EUROPEAN RESTRUCTURING AND DISTRESSED TRENDS

ROPES & GRAY

THE EUROPEAN DISTRESSED MARKET WAS QUIET THROUGHOUT 2021, a function of **ongoing government support, supportive sponsors and lenders, and a huge amount of liquidity in the market.** In this article, we look back at European **distressed debt, restructuring and leveraged finance trends in 2021** and share our thoughts on potential market developments in 2022. We also summarise key developments in **English schemes of arrangement and restructuring plans** and consider the **equivalents of these tools** currently being introduced by EU member states, with a focus on the new frameworks in Germany, the Netherlands, France and Italy.

2021: WHAT JUST HAPPENED?

- **Jan. 1:** Brexit takes effect
- **Jan. 1:** StaRUG takes effect in Germany
- **Jan. 1:** WHOA takes effect in the Netherlands
- **Jan. 6:** England enters third national lockdown
- **Jan. 6:** U.S. Capitol riots occur
- **Jan. 20:** Joe Biden is inaugurated as president of the United States
- **Jan. 28:** *DeepOcean* Part 26A restructuring plan is sanctioned and first cross-class cram-down mechanism is used
- **Mar. 4:** "Delta" variant of COVID-19 is identified in the UK
- **Mar. 19:** *Smile Telecoms* Part 26A restructuring plan first sanction hearing is held
- **Mar. 23:** Suez canal is first obstructed by the Ever Given container ship
- **Mar. 26:** *Gategroup* Part 26A restructuring plan is sanctioned (for further information, please read our alert *Gategroup: implications for the recognition of English restructuring processes in the EU*)
- **Mar. 30:** *Smile Telecoms* Part 26A restructuring plan is sanctioned
- **Apr. 6:** Recovery Loan Scheme is launched in the UK to provide financial support to businesses affected by COVID-19
- **May 1:** U.S. troops are withdrawn from Afghanistan
- **May 12:** *Virgin Active* Part 26A restructuring plan is sanctioned
- **May 24:** *Amigo* scheme of arrangement is not sanctioned by the court
- **Jun. 3:** "Delta" becomes dominant variant in the UK
- **Jun. 16:** UK government extends moratorium on commercial evictions for non-payment until 31 March 2022
- **Jun. 28:** *Hurricane Energy* Part 26A restructuring plan sanction hearing is held and court refuses to approve cram-down
- **Jun. 30:** Second suspension of the wrongful trading rules ends in the UK
- **Jul. 17:** Restructuring Directive initial implementation deadline passes
- **Jul. 23:** Tokyo Olympics start
- **Aug. 19:** *Amicus Finance* Part 26A restructuring plan is sanctioned
- **Sep. 15:** AUKUS trilateral security partnership is announced
- **Sep. 30:** "Relevant period" suspending the serving of statutory demands in the UK ends
- **Oct. 1:** Ordinance no. 2021-1193 takes effect in France
- **Oct. 1:** New modified rules for the restriction on winding-up petitions begin in the UK, to last until Mar. 2022
- **Oct. 31:** COP26 begins in Glasgow
- **Nov. 15:** New settlement procedure *(composizione negoziata)* comes into force in Italy
- **Nov. 27:** "Omicron" variant of COVID-19 is first detected in the UK
- **Nov. 30:** Consumer Price Index 12-month inflation reaches highest rate in the UK since Sep. 2011
- **Dec. 8:** PM introduces "Plan B" measures in England
- **Dec. 8:** Olaf Scholz becomes new chancellor of Germany
- **Dec. 16:** Bank of England increases interest rates by 0.15% to 0.25%
- **Dec. 17:** "Omicron" becomes dominant variant in the UK

2021: DEVELOPMENTS IN SCHEMES OF ARRANGEMENT AND RESTRUCTURING PLANS

Throughout 2021, schemes of arrangement and Part 26A restructuring plans have continued to be popular tools for restructurings in Europe. We have **highlighted below key takeaways** from judgments over the past 12 months, looking in particular at the evolution of the cross-class cram-down mechanism, the recognition of schemes and restructuring plans post-Brexit, and the impact of fees on class composition in schemes and restructuring plans.

