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EVENT-DRIVEN CREDITOR ACTIVISM - A CORPORATE PERSPECTIVE

1.Introduction

Interventions from activist debt investors - normally hedge funds - are familiar in crisis and insolvency scenarios. A flurry of recent news stories and claims have highlighted that companies can attract the attention of activist funds as a result of corporate events which may be unrelated to financial distress.

This type of event-driven creditor activism (named to distinguish it from strategies focussed on distress) is opportunistic, often arising out of unforeseeable or unforeseen events. Successful claims are not common, but when they arise, they can be a significant distraction to manage.

In this article, we consider the nature and incidence of event-driven creditor activism in the UK and Europe and the key risk indicators for claims. We look at some examples of the types of claims that arise, which often turn on competing interpretations of contractual terms. Finally, we outline some strategies for anticipating and responding to activist claims when planning for disposals and other corporate events.

2.Shareholder activism vs. creditor activism

Shareholder activism has become a feature of listed company life in the UK and Europe. The potentially adverse implications of shareholder challenges in public forums such as the AGM mean that many companies devote significant resource on an ongoing basis to managing equity investors with an agenda for change. The activist agenda may be driven by economic returns but increasingly, the primary motivation may be an ethical or sustainability outcome.

The strategies of activist debt investors (normally hedge funds) are similar to those of activist equity investors. Both debt and equity activists acquire participations in a company's capital structure, with a view to using the rights that come with their status as investors to influence the company's decision making. The difference between debt and equity investment is that debt activism requires the existence of a particular set of circumstances and is almost always a financial play. There is no regular rhythm to creditor interventions, so debt activism tends not to be a constant feature of the board or treasury agenda.

The credit activist's strategy involves monitoring corporate activity, analysing publicly available information on the company's financial position and debt terms and identifying when an event or transaction might give rise to an arguable default.

Debt activism can be a standalone strategy. We have also seen instances where shareholder activism and creditor activism are related, for example, equity investors campaigning for a business to be demerged which, in turn, gives rise to activism on the creditor side with bondholders alleging that the demerger triggers an event of default under the bonds.

Careful attention to certain contractual terms when negotiating debt documentation (discussed further below) can mitigate the risk of future transactions being derailed or delayed by creditor intervention. However, the full range of circumstances down the line that could prompt debt investment with unwelcome intent can be difficult or impossible to predict.

3.What are the risk indicators for creditor activism?

The ability to implement an activist agenda through debt typically relies on a combination of three factors: the existence of ***transferable debt***, which is ***trading below par***, and which is either ***in default or at risk of default***.

The nature of these risk indicators is explained in more detail in the box below.

Transferable

Activist debt funds tend not to be originators, so are reliant on the ability to buy into their target's capital structure, directly or indirectly, on the secondary market. The acquisition of participations in loans and other private instruments – whether directly or indirectly through a sub-participation or similar arrangement - may be restricted to an extent by the contractual terms, at least pending an event of default. This is key reason why activism in loans and private debt tends to occur in distressed circumstances. Publicly traded bonds, on the other hand, are obviously freely transferable.

Trading below par

Activist debt strategies are usually sensitive to the price at which the debt is trading. The financial opportunity relies on the possibility of using voting rights to elicit returns (in the form of additional margins/fees, prepayments/ redemptions or an equity stake, for example) that exceed the cost of acquiring a seat at the creditors' table. If a company's syndicated loans or bonds are trading below par, that may indicate financial difficulties. However, there are many other reasons – a changing interest rate environment, regulatory or macroeconomic uncertainties or market events affecting the relevant instrument – which may prompt debt to change hands at a discount.

Default (actual or arguable)

Creditors, in particular bondholders, are largely passive stakeholders until the occurrence of an event or circumstance that gives them a legal right to intervene in the company's operations. This means that the ability to implement an activist agenda through debt investment typically depends on the existence of circumstances that trigger a creditor vote or other engagement requirement under the applicable documentation terms. In other words, it requires the debt to be in default or at risk of default.

4.Incidences of event-driven creditor activism

The purpose of most events of default in debt documentation is to enable the creditors to take enforcement action if the debtor's credit deteriorates. Interest rate movements, inflation, and macroeconomic uncertainty have exposed borrowers of all types to refinancing risk and the prospect of financial covenant or payment defaults. The extension of the sources of debt funding beyond bank loans into leveraged loans, private credit, high yield and other instruments opens both private equity portfolio companies and corporates to a wider investor base, including hedge funds and distressed debt funds, who are more willing to take activist positions where financial difficulties are apparent. Against this backdrop, activist funds can acquire debt at a discount with the explicit intention of influencing the company's restructuring or driving divestments. Campaigns are often proactive and assertive, intended to extract value in advance of formal insolvency processes when recovery prospects may become less certain.

