EUROPEAN DISTRESSED DEBT
AND RESTRUCTURING

Trends Past and Future

ROPES & GRAY

THE EUROPEAN DISTRESSED MARKET STEADILY PICKED UP IN 2022, a function of energy price rises, supply chain disruption, interest rate rises and inflationary pressures. Distress was mitigated by the prevalence of covenant-lite/covenant-loose debt documentation, and many companies having refinanced their existing debt in 2021, pushing out maturity walls to 2025 and beyond. In this article, we look back at European distressed debt, restructuring and leveraged finance trends in 2022 and share our thoughts on potential market developments in 2023, including our expectations for a likely uptick in aggressive US-style liability management techniques in the European market.

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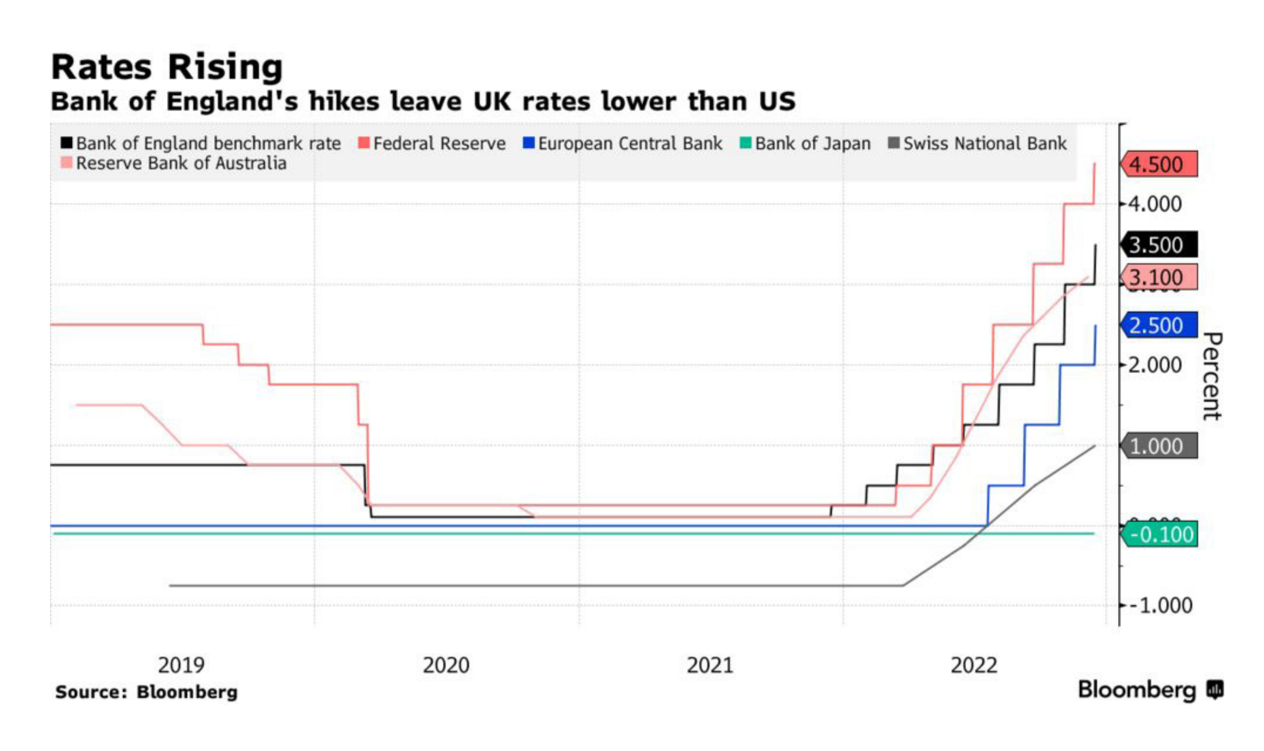
2022: WHAT JUST HAPPENED?