CROSS-CLASS CRAM-DOWN

- In June 2020, the Corporate Insolvency and Governance Act introduced a cross-class cram-down mechanism, inspired by US Chapter 11 proceedings, through the new Part 26A restructuring plan. This enables stakeholders to "cram down" dissenting classes *provided that* (i) at least one class that would receive a payment or would have a genuine economic interest in the context of the relevant alternative voted to approve the plan and (ii) no member of a dissenting class would be worse off under the restructuring plan than under the relevant alternative.
- The "cross-class cram-down" feature of the restructuring plan was **utilised for the first time** in 2021 *(DeepOcean)*. In this first case, the restructuring plan was used to cram down a dissenting class of creditors in one of the three group companies implementing an interconditional plan. Only 64.6% of the dissenting class had voted in favour of the plan (short of the 75% majority required). From this first application, the cross-class cram-down has continued to evolve, being used to cram-down dissenting **secured creditors** *(Amicus Finance)* and **landlords** *(Virgin Active).*
- 2021 also saw the first use of the restructuring plan by a non-European company, with the cross-class cram-down of senior lenders in order to amend certain finance documents to **introduce additional super senior facilities** *(Smile Telecoms).*
- We also saw in 2021 the **first court refusal to sanction** a restructuring plan *(Hurricane Energy)*, with the court determining that the proposed cram-down of shareholders failed to satisfy the condition that no member of the dissenting class be worse off under the plan than in the relevant alternative.

> "[To] retain 100% of the equity in the Company that is continuing to trade, with a realistic prospect of being able to repay the [Company's obligations to bondholders] in due course, is to my mind a better position than immediately giving up 95% of the equity with a prospect of a less than meaningful return as to the remaining 5%."
>
> — *In the Matter of Hurricane Energy Plc, [2021] EWHC 1759 (Ch), §125 and §126*

RECOGNITION POST-BREXIT

Companies can use both schemes of arrangement and restructuring plans if they can demonstrate "sufficient connection" to England and Wales. "Sufficient connection" is typically demonstrated through one or several of the following elements: (i) an English issuer or borrower; (ii) a COMI shift of the issuer or borrower to England; (iii) the accession of an English co-issuer or co-borrower; or (iv) English governing law and jurisdiction for the relevant debt documents (including where they are amended to have such governing law and jurisdiction). The English court will assess expert evidence on the likelihood of the scheme or plan being recognised in relevant foreign jurisdictions. Post-Brexit, **EU recognition of a scheme or plan is more complicated** than under the previously applicable European frameworks for recognition of insolvency proceedings and judgments. However, recognition remains possible under private international law, subject to **increased time and costs** to attain the relevant expert input and make any required recognition applications.

SUCCESS AND WORK FEES

- In recent years, schemes (and now restructuring plans) have included consent fees payable to scheme creditors, which continue to be scrutinised by the English courts to ensure such fees **do not result in the fracturing of creditor classes**. The court's focus is on whether consent fees benefit certain creditors over others in their class to such an extent that it is impossible, or otherwise inappropriate, for them to consult together on the merits of the scheme/plan.
- In 2021, we saw courts also turn their focus to success fees, which are payable to advisors. In *Port Finance Investment*, the **court determined that success fees did not fracture creditor classes**. However, success fees remain under scrutiny; in his judgment, Snowden J noted that:

> "the possibility that the Financial Adviser to the [ad hoc group] will be given a financial incentive by the Group by way of the Success Fee to advise the members of the [ad hoc group] to vote in favour of the Scheme is an unusual arrangement."
>
> — *In the Matter of Port Finance Investment Limited [2021] EWHC 378 (Ch), §106*

- *Port Finance Investment* and another 2021 restructuring plan, *China Fishery*, also saw further English court scrutiny of work fees, which are typically payable as consideration for supporting creditors' work in developing the restructuring and are not dependent on sanction of the scheme or restructuring plan. As with success fees, a work fee has not been deemed to fracture classes, with a work fee of 1% accepted in Port Finance Investment and 1.5% accepted in China Fishery. To date, case law has deemed work fees between 1-2% as acceptable.

