant thoughts:

- **Abandon the “no premium on default” language.** Deals with this provision became unsellable in the last week. There are many shops that have adopted a policy not to buy deals with this language, and we have a legion of traders and portfolio managers that have asked to be immediately alerted by us of any deal that has this provision so it can be eliminated swiftly. Taking a risk on including this language is not worth impeding your deal.

- **Please don’t sneak the concept in through the back door.** We’re scanning offering documents for permutations of the language, and checking indentures as well. Our view is that if any indenture language attempts to neutralize premium enforcement, and there wasn’t such language in the offering document, then that is a material omission from the offering document, and that is a bad thing.

- **Covenants can get pushed too far.** Sometimes people think that most any covenant package can get done in a good market, but the truth is that sometimes deals get changed. Deals change more often than individual lawyers seem to think, and when the covenant questions start interfering with the bankers’ sales process, that’s not good for the issuer or the underwriter. We’ve seen deals stumble and even price as much as 125 bps wide of talk in part because enough buyers got upset and walked away from the deal. Additionally, we **routinely** have bond buyers tell us things like “I was kind of on the fence about this deal, and with these covenants I’m going to pass.” In some real way, lousy covenants reduce the number of bids for some deals and could thereby raise issuer costs (though we cannot put a number on it). We would suppose that dealers would dispute this on the basis of deals pricing within talk, but then again on a regular basis we will write up some deal where four or five subscribers tell us that they complained about the covenants to the bankers, and somehow every one of them got told “well, you’re the only one who is complaining.”

- **Buyers are on high alert.** The hornet’s nest has been stirred up, and the buyside is engaged on this issue. It’s a good time to dial back the loopholes.

- **Terribly shameless plug:** We’re hiring! Moving the market is more fun than debating what’s market – contact careers@covenantreview.com.

For bond investors, reject the risk factor also

In the Novolex offering memo, the lawyers (Latham and Cravath) cooked up a risk factor to go into the offering memo.
even though the no premium language had been removed:

In addition, in light of a recent decision by the U.S. District Court for the Southern District of New York (Wilmington Savings Fund Society, FSB v. Cash America International, Inc.) and inconsistencies in the body of existing case law addressing the subject, whether holders of the Notes are entitled to receive the premium, including any make-whole premium, on the Notes in circumstances other than a redemption by the Issuer of the Notes as described under "Description of Notes -- Optional Redemption" (including as a remedy in connection with an Event of Default or otherwise), is unclear under applicable law, and will likely depend upon particular facts and circumstances.

This risk factor is nonsense and should not be placed in any deals. No one rationally thinks that the Cash America and Energy Future cases made it less likely that bondholders will be entitled to a redemption premium; indeed, Cash America was either a confirmation or enhancement of redemption premium rights depending upon your view, while most people in BigLaw and elsewhere think Energy Future was an enhancement of rights to premium in bankruptcy. For example, White & Case declared Recent Cases Restrict Issuers' Ability to Avoid Paying Premiums, and Willkie Farr & Gallagher said that the Cash America case could “expand the remedies available to noteholders” in its client alert Court Holds Issuer Liable for a Make-Whole Based on Its Voluntary Breach of an Indenture. So, if the case law is better for bondholders than it was two years ago, why on earth would someone add a risk factor raising “inconsistencies” and saying things were “unclear”? This is raising confusion and suggesting that something has changed for the worse, when the opposite has occurred. And why would someone add in a risk factor to a deal in connection with removing the no premium on redemption language from the bonds?

This risk factor is misleading at best, and looks like a potential gambit for a self-fulfilling prophecy at worst – “gee, we told you in a risk factor that the redemption premium might not be enforceable.” Investors should reject this risk factor wherever seen, and to the extent that it makes its way into any deal, we label it as malarkey that should have no bearing upon how any indenture is interpreted.

The buyside is winning this, has won before, and can win again!

There is a pessimistic view that covenants only get worse. However, in the credit-specific case, we’ve seen a good number of deals change. And in the macro, these big revolts happen. Just consider the great success of putting Change of Control covenants in the majority of high grade corporate offerings since 2010! That was a great victory for the integrity of investing in high grade corporates. And there are other dangerous provisions that have been generally killed off in the U.S. rather quickly in the past, such as the 110% Change of Control call option, the 103% call option for unsecured deals, and Change of Control portability.

Also, it is encouraging that the victory against the “no premium on default” was driven by every kind of investor across the spectrum: mutual funds, hedge funds, insurance companies, focused credit managers….even family offices were putting in tickets “subject to” removal of the provision. This was not some case of just a few big managers rowing the whole boat, nor did it matter that some other large managers didn’t pick up the oars.

This was a great example of why the market needs active managers who are doing the hard work of reading documents and debating with the sellside to make a healthy market.

Buyside, take heart! It can be done, has been done, and will be done again!
In conclusion

While it is hard to see why this issue was of much more than academic importance to a big law firm or the typical issuer, it’s important to the investors who rely on the stability of fixed income and the managers who have a duty to protect those investors. It is important to the managers who want to feel like they are being dealt with fairly by the Street.

Defending bondholders rights means something very real to us, as it does to our readers.

We conclude with two of many comments from subscribers this past week:

- “It is a point of principle - we should have pride in our market. We can’t allow disrespecting the agreements we sign.”
- “Thank you to you and Covenant Review for manning the barricades on this one and defeating the forces of evil! You have done bond investors a huge service.”

It is not a good sign for the market when the customers are describing the sellside as “the forces of evil.” It is time for the law firms and others on the sellside to practice some restraint and dial down their War on Covenants.

— Adam Cohen, Founder, Covenant Review

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