Corporate transactions such as disposals and reorganisations (even if not related to financial difficulties) can, however, also trigger the attention of activist debt funds, as can other events such as legal and regulatory changes which impact debt terms. In these circumstances, the impending or possible default will usually be analysed when planning for the transaction. This is the prompt for the company to consider whether and when to engage with its stakeholders and develop strategies for doing do, taking into account the possibility of activist dissent.

Event-driven creditor activism is not widespread and the fact pattern that triggers a claim in relation to one borrower or issuer may not be capable of replication. As discussed above, claims usually stem from a cocktail of circumstances which reveal an unexpected vulnerability in the company's debt documentation - or simply a provision, the interpretation of which is not clear-cut - which investors are able to spot and then exploit. The availability of these claims is dependent on the terms of the relevant instrument.

For investment grade corporates, the prospect of creditor activism may seem remote in the absence of financial stress. High grade corporate loans contain only a limited and light touch covenant package. Eurobond terms and conditions contain even fewer but interestingly, this is where a number of recently publicised examples have arisen, many of which relate to cessation of business events of default, discussed further below. It is relevant, in this regard that bond terms and conditions are publicly available, while loan terms, in the vast majority of cases, are not.

5.Example - cessation of business events of default

In February, the Financial Times highlighted that certain bond investors have been challenging disposal transactions on the basis that the transaction in question breached the cessation of business event of default in the relevant bonds. The article describes the provision as "obscure" and "unique". In fact, while the combination of drafting and fact patterns that trigger any particular clause can be unique, cessation of business events of default are not unusual. While terms vary quite considerably, they are a common feature of bonds of all types.

There are variations in the scope of cessation of business events of default in bonds i.e. with regard to which entity or entities must cease business for the cessation of business event of default to be triggered - is it the issuer or the guarantor only, their material or principal subsidiaries (typically a defined term) or even any member of the group? There are also variations in what constitutes a cessation of business i.e. whether the event of default requires the cessation (or threatened cessation) of all of the relevant entity's business, or substantially all, or a substantial part - or even a "material" part.

Cessation of business events of default also feature in some sub-investment grade loans. Drafting varies, but where included, the formulation is often slightly different to that applicable in the bonds context. Drafting is often based on the cessation of business event of default in the LMA's leveraged facility template, which is as follows: "*Any member of the Group suspends or ceases to carry on (or threatens to suspend or cease to carry on) all or a material part of its business*".

A significant disposal will generally require a company to seek consents under its loan documentation (so whether or not an additional event of default may be triggered under any cessation of business provision is most likely a secondary consideration). Cessation of business events of default tend to come into particular focus in the context of disposals in debt instruments such as Eurobonds, which do not contain restrictions on disposals.

We have been asked to advise on the applicability of cessation of business events of default many times, in the context of both solvent and distressed disposals. The more recent claims, and the suggestion that hedge funds are drawing up "shopping lists" of companies that could be potential candidates for claims should a disposal be proposed, have prompted queries from corporate clients. Low interest rate-era bonds are trading at a discount, which lays the ground for activist investment with a view to forcing repayment or buyback above market value, if an arguable and actionable event of default can be found to have occurred.

6. Analysing cessation of business events of default

It is important to re-emphasise that opportunities for activist intervention are in this instance, very case specific, turning on the drafting of the event of default and the fact pattern (the nature of the disposal or transaction in question). There are often a number of layers of analysis in terms of the likelihood of the event of default being triggered, which creates a significant practical barrier to claims in many cases.

Is the disposing entity subject to the event of default?

Does the event of default apply to the Issuer, the Guarantor(s), Material/Principal Subsidiaries and/or any member of the Group? If it bites on Material/Principal Subsidiaries, how is that term defined? Definitions vary but are often defined as subsidiaries of the Issuer/Guarantor whose revenues, assets, or EBITDA comprise 5-10% or more of the revenues, assets, or EBITDA of the group.

What is meant by "cessation" in this context?

Does the transaction in question engage the event of default? Is the clause intended to restrict disposals? The effect of the proposed disposal may be that the business disposed of ceases to be conducted by the disposing entity, but there is often a debate as to whether that is truly what the clause is intended to restrict.

It is sometimes argued that the purpose of cessation of business events of default in eurobonds is to give bondholders comfort on the issuer's/group's ability to service the bonds. That ability could be prejudiced by material disposals of the issuer's business, even in a solvent context. The counterargument is that this is not a natural interpretation, and that the clause should be viewed in context.