2021: IMPLEMENTATION OF THE EU RESTRUCTURING DIRECTIVE

2021 saw the initial deadline pass for implementation of Directive (EU) 2019/1023 of the European Parliament and of the Council on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) (the **"Restructuring Directive"**), which:

- aims to ensure that each EU member state has in place a restructuring framework that allows debtors in financial distress to restructure in a manner that improves prospects for avoiding insolvency and continuing as a viable business; and
- was required to be implemented by EU member states by 17 July 2021. However, many EU member states have taken advantage of the option to extend the implementation deadline to July 2022. Therefore, we expect significant developments in this space to continue over the first half of this year.

> "…[the] Directive aims to [ensure that] viable enterprises and entrepreneurs that are in financial difficulties have access to effective national preventive restructuring frameworks which enable them to continue operating; honest insolvent or over-indebted entrepreneurs can benefit from a full discharge of debt after a reasonable period of time, thereby allowing them a second chance; and that the effectiveness of procedures concerning restructuring, insolvency and discharge of debt is improved, in particular with a view to shortening their length."
>
> — *Preamble, Restructuring Directive*

STATUS OF IMPLEMENTATION

As of the date of this article, seven EU member states have implemented the Restructuring Directive in whole or in part: Germany, the Netherlands, France, Italy, Austria, Greece and Lithuania.

KEY FEATURES OF THE RESTRUCTURING DIRECTIVE

EU member states can implement the Restructuring Directive either by introducing one or more new procedures or by amending existing procedures. The preventive restructuring frameworks implemented in accordance with the Restructuring Directive must include certain elements, including:

- **the debtor remaining totally or partially in control of its assets and business operations;**
- **in certain circumstances, appointment of an insolvency practitioner to assist in preparation of a restructuring plan;**
- **a general or limited stay of individual enforcement actions for up to a maximum of 12 months (including any extensions or renewals);**
- **division of creditors into classes, with a requisite majority of no more than 75% for each class;**
- **prescribed information to be contained in a restructuring plan submitted for adoption;**
- **prescribed procedural criteria for the adoption and confirmation of the restructuring plan;**
- **a cross-class cram-down mechanism; and**
- **protections for creditors providing new and interim financing.**

Notwithstanding the prescriptive nature of the Restructuring Directive, EU member states retain a significant degree of flexibility in the manner of implementation, so jurisdictional differences will remain within the EU. It remains to be seen whether this leads to certain EU jurisdictions developing a competitive edge over others in complex cross-border restructurings.

While the Restructuring Directive is gradually leading to the creation of a range of new tools and procedures for companies across the EU, it will take time for these to be thoroughly tested in practice and for debtors and creditors to become as comfortable with the new tools as they are with the existing cross-border restructuring toolkit, including the well-established English scheme.

> "The objective of this Directive is to contribute to the proper functioning of the internal market and remove obstacles to the exercise of fundamental freedoms, such as the free movement of capital and freedom of establishment, which result from differences between national laws and procedures concerning preventive restructuring, insolvency, discharge of debt, and disqualifications"
>
> *— Preamble, Restructuring Directive*