- **Feb. 2:** Bank of England raises bank rate by 0.25% to 0.5%
- **Feb. 24:** Russia invades Ukraine
- **Mar. 16:** Bank of England raises bank rate by 0.25% to 0.75%
- **Mar. 16:** Fed raises target for funds rate by 0.25% to 0.25-0.5%
- **Mar. 23:** *Re ED&F Man Holdings Ltd.* Part 26A restructuring plan is sanctioned, using the cross-class cram-down mechanism
- **Mar. 30:** *Re Smile Telecoms Holdings Ltd.* Part 26A restructuring plan is sanctioned and cram-out strategy used for the first time
- **Apr. 24:** Emmanuel Macron is re-elected as president of France
- **May 4:** Bank of England raises bank rate by 0.25% to 1%
- **May 4:** US Federal Reserve raises target for funds rate by 0.5% to 0.75-1%
- **May 30:** *Re ALL Scheme Ltd.* scheme of arrangement is sanctioned, validating the company's approach to addressing concerns relating to consultation with customer creditors and explaining proposals in readily understandable language that had led the court to refuse to sanction previous scheme
- **Jun. 9:** *Re Haya Holco 2 PLC* scheme of arrangement is sanctioned
- **Jun. 19:** French legislative elections conclude; Emmanuel Macron's Ensemble coalition secures the most seats but falls 44 short of an absolute majority
- **Jun. 15:** Bank of England raises bank rate by 0.25% to 1.25%
- **Jun. 15:** US Federal Reserve raises target for funds rate by 0.75% to 1.5-1.75%
- **Jun. 30:** *Re Nostrum Oil & Gas PLC* scheme of arrangement is sanctioned
- **Jul. 14:** Announcement by Giuseppe Conte, leader of the Five Star Movement (M5S) in Italy, that M5S will revoke its support for the national unity government of Mario Draghi
- **Jul. 21:** European Central Bank raises policy rate by 0.5% to 0.5%
- **Jul. 22:** *Re Houst Ltd.* Part 26A restructuring plan, departing from order of priority under relevant alternative, is sanctioned
- **Jul. 27:** United Nations brokers grain corridor deal
- **Jul. 27:** US Federal Reserve raises target for funds rate by 0.75% to 2.25-2.5%
- **Jul. 31:** England wins the UEFA Women's Euro 2022
- **Aug. 3:** Bank of England raises bank rate by 0.5% to 1.75%
- **Aug. 9:** A European Commission researcher describes Europe's summer drought conditions as the worst in 500 years
- **Aug. 15:** *Oceanfill Limited v Nuffield Wellbeing Limited and another* holds that restructuring plan does not impact on the rights and liabilities of third parties not part of the plan
- **Sep. 6:** Liz Truss is appointed as prime minister of the United Kingdom
- **Sep. 8:** Queen Elizabeth II dies at Balmoral Castle
- **Sep. 8:** European Central Bank raises policy rate by 0.75% to 1.25%
- **Sep. 21:** Bank of England raises bank rate by 0.5% to 2.25%
- **Sep. 21:** US Federal Reserve raises target for funds rate by 0.75% to 3-3.25%
- **Sep. 23:** Kwasi Kwarteng delivers a Ministerial Statement entitled "The Growth Plan" (also known as the "mini-budget")
- **Sep. 25:** A snap general election is held in Italy following the fall of the Draghi government
- **Sep. 28:** Bank of England begins temporary purchases of long-dated UK gilts

- **Oct. 5:** UK Supreme Court delivers judgment in *Sequana* case
- **Oct. 20:** Liz Truss announces her resignation
- **Oct. 22:** Giorgia Meloni is appointed prime minister of Italy
- **Oct. 25:** Rishi Sunak is appointed prime minister of the United Kingdom
- **Oct. 27:** European Central Bank raises policy rate by 0.75% to 2%
- **Nov. 2:** US Federal Reserve raises target for funds rate by 0.75% to 3.75-4%
- **Nov. 3:** Bank of England raises bank rate by 0.75% to 3%
- **Nov. 8:** US midterm elections held
- **Nov. 11:** FTX files for bankruptcy protection
- **Nov. 17:** Black Sea grain corridor deal extended
- **Dec. 2:** The G7 and Australia join the EU in imposing a cap of $60 a barrel on Russian crude oil
- **Dec. 14:** US Federal Reserve raises target for funds rate by 0.5% to 4.25-4.5%
- **Dec. 15:** Bank of England raises bank rate by 0.5% to 3.5%
- **Dec. 15:** European Central Bank raises policy rate by 0.5% to 2.5%
- **Dec. 17:** Leo Varadkar succeeds Micheál Martin as Prime Minister of Ireland
- **Dec. 19:** EU energy ministers agree a gas price cap