Cessation of business events of default are often placed under the heading of insolvency events of default. The more natural interpretation in that context (it might be argued) is that the clause is directed at an insolvent or extremely distressed scenario, rather than a solvent disposal by a solvent issuer.

It is often highlighted in support of this narrower interpretation that if creditors wish to restrict disposals (in loans or bonds), disposals would be controlled explicitly, rather than by a provision buried within the insolvency events of default.

Are there exceptions to the event of default and do they apply?

In some instances, the drafting of the clause may include negotiated exceptions that are relevant (and potentially helpful) to the key point of how "cessation" should be construed. For example, solvent group reorganisations are commonly carved out from the event of default.

When might a "threatened" cessation occur?

Some cessation of business events of default are triggered by a threatened cessation of business as well as an actual cessation. Where the clause is engaged (i.e. when the transaction occurs, it is likely there will be an event of default), this can be a tricky question, and advice tends to be nuanced. In broad terms, initial discussions about a disposal or transaction without a clear deal in mind may not present a material risk. As the deal is agreed and the terms fleshed out (assuming the disposal constitutes a "cessation of business") - the higher the risk that the deal is "threatened" becomes. Clearly an important consideration in this instance is confidentiality - i.e. whether the deal or potential deal can legally be kept under wraps from investors.

How do you measure "substantially all", a "substantial part" or a "material part" of the business?

Pinning down whether the disposal or transaction meets the threshold specified in the relevant documentation is often the key area of focus. Although advice is often sought on the interpretation of these terms, there is no English caselaw that is precisely on point. The analysis therefore typically considers the question through both a quantitative and a qualitative lens to take into account the full range of possibilities[1].

Quantitative assessment

The rule of thumb typically employed is that "substantially all" means upwards of around 75%, "substantial part", around 10% and "material part" around 5%.

In the absence of judicial authority, these percentages are normally assessed by reference to a range of indicators. These commonly include each of revenue, profits (EBITDA) and assets.

Qualitative assessment

The qualitative analysis considers whether the cessation (disposal, demerger etc.) has a significant impact on the disposing entity operationally.

Does the disposal relate to the core of the business or something peripheral?

To what extent can the issuer be said to be able to continue its business after the disposal? Does it involve the transfer of the bulk of the group's employees or office locations?

If an event of default has occurred, is it actionable?

In bonds constituted using an English law trust structure, it is the bond trustee, rather than the individual bondholders, who must take action to accelerate the bonds following an event of default. A trustee may accelerate at its own discretion or will be obliged to do so if directed by a minimum proportion of bondholders (for example, 20% by value) who must indemnify the trustee to its satisfaction before the claim can be pursued.

An additional hurdle applicable in many eurobonds is that before pursuing an enforcement claim, the trustee must determine that the event of default is "materially prejudicial" to the interests of the bondholders.

Where the bonds use a fiscal agency structure, the enforcement process is different. The fiscal agent is an agent of the issuer and therefore does not perform the same role as a trustee, with each bondholder typically entitled to accelerate their bonds following an event of default.

Fiscal agency structures are used in a number of cases, including in jurisdictions which do not recognise trusts, which includes a number of European countries. The hurdles to creditor enforcement are fewer in fiscal agency structures, which puts more focus on ensuring the triggers for enforcement are appropriately drafted.

Who can enforce the cessation of business event of default in bonds?

An interesting dispute, currently before the English courts, relates to the alleged breach of the cessation of business event of default in the bond terms of Essity, the Swedish hygiene products maker (one of the issuers mentioned in the FT article).

The claimants, who are beneficial holders of the bonds, allege that Essity's 2024 disposal of a majority stake in one of its subsidiaries constituted a disposal of a substantial part of its business, and therefore an event of default. The issuer is seeking to have the bondholders' claim thrown out in part, based on a technical argument

[1] This analysis is applicable to English law documentation. The New York law analysis may operate at different and lower thresholds.

that the claimants have no standing to make the claim. This is in reliance on the so-called "no look through" principle under English law.

Under the "no look-through" principle, an investor with an interest in securities that are immobilised in a clearing system has no claim against the issuer. The issuer is arguing therefore, that only the custodians and/or clearing systems should be able to bring the claim.

The dispute remains ongoing at the time of writing.

7.Minimising the risk of activist claims

Prevention is obviously always better than cure, so getting the debt terms right at origination and importantly, avoiding as far as possible some of the terms which have been challenged is the best route to minimising claims. The general point is to ensure covenants and events of default around corporate events are as clear and precise as possible, considering the company's future plans.