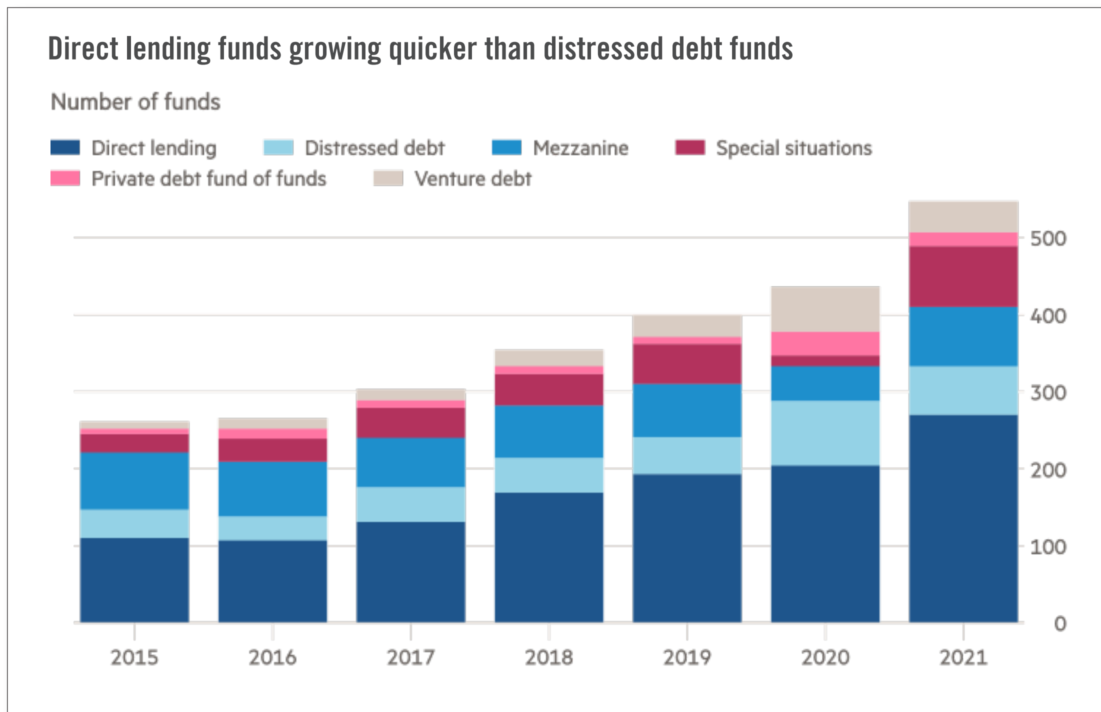
LATEST DEVELOPMENTS IN IMPLEMENTING LEGISLATION IN GERMANY, THE NETHERLANDS, FRANCE AND ITALY

	GERMANY	THE NETHERLANDS	FRANCE	ITALY
Implementing legislation	StaRUG *(Gesetz über den Stabilisierungs- und Restrukturierungsrahmen für Unternehmen)*	WHOA *(de Wet homologatie onderhands akkoord ter voorkoming van faillissement)*	Ordinance no. 2021-1193[1]	Law no. 118 of August 2021, as amended by Law no. 147 of October 2021[2]
Key new restructuring process	German scheme	Dutch scheme	Accelerated safeguard	Negotiated settlement
Effective date	1 January 2021	1 January 2021	1 October 2021	1 November 2021
Who can initiate	Debtor	Debtor, creditors, shareholders or works council	Debtor	Debtor
Who can be compromised	Creditors and equity holders	Creditors and equity holders	Creditors and equity holders	Not applicable
Moratorium	Yes, with court authorisation	Yes, with court authorisation	Yes, with court authorisation	Yes, with court authorisation
Approval threshold	75% by value of all members of each class	$^{2}/_{3}$ by value of voting members of each class	$^{2}/_{3}$ by value of voting members of each class	Consensual
Cross-class cram-down	Yes	Yes	Yes	No
Protections for new money	Clawback protection, subject to court authorisation	Clawback protection, subject to court authorisation	Super senior priority and clawback protection, subject to court authorisation or approval of plan	Super senior priority and clawback protection, subject to court authorisation

[1] Ordinance no. 2021-1193 also introduced certain changes to the regular safeguard and reorganisation proceedings, including allowing for super senior ranking for creditors that provide new money following a filing.