Bloomberg UK, "BOE says inflation may have peaked as rates hit 14-year high" by Reed Landberg and Philip Aldrick, 15 December 2022

DEVELOPMENTS IN RESTRUCTURING PLANS

Throughout 2022, the Part 26A restructuring plan (the "Plan") has continued to be a popular tool for restructurings in Europe. We have highlighted below our key takeaways from judgments over the past 12 months, looking in particular at the continued popularity of the "cross-class cram-down", the first use of the "cram-out mechanism" and the recent departure from "absolute priority" in ***Re Houst Ltd.***

CROSS-CLASS CRAM-DOWN

- In June 2020, the Corporate Insolvency and Governance Act 2020 (CIGA) **introduced a "cross-class cram-down"** mechanism, inspired by US Chapter 11 proceedings, in the form of the 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 votes 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.
- In 2022, the **"cross-class cram-down" has remained an attractive feature** of the Plan. It has been used in **two out of three Plans** sanctioned in 2022 *(**ED&F Man** and **Houst**)*. **Selection of the relevant alternative and valuation evidence presented by the company and opposing stakeholders play a critical role** in the likelihood of sanction, particularly where the use of the cram-down power is contemplated.

CRAM-OUT MECHANISM

- 2022 saw the **first use of the "cram-out mechanism"** *(**Smile Telecoms**)*. Creditors or members whose rights are affected by the Plan must be permitted to participate in a class meeting. A Plan company can petition the court to exclude out-of-the-money stakeholders (i.e., those who do not have a genuine economic interest in the company under the relevant alternative). Given the draconian consequences of exclusion, the court has indicated that it needs to be "entirely satisfied" that it is appropriate to use the "cram-out mechanism" *(**Smile Telecoms**)*. This reinforces the need for strong valuation evidence supplied in a timely manner.
- In ***Smile Telecoms*** the court permitted the "cram-out" and convened a single class meeting, as it was satisfied that the **excluded classes were "well out of the money"** and this was "not a marginal case". Further, the **valuation evidence was provided to all the interested parties in sufficient time** (one month prior to the convening hearing) and was analysed at length by their advisers. Objections were raised by one excluded creditor about the decision made on class composition, but the court refused to revisit the decision at the sanction hearing, as the creditor had **neither sought to appeal the convening decision nor appeared at the sanction hearing.**

DEPARTURE FROM ABSOLUTE PRIORITY

- In ***Houst***, the court **departed from the statutory order of priority** under the relevant alternative (a pre-pack administration), permitting under-secured bank lender claims to jump ahead of HMRC's claims as a preferential creditor. Under the relevant alternative, the recipient of the largest dividend would have been HMRC (15p/£) versus 7p/£ for a bank lender. The remainder of the bank lending would have ranked as an unsecured claim. Under the plan, although HMRC's net return would increase (to 20p/£), the bank lender would also receive significantly more than their fixed charge security would otherwise have yielded (27p/£, including 20p/£ for their under-secured debt, while ordinary unsecured creditors would only receive 5p/£). This illustrates a **key difference**

> "[I]f a creditor or member wishes to oppose a scheme or plan based upon a contention that the company's valuation evidence as to the outcome for creditors or members in the relevant alternative is wrong, they must stop shouting from the spectators' seats and step up to the plate."
>
> — *In the Matter of Re Smile Telecoms Holdings Limited [2022] EWHC 740 (Ch), §53*

between the approach to priority of claims under the Plan and foreign restructuring and insolvency proceedings where an absolute priority rule applies, including Chapter 11 proceedings in the United States.