Another key point to pay attention to, in both loans and bonds, is the definition of "continuing" in relation to an event of default. Under LMA loan terms, an event of default is actionable by Lenders if it is "continuing", which is a defined term. In many cases, Borrowers negotiate this definition such that an event of default is "continuing" unless remedied or waived. This is not always the case; it is necessary to check. A narrower definition (continuing unless waived) would mean that a waiver would be necessary notwithstanding the Event of Default being remedied. Similar considerations apply to the use and definition of the word "continuing" in relation to bond events of default.

In the context of loans, attention should also be paid to the provisions governing the assignment and transfer of lender participations. Ideally, any changes to the lenders of record should require the borrower's consent as far as possible. Borrowers may also seek consent rights in relation to sub-participations and the like, or at least, rights to be kept informed and/or to request information about the existence of any sub-participation or similar transaction (acknowledging that this will not be achievable in all circumstances). The terms of the amendments and waivers clause are also important, to ensure that when needed, the path to consent is as smooth as possible.

When consents are required, an important part of the process will be to consider the appropriate strategy for achieving the relevant threshold of support - and where necessary, considering how best to approach individual investors or groups of investors to achieve the desired result.

Accordingly, once the debt has been issued, keeping track of lenders/investors and nurturing good relationships with them is the key to minimising problems down the line. Ensuring continuing engagement with key debt investors can be as important as engagement with shareholders.

8.Preparing for corporate events and transactions

An analysis of the group's debt documentation to determine whether corporate transactions such as acquisitions and disposals of shares or assets, mergers, demergers, corporate reorganisations or reconstructions or dividends and distributions are restricted is a normal part of the planning process.

Loan terms

Loan terms are not homogenous even when modelled on an LMA form. Bond terms tend to follow a familiar framework, but the detailed provisions vary. Accordingly, the due diligence will involve a review of the full package of terms, in particular (usually), the covenants and events of default.

Most investment grade loan documentation will contain a negative pledge, a disposal covenant of some kind (loose for stronger credits), as well as a restriction on amalgamations, demergers, mergers or corporate reconstructions and substantial changes to the general nature of the business, in most cases, plus financial covenants of some kind. Crossover and sub-investment grade loan documentation will contain a fuller set of restrictions in addition to those already mentioned. These may include restrictions on debt incurrence, loans, guarantees, dividends and distributions and acquisitions.

Cessation of business covenants or events of default do feature in some corporate loans but are not standard. Insolvency and insolvency proceedings events of default may also be a relevant consideration, although negotiated exceptions for solvent liquidations and amalgamations are common. It may also be necessary to analyse any material adverse change (MAC) provisions.

Bond terms

Investment grade bonds are typically covenant-light. The only relevant restrictive covenant is normally the negative pledge. Specific restrictions on disposals and financial covenants do not apply. Events of default (to the extent relevant to corporate events and transactions) are focussed on insolvency. These provisions typically include a cessation of business event of default. As discussed above, the formulation varies, but it often seeks to capture the issuer, any guarantor and sometimes also significant companies in the group ceasing to trade.

Crossover and high yield bonds will contain an extensive covenant package covering the full range of corporate transactions, subject usually to a complicated patchwork of exceptions and permissions which may or may not operate in combination or cumulatively. Sub-investment grade bond terms can be particularly tricky to navigate.

Identity of debt holders

In addition to analysing the terms of the debt, it will be important to analyse (to the extent possible) who holds it:

- In investment grade syndicated loans, restrictions on transfer and consent rights will often provide the borrower with a good picture of with whom it is dealing (although it may not have the same information regarding indirect holdings via sub-participation or similar arrangements). Some widely held leveraged loans may include rights for the borrower to request lender details from the Agent.

- Publicly available information in relation to bond investors is normally quite limited. Bondholders are not under any obligation to reveal themselves and custody chains can make the picture quite complex. Identifying bondholders will therefore normally involve engaging an identification agent.

9. Anticipating and responding to activist claims

Take legal and financial advice as early as possible

The key point is to ensure that if any corporate event or transaction is planned, the company's debt documentation is reviewed and legal and financial advice sought, as early as possible.

Where there is concern about cessation of business events of default for example:

- Due to the various layers of analysis, whether the event is triggered may be a difficult call; and equally, difficult to prove successfully. It may often be a sensible investment to seek advice from counsel to test and confirm the legal analysis.

- In situations where the event of default clearly excludes solvent transactions, robust solvency analysis is helpful. Where enforceability depends on the trustee's ability to illustrate material prejudice or a MAE, the preparation of evidence that illustrates how the transaction proceeds will be applied and the post-transaction financial position of the debtor entities is worthwhile.

Are there structural solutions that provide a safer path?