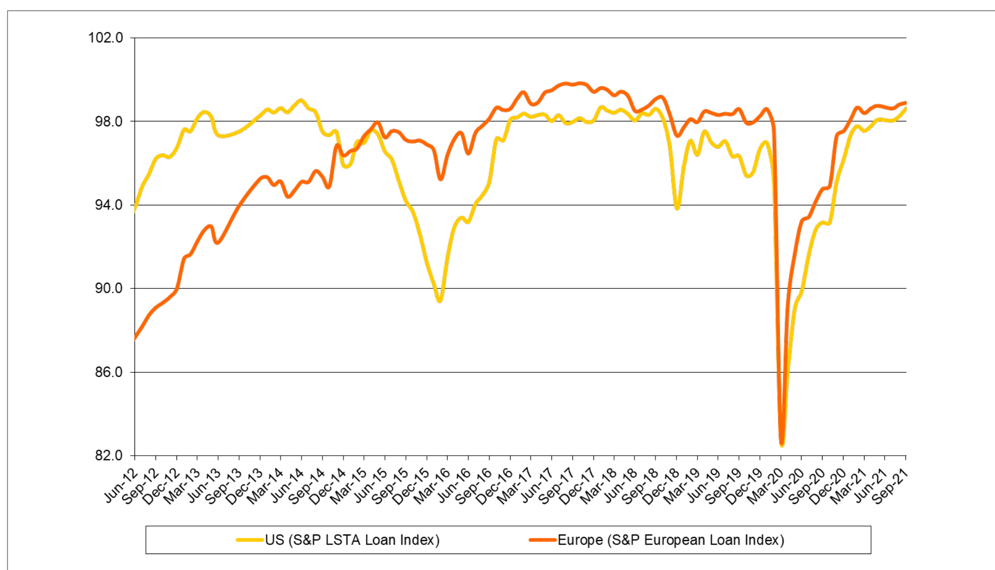
[2] Italy will fully implement the Restructuring Directive and existing Italian bankruptcy law will be subject to a comprehensive overhaul when a new Code of Business Crisis and Insolvency comes into full effect, which will amend existing Italian restructuring and insolvency tools to streamline proceedings and prioritise business rescue. Most of the new code will come into force by 16 May 2022, with the provisions relating to a new out-of-court early alert procedure coming into force on 31 December 2023.

2021: TRENDS IN EUROPEAN LEVERAGED FINANCE



Financial Times, "Distressed debt funds sparkle in Covid recovery" by Robin Wigglesworth, 25 August 2021

- Building on the momentum of the latter half of 2020 and the rollout of the Covid-19 vaccination programme, the European leveraged finance market set off at an unprecedented pace, and there were few signs of let-up throughout the year, with deal flow at near record levels, driven by a combination of:
  - **bounce-back in EBITDA for many businesses (particularly those most heavily impacted during the COVID-19 pandemic);**
  - **pent-up investor demand**;
  - **a sustained low interest rate environment**;
  - **resurgence of M&A**;
  - **government financial support**;
  - **economies reopening; and**
  - **low default rates**.
- Reaching into their increasingly vast reserves of dry powder, **private equity sponsors were yet again at the forefront of the market,** launching numerous buyouts and tapping both the loan and bond markets. The prospect of rising interest rates also had investors rushing to floating-rate loans, creating a **borrower-friendly environment and allowing issuers to take advantage of refinancing and dividend recapitalisation opportunities.**
- Greater competition for assets across both equity and credit investors resulted in **higher EV and leverage multiples plus borrower-friendly terms.** There was **increased traction for sectors that were most acutely impacted by the COVID-19 pandemic**, such as leisure, aviation, hospitality and automotive, though borrowing costs in these sectors tended to be higher than pre-pandemic levels.
- **In the mid market, direct lending activity expanded,** and credit funds are now very much the dominant players. The advantages for borrowers around deal execution (including speed of diligence, execution and absence of syndication risk) and enhanced flexibility around leverage, EBITDA adjustments and covenants have resulted in debt funds increasing their share of the market. Moreover, there are a growing number of debt funds that can offer scale of a type that was traditionally exclusively limited to the syndicated loan and bond markets, meaning unitranche financing offerings have started to turn up the heat on widely syndicated TLB and bond products.