- The **applicability of this development to other cases should be viewed cautiously,** as ***Houst*** turned on its facts. Among the factors the court considered when sanctioning the plan were: (i) the Plan offered the opportunity of continued trading and an enhanced dividend to HMRC; (ii) benefits to be received by new shareholders under the Plan were justified, as the new capital they injected was imperative for the solvent rescue of the company; (iii) HMRC did not attend the sanction hearing or present any arguments against sanctioning, nor did they seek to negotiate with other parties; and (iv) the assets which would have been available in the event of the company's administration were applied in a manner consistent with the order of priority in administration.

LENDER-ON-LENDER VIOLENCE: WILL IT COME TO EUROPE?

Lender-on-lender violence refers to a type of liability management transaction through which a company gives an advantage to a subset of creditors at the expense of another subset. These "priming" deals enable the participating creditors, post-execution, to have some form of priority ranking relative to non-participating creditors. A company may be able to reduce the overall principal amount of debt outstanding, reduce the interest burden, manage an upcoming maturity or avoid an impending financial covenant default. Liability management can be considered both from an offensive and defensive perspective within many capital structures.

These transactions have become commonplace in the US market but are yet to be widely used in Europe, where such deals are more challenging to execute due to differences in the market standards for documentary terms and legal frameworks. Such deals are potentially less attractive in Europe given the existence of well-trodden alternative means of execution, such as by way of a scheme of arrangement. As macroeconomic pressure continues to apply to companies through rising inflation, increasing interest rates, supply chain disruption and geopolitical instability, we expect to see an increase in the number of distressed European companies seeking more bespoke refinancing techniques. For instance, BC Partners' portfolio company Keter Group B.V. reportedly considered carrying out an amend-to-extend of its English debt through an "exit consent" in October 2022 (see details below). This was the first prominent example in recent history of a company proposing an uptiering transaction under English law governed documents.

These more aggressive forms of liability management fall broadly into two categories:

1. Dropdown transactions The dropdown or "J.Crew" transaction (eponymous with that company's 2017 deal) **involves the transfer of previously encumbered assets outside the restricted group to an unrestricted subsidiary that is not subject to the restrictive covenants** in the existing credit documents without equivalent (or any) value being received for such transfer, a release of any liens or guarantees relating to such assets, and the subsequent raising of new financing secured against those assets.

2. Uptiering transactions In an uptiering transaction, **participating creditors exchange existing debt** (typically at a premium to the trading price but at a discount to the par value) **for debt in a new, super senior instrument.** Participating creditors must constitute a group large enough to reach the thresholds required to provide any consents necessary to effect the transaction.

An uptiering transaction is characterised by: (a) **majority consent** – which may be needed for new, super senior debt. A majority of existing creditors will form a group and consent to amendments

> "The court will look to see whether the priority, as among different creditor groups, applicable in the relevant alternative is reflected in the distributions under the plan. A departure from that priority is not in itself, unlike the position in the closest equivalent procedure in United States federal bankruptcy law, the Chapter 11 plan, fatal to the success of the plan."
>
> *— In the Matter of Re Houst Ltd [2022] B.C.C. 1143, §30*

[1]"Absolute priority" is typically taken to mean that no junior class may recover until any senior classes have recovered in full and no senior class should recover more than it is owed.

> "[O]ppression of a minority is of the essence of exit consents of this kind, and it is precisely that at which the principles restraining the abusive exercise of powers to bind minorities are aimed."
>
> — *Assénagon Asset Management S.A. v Irish Bank Resolution Corporation Limited (Formerly Anglo Irish Bank Corporation Limited) [2012] EWHC 2090 (Ch), §86*

to terms to permit the creation of a new instrument, on the condition that they can participate in the new instrument (this is sometimes known as an "exit consent"), and (b) **open market repurchase provisions** – the debtor will make use of these provisions to repurchase the debt of the participating creditors on a non-pro-rata basis, in consideration for participation in the new super-senior instrument.

Applicability in the European market

1. Dropdown transactions **Dropdown transactions have already been successfully undertaken in the European market.** A company's ability to enter into a transaction like this is fact- and documentation-specific. The transaction can be structured by making use of the relevant permitted investment baskets, restricted payments baskets or asset disposal baskets, and, if basket capacity is sufficient, no additional consent is typically required.