If there is real concern about a potential event of default, there are generally a number of possible courses of action, depending on the drafting/fact pattern. These may involve adjustments to the transaction structure.

For example, in the context of disposals, this could mean effecting intra-group transfers, transfers of shares rather than assets or separate sales rather than a single transaction. In some cases, more creative options may be available, such as the substitution of the entities on which the event of default bites (i.e. the issuer or guarantor of the bonds).

Is a liability management exercise the answer?

A liability management exercise is another potential way to insulate an issuer from claims that a covenant breach has occurred.

The recently completed exchange and tender offer by Swedish real estate company SBB is an interesting case in point. It involved the issue of new listed notes with, among other things, amended covenants. According to reports, one reason behind the exchange offer was to avoid proceedings claiming that the existing bonds were in default. The alleged breach in this case, related to some fairly unusual financial covenant terms and was eventually withdrawn.

Interestingly, one of the key changes to SBB's bond terms as part of this recent exchange offer was to the cessation of business event of default. These changes appear intended to clarify the scope of the provision. References to a "substantial part" of the business were removed in favour of a cessation or a threat to cease of a material part of the issuer group's business, defined as part of the issuer group's business representing 20% or more of the consolidated total assets or consolidated rental revenue of the issuer group.

The cessation of business event of default for the new notes also added a carve-out that permits a cessation or a threat to cease the whole or a material part of the issuer group's business, if in connection with the sale on an arm's length basis of any assets or business of the issuer group for full consideration, received by the issuer group.

What about going straight to court?

In some instances, the appropriate decision may be to apply to court to quash the activist investor's claim by seeking a declaration on the proper construction of the relevant clause. This can be a time consuming and expensive process, especially when the possibility of appeals is taken into account. However, in cases of genuine urgency, the courts can act expeditiously.

One example of an urgent contractual interpretation claim on which Slaughter and May acted, was the Financial Conduct Authority (FCA) test case for COVID-19 Business Interruption claims. The FCA sought on behalf of policyholders a series of declarations interpreting various standard policy wordings. The claim was heard by a Divisional Court of two judges under the Financial Markets Test Case Scheme on an urgent basis in the summer of 2020, with the appeal stage leapfrogging to the Supreme Court in a matter of months.

A more relevant example in the financing context, is the first case arising out of the cessation of LIBOR to come before the English courts, also brought under the Financial Markets Test Case Scheme. The proceedings related to the benchmark rate to be substituted for three-month US dollar LIBOR to calculate the dividends payable on a series of perpetual preference shares issued by Standard Chartered PLC in 2006.

Standard Chartered (advised by Slaughter and May) sought declarations from the Court on the use of an alternative benchmark rate to calculate the dividends payable on the preference shares after the final cessation of 3-month USD LIBOR. The claim was opposed by certain ADS holders who intervened in the proceedings and argued that there was an implied term which, subject to applicable laws and regulations and regulator's consent, required Standard Chartered to redeem the preference shares.

The Court rejected the ADS holders' claim, and agreed with Standard Chartered's argument that the preference shares included an implied term that, if the relevant express term ceases to be capable of operation, dividends on the preference shares should be calculated using a reasonable alternative rate to three-month USD LIBOR and that the rate proposed by Standard Chartered (three month CME Term SOFR plus a credit adjustment spread) was a reasonable alternative rate. Our briefing on this judgment contains further details.

10.Concluding thoughts

Unlike shareholder activism, creditor activism may take place in private, making overall impacts more difficult to assess. Based on press reports regarding litigation and claims and our own experience, it seems to be becoming a more regular feature of the risk landscape. Companies are becoming more aware of the potential risks presented by activist debt investors and the importance of considering those risks both when debt terms are being settled and in the context of corporate events and transactions. Creditor activism is no longer only the domain of restructuring lawyers and insolvency practitioners.

The challenges of the current trading environment - tariffs, fiscal tightening, persistent inflation and "higher for longer" interest rates - may mean more companies are considering divestments, disposals and reorganisations with a view to realising cash and shoring up the financial position of business. Taking positive steps to minimise potential issues at an early stage are key - as are ensuring that proposed transactions are kept strictly confidential until such time as announcements are appropriate or required. Proactive planning and creditor engagement are our most important tips if an issue arises - as well as readiness to take decisive legal action where necessary.

Regardless of the merits of activist claims, the time and resource required to head off or where appropriate, litigate can be significant. Boards should stay alert to the strategic implications of creditor actions and ensure that debt stakeholder management is taken into account in decision making.

FURTHER INFORMATION

For more information about the issues highlighted in this briefing, please contact any of the lawyers listed below or your usual adviser at Slaughter and May.

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