Limiting Voting Rights Of Bond Holders With CDS Exposure Won't Work Without Transparency, Says Legal Expert

Corporate lending was at one point a staid and relatively low-risk endeavor. But concern is mounting as risk profiles soar on several levels.

Q1 hedge fund letters, conference, scoops etc

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As Congress held hearings on leveraged corporate loans last week, Bank of America CEO Brian Monahan, one of the largest enablers of such lending, warned of a "carnage" to come. This oddity occurred as the interest rate paid by borrower JC Penny hit an unsustainable 33%.

But there has been a more subtle change that concerns those familiar with individual name credit derivatives. Bond issuers are now creating provisions in loan covenants that restrict the voting rights of certain bond holders with derivatives exposure. Like much in today's world of over the counter (OTC) derivatives, clarity and common sense appears in short supply, according to analysts.

The catalyst for the subtle change in loan covenants is part of the larger trend of manufactured default CDS defaults, according to Vince Pisano, senior covenant analyst at Xtract Research.

Corporations defaulting on loan obligations to trigger insurance payments to strategic beneficiaries started to gain significant momentum in 2017 when Blackstone Group, one of the World's largest asset managers, provided economic benefit to home builder Hovnanian Enterprises to default on a small portion of their loan obligations despite having the money to pay. The goal of the "shady" practice, according to independent lawyer Jake Zamansky, was for Blackstone to collect on their CDS bet that Hovanian would fail to pay their debt. Goldman Sachs had underwritten the CDS insurance in question and publicly cried foul over the issue. Regulators then called the practice "market manipulation" in an attempt to curtail it.

Then along came the CDS default of Windstream Holdings, a Little Rock, Arkansas provider of voice and data network communications services with nearly $6 billion in revenue at the time. This was considered a tipping point because one hedge fund, Aurelius Capital Management, purchased nearly 25% of Windstream corporate bonds yielding 6.375% that were due in 2023. In 2017 they alleged that Windstream technically defaulted. Windstream, for its part, alleged the hedge fund used its position as a bond holder to hasten Windstream's problems. What was little known was Aurelius and its founder, onetime bankruptcy lawyer Mark Brodsky, had purchased ten times as much CDS insurance that paid out if the company defaulted, Windstream alleged. The hedge fund's actual holdings remain unconfirmed.

Under most circumstances such bond holders were expected to be rooting for the company's and vote in that direction. But, according to Tony Thomas, Windstream's president and chief executive officer, a new reality exists when CDS is involved.

"You can no longer assume the people investing in your debt instruments are going to be aligned to your interests," he told *The New York Times*.

Aurelius sued in court, with the divestiture of Windstream's Unti Group a key issue, and the hedge fund won a $310 million verdict. The loss was quickly followed by Windstream stock losing 99% of its value while the case is on appeal. In addition to the $310 million verdict, Aurelius could have netted nearly $3 billion from the CDS bet, but the exact amount is unconfirmed. A representative for Aurelius did not comment.

The case has numerous long-term implications, some of them more nuanced than others. It most obviously points to problems with opaque CDS derivatives and misaligned interests that can intentionally harm a company and put in jeopardy jobs associated with its success. The case also highlights the increasingly divisive relationship between corporations and bond holders. Not only are bond holders without larger negative CDS holdings threatening corporations, Windstream's spin-off of its Unti Group, used as collateral in the bond agreement, points to an increasing trend of corporations weakening bond holder collateral positions. Further, some bond holders are creating loopholes in their agreements that allow them to escape their payment obligations entirely. But less obvious are several legal issues that largely remain undercover.

"What jumps out in the Windstream bankruptcy is how badly the lawyers screwed up," Pisano told ValueWalk. "Not only in the initial transaction but also attempts to undo the default. There is too much in there that is incomprehensible."

Legal documentation governing the bond offering and CDS terms were written by lawyers with different focuses. “Law firms have become so specialized you don’t have people on the finance side who understand what’s happening on the derivatives side,” Pisano, formerly head of the Capital Markets Group at Kirkland & Ellis, said. “Likewise, derivatives people rarely think about the credit agreements.”

CDS derivatives have been criticized for their lack of clarity, an issue that typically rears its head during defaults and when insurance payouts are involved. Another issue is that bond holders taking out much larger CDS positions who can now vote their interests on a corporate level – to the detriment of the corporation. This CDS quandary was summed up by one lawyer in court at the beginning of the Windstream trial:

It’s one thing to buy insurance on my neighbor’s house, it’s another to burn it down, it’s a third thing to collect money on insurance and another thing to be welcomed at my neighbor’s table.

To combat the problem, corporations are beginning to insert provisions in their loan covenants that restrict CDS holder voting rights. A recent Sirius Computers debt offering is one example, Pisano points out.

Pisano says limiting voting rights as currently proposed wouldn’t be effective due to the fact CDS holders can easily mask their positions, making identifying those with a negative net position difficult on several levels. What he recommends is that CDS positions should be published and updated daily. While such transparency is unheard of in the secretive world of CDS and is likely to be a major hurdle, it is one of a handful keys to success. “Limiting voting rights is a great place to start but will not cure all ills if the language used has too many ways around it,” he said.

Help may be on the way. Outgoing Commodity Futures Trading Commission (CFTC) Chair Chris Giancarlo recently announced the derivatives regulator is examining the hedge ratio between leveraged loan exposure and offsetting CDS exposure, he revealed at a conference in Washington DC.