2. Uptiering transactions **Uptiering transactions have been rarely seen in the European market,** for reasons including:

- The **consent thresholds** for amending the ranking or subordination provisions in an intercreditor agreement are generally agreed in the underlying credit documents and are **typically 100% under an English credit agreement**, which would prevent an uptiering transaction. However, some documents do allow such amendments to be made with a lower voting threshold and/or include a "hollow" super senior tranche built into the intercreditor agreement, which may permit an uptiering transaction without all-lender consent.
- **Debt repurchase provisions in English credit agreements** typically require the debtor to offer an opportunity for **all lenders to participate** and to accept offers at the same price **on a pro rata basis,** although such requirements could potentially be amended with majority or supermajority consent.
- Finally, and most importantly, although consent payments are permissible (see ***Azevedo***), provided that the offer is open to all creditors equally, an **exit consent could be challenging under English law**. ***Assenagon*** (a case from 2012) held that the exit consent in that case was an abuse of power used to coercively intimidate the minority into approving the consent solicitation and was thus not in the best interests of the class of creditors as a whole and did not benefit the creditors as a class. In light of this case law, the purpose and effect of a proposed exit consent under English law would need to be considered very carefully, as would the treatment of creditors as a class.

Keter's recent exit consent attempt

In October 2022, Keter Group B.V., a portfolio company of BC Partners, reportedly launched an amend and extend request in respect of its €1.205 billion Term Loan B due October 2023. It has been reported that lenders were asked to grant a two-year maturity extension of the existing debt and, in return, were offered an uplift on the margin and a partial repayment (of around €250 million) at par funded via a €50 million equity injection by BC Partners and €200 million of new second lien debt. The proposal was also reported to include a new $250/€300 million Term Loan B with the same maturity as the extended debt (i.e., October 2025).

The request, however, reportedly came with a "threat" that if lenders holding 66.66% of the loan consented to the deal, the current debt would be stripped of certain key covenants, and with the consent of 80% of lenders, it would be stripped of security and guarantees (i.e., an exit consent process). In other words, non-consenting lenders could be left with a shorter-dated (to be repaid at the original maturity in October 2023) but potentially unsecured debt instrument, without the margin uplift offered to consenting lenders. All lenders were reportedly given the opportunity to participate in the transaction.

Although the proposal was subsequently dropped by Keter (which is reported to instead be considering implementing the transaction via a scheme of arrangement, requiring support of lenders representing 75% in value and a majority in number of each relevant class), it illustrates the attraction of exit consents and uptiering transactions for sponsors and companies versus the more well-established paths of schemes of arrangements and Plans.

> "[A]s a general rule that the more parlous the state of the company, the more the interests of the creditors will predominate, and the greater the weight which should therefore be given to their interests as against those of the shareholders."
>
> — *BTI 2014 LLC v Sequana SA and others [2022] UKSC 25], §81*

In what circumstances would English courts be more likely to find the use of "exit consents" acceptable as opposed to coercive?

While the boundaries of acceptable exit consents have not been fully tested in the English courts, the court is likely to find a transaction more readily acceptable in certain circumstances, including:

- a drag-along transaction – where those who did not vote in favour of the resolution/exit consent would still be given the same benefit. This undermines the attractiveness of uptiering as a means of subordinating part of the debt in favour of a sub-set of creditors; or
- where a right to reconsider is offered – where those who did not vote in favour of the resolution have the right to reconsider their vote after the benefit has been accepted by the majority. This suffers from similar disadvantages (from a debtor perspective) to the drag-along option.

DIRECTORS' DUTIES: SEQUANA

The UK Supreme Court handed down judgment in the ***Sequana*** appeal, providing guidance to directors on their duty to consider the interests of creditors (a sub-category of the broader duty to promote the success of the company under Section 172(1) of the Companies Act 2006, or the rule in ***West Mercia***), as a company enters the "zone of insolvency".