Weighted Average Bid: S&P Global Market Intelligence, Leveraged Commentary & Data Global Review – US / Europe, 3Q21

- The focus by corporates, lenders and their stakeholders on ESG considerations is greater than ever, and there has been a **noticeable uptick over the past year in ESG investor mandates requiring them to invest in ESG-linked products**. A greater global awareness and recognition of the climate change crisis (which was in the global spotlight at "COP26" in November) will continue to put pressure on investors to seek ESG solutions and demand ESG products. In addition to sustainable or green loans specifically provided to borrowers who are financing a "green" project or to companies in "green" industries, we are also seeing **loans with ESG-linked margin ratchets and associated KPIs being used as a means of incentivising improved ESG performance of borrowers while also providing an opportunity to reduce financing costs.**

- **Recurring revenue financings gained further traction** over the past year in the European market. This type of financing is made available and sized on the basis of a recurring revenue stream of a company. This product has become increasingly popular, particularly in software businesses and other businesses that are in relatively early growth stages with low or negative EBITDA but are able to demonstrate strong committed revenue streams from customer contracts. Given the continued trajectory of growth-stage companies and their ongoing need for funding, the availability of debt funding on non-EBITDA-based metrics provides significant additional flexibility to enable these companies to continue to grow while limiting the need to raise additional equity.

- The market has **not yet witnessed the major flow of distressed debt opportunities anticipated as a result of the COVID-19 pandemic**, but we expect the landscape to change significantly as government-supported liquidity measures dry up.

- Despite ongoing uncertainty surrounding the long-term economic impact of the pandemic and what exactly the "new normal" will entail, **loan documentation terms remained largely unchanged and, for the most part, moved further in favour of sponsors in sectors that were able to weather the COVID-19 pandemic**. During the pandemic, many borrowers were able to suspend financial covenant testing or make them less onerous, often in exchange for minimum liquidity requirements, tightening of restrictive covenants and enhanced reporting. 2021 witnessed an unwinding of many of these concessions as the economy rebounded and EBITDA returned to more normalised levels. As investor demand began to taper off somewhat during Q4, there was some evidence of lenders in the syndicated market successfully pushing back on the more aggressive borrower terms. However, the **past 12 months generally saw the market shift further in favour of sponsors (i.e., greater flexibility in terms of restrictive covenants and looser EBITDA add-backs)**.

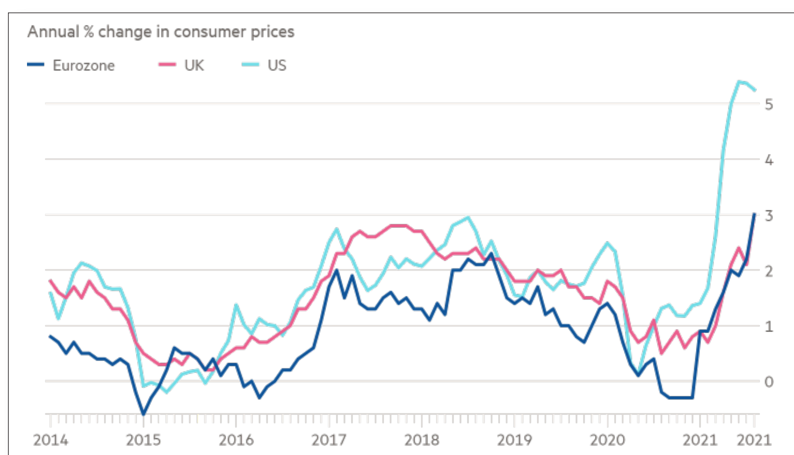
2022: WHAT'S TO COME THIS YEAR?

> "[2021] ended with around $62 billion of distressed bonds and loans outstanding, down substantially from nearly $150 billion at the end of 2020."
>
> *— Bloomberg Law, "Distressed Daily: 2022 starts with just $62 billion of distress" by Nicole Bullock and Dawn McCarty, 3 January 2022*

In the UK and across Europe, **company insolvencies have remained low compared to pre-pandemic levels,** driven by a combination of government support measures and the willingness of stakeholders to amend, forbear or waive debt terms, or extend new lines of credit. With unprecedented levels of liquidity in the market and loose financing terms, there is little urgency for many companies to address over-levered balance sheets, and few documentary triggers. Against this backdrop, many companies managed to complete successful refinancing transactions and avoid coming to the restructuring negotiation table.