Specifically, the court:

- affirmed the existence of a duty to consider the interests of creditors and that this duty is not a standalone duty nor a duty that directors owe directly to creditors, but instead arises from the duty of directors to act in the best interests of the company;
- explained that this duty arises when the directors know, or ought to know, that the company is insolvent, bordering on insolvency (imminent insolvency), or when an insolvent liquidation or administration is probable (which could be earlier than actual or imminent insolvency); and
- guided that when the interests of creditors differ from those of shareholders:
  - where an insolvent liquidation or administration is inevitable, creditors' interests become paramount; and
  - prior to that, there must be a balancing exercise on a case-by-case basis to weigh up the competing interests, which will shift depending on the level of distress.

This provides welcome guidance for directors, which will be of paramount importance as we head into a difficult trading environment in 2023.

EVOLUTION IN MARKET TERMS FOR PRIMARY DEALS

The levels of activity in the bank financing market in Q3 of 2022 were low in comparison to the equivalent period in 2021. As the market shifted to direct lending providers, we have seen an increase in intention by the direct lenders to rein in some of the more aggressive features in sponsor-friendly credit documentation precedents that had previously been syndicated.

The terms that we have seen most commonly requested by direct lenders are as follows:

1. **High water marking:** The removal of "EBITDA high water marking", the provision allowing the borrower to peg the restrictive covenant calculations off of the highest EBITDA achieved by the group in a relevant period (with no downward adjustment to reflect a decrease in EBITDA in a subsequent period).
2. **EBITDA addbacks:** The reduction of the cap and the shortening of the time horizon with respect to the addbacks to EBITDA on the account of expected "synergies" and the removal of the addback for "revenue synergies".
3. **Revolving facility debt:** The re-inclusion of revolving facility debt in restrictive covenant calculations.
4. **"No worse" flexibility:** The removal of "no worse" fixed charge coverage ratio tests in restrictions on debt incurrence, investments and restricted payments.

5. **Leverage governor for restricted investments and payments:** The inclusion of a leverage governor (in addition to a fixed charge coverage test) in the ratio baskets restricting investments and restricted payments.
6. **Restricted payments "zero floor":** The removal of the "zero floor" in the restricted payments build-up basket, in order for the basket size to reflect a decrease in performance in a downside case.
7. **"Permitted debt" component removed from "available amount" restricted payments basket:** The removal of the "permitted debt" component in the calculation of the "available amount" restricted payment basket, so that the incurrence of permitted debt does not automatically increase the permission for leakage out of the restricted group.
8. **"Freebies":** The reduction in or the removal of the "freebie" component of the credit facility debt incurrence basket.
9. **"J.Crew blockers":** The inclusion of so called "J.Crew blocker" provisions.
10. **Non-guarantor debt incurrence sub-limits:** The inclusion of a sub-limit on debt incurrence by non-guarantors to address the risk of priming financing transactions that would be secured on the assets of non-guarantors (which in some cases comprise a large portion of the total assets of the business as a result of limited guarantor and security coverage).
11. **"Chewy" blockers:** The inclusion of the so-called "Chewy" provisions, to address the risk of the group releasing share security following the disposal of a minority interest in a subsidiary.
12. **Liability management protections:** The inclusion of provisions to address the risk of uptiering and other liability management transactions, such as requiring all-lender consent for amendments to the waterfall in the intercreditor agreement, requiring all-lender consent for increases in debt baskets (specifically, the incurrence of super senior debt) and requiring majority lender consent in addition to participating lender consent for certain structural adjustment transactions.

Sponsors generally remained determined to retain their precedent positions (reflective of the height of the market in 2021) with respect to most of the above points, so the tightening of documentation has largely been implemented by way of side letters rather than updates to the credit agreements. Therefore, the documents currently in the market will very often not be reflective of the lender protections that are elsewhere documented. Side letters typically only benefit the individual lenders that have requested them and do not travel on transfer. Equally, side letters are typically not designated as "finance documents", so any breach thereunder would not be a default under the credit agreement. Instead, they primarily rely on the commercial relationship between the parties and the reputational damage that non-compliance could cause.

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