However, there are **significant market pressures as we move into 2022,** any one of which could trigger increased levels of distress, including:

- **COVID-19:** the ongoing threat of the pandemic recovery being derailed, particularly as new variants of SARS-CoV-2 emerge;
- **Global supply chain disruption:** the ripple effect across both businesses and consumers, as well as the steep increase in shipping costs seen over the course of 2021;
- **Government support:** especially as many government stimulus measures start winding down;
- **Inflation:** persistently high levels of inflation as a result of a number of trends, including labour shortages, rising labour costs, higher raw material costs and higher energy costs; and
- **Brexit:** the adaptation of businesses both in the UK and across Europe, with the effect of Brexit having been somewhat masked in 2021 by other market pressures.



Financial Times, "Stagflation fears intensify in signs of slowing growth" by Tommy Stubbington and Delphone Strauss, 30 September 2021

> "Rising inflation is the big cloud on the horizon for the global economy, as supply chain disruption, higher energy costs, labour shortages and post-lockdown demand pushes up prices at rates not seen for decades."
>
> *— Reuters, "Inflation trap looms for British retailers" by Paul Sandle and James Davey, 6 January 2022*

2022: MARKET WATCH

DEVELOPMENTS

In spite of the numerous market pressures, we are **yet to see significant volumes of distress**. Although cracks are starting to appear, continued availability of government support and significant liquidity in the market may mean that the **early part of 2022 looks very similar to 2021**. In the absence of distress, we anticipate a continued **refocusing by distressed investors on a broader range of opportunistic investments**, including in private and illiquid situations.

Moving further into 2022, market pressures and a need for companies to address increased leverage and pending maturities may yet result in increased levels of distress.

STIMULUS MEASURES

- In the UK, the **recovery loan scheme** is available until 30 June 2022. It enables **SMEs** to secure up to **£2 million** in financing, with **70% of the loan guaranteed** by the UK government.
- In the EU, the temporary framework for **state aid has been extended until 30 June 2022,** and a number of EU member states have, as a result, chosen to extend support measures. By way of illustration:

France

- Certain **state-backed loans, debt relief plans and furlough** schemes remain available, as well as support schemes aimed at recovery from the health crisis.
- The French government also extended a support scheme to help companies meet fixed costs, which is currently available to certain companies in sectors particularly affected by the health crisis and losing more than half their turnover compared to the same month of 2019. The scheme enables such companies to claim either **90% of operating losses (dropping to 70% where the company has more than 50 employees)**, in each case up to a total cap of €12 million.

Germany

- The government has continued to provide access to **special loans** provided by KfW, **guarantee programmes** and certain **stabilising measures** facilitated by the Economic Stabilisation Fund.
- In addition, the **temporary aid programme** has been extended to March 2022, which enables companies and self-employed individuals whose turnover has shrunk by over 30% to claim subsidies of their fixed costs.
- The government is providing various **tax reliefs to support companies directly impacted by the pandemic**, and is in the process of introducing new tax reliefs for 2022.

UK COVID-19 TEMPORARY MEASURES

In the UK, the government has increased the **threshold for issuing a winding-up petition from £750 to £10,000 until 31 March 2022**. A **moratorium on commercial evictions for non-payment** has also been extended until 31 March 2022.

On 9 November 2021, the UK government published a **code of practice for commercial property relationships** following the COVID-19 pandemic. This guidance encourages tenants to meet obligations under their lease in full where it is affordable. It otherwise makes clear that tenants should not have to take on more debt or restructure their business in order to pay rent. The guidance further encourages landlords and tenants to agree repayment plans for rent arrears accrued since March 2020.

The UK government has also put forward the **Commercial Rent (Coronavirus) Bill,** which is expected to become law in March 2022. The bill proposes to **ring-fence rent arrears** incurred between March 2020 and July 2022. A **binding arbitration process** will then be established to decide what happens to the ring-fenced arrears.

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