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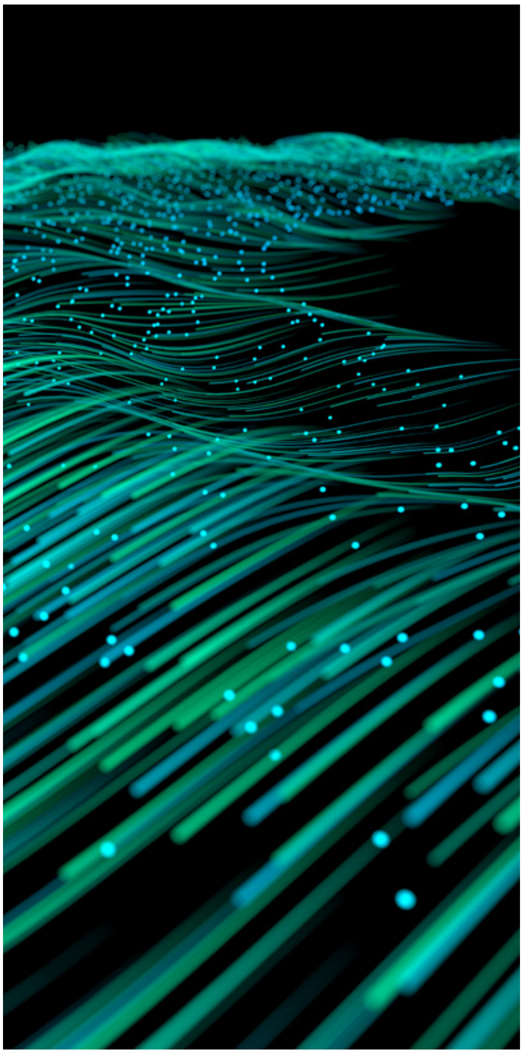
Current considerations when restructuring European private credit investments

This article discusses considerations for credit funds that face a restructuring situation in the post-COVID-19 world — whether one largely caused by the challenges posed by the pandemic or one simply accelerated by such challenges — and how workouts of these investments present their own challenges.



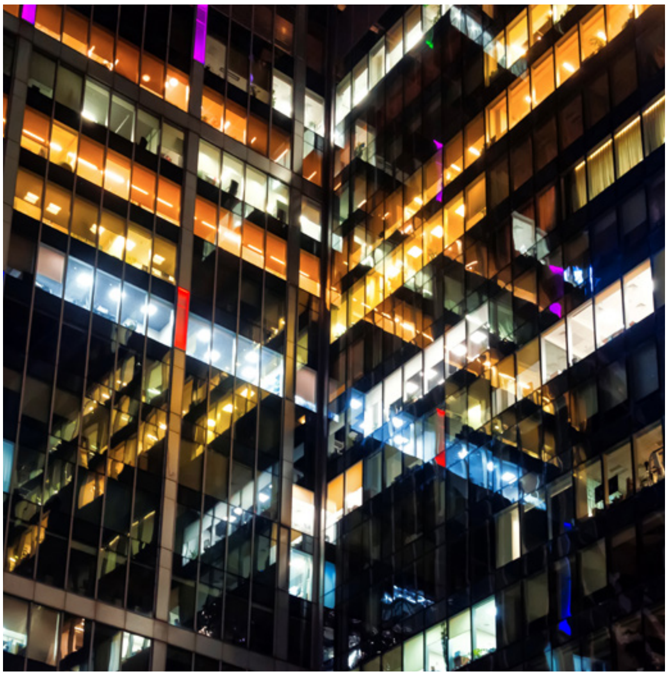
Over 12 months ago, in the early days of the COVID-19 pandemic, PE sponsors and their portfolio companies began to address the new and immediate existential threats to their businesses; liquidity was the watchword for every CFO, and lenders stood ready to help — whether by providing covenant waivers or consenting to incurring additional debt or using government support schemes. Those efforts allowed many of the companies whose business models were challenged by the disruption to survive. However, as government support initiatives are scaled back and the realities of the aftereffects of the COVID-19 pandemic on international markets become more apparent, questions are inevitably being posed about the long-term viability of some pre-pandemic capital structures.

Understanding cash flows

As a first principle in this analysis, it is critical to understand the valuation of the group and its current cash flow metrics. If these two are stable and the value of the group comfortably exceeds the amount of external debt (and therefore, equity value remains), the parties may be prepared to enter into a relatively straightforward amendment and extension of existing facilities.

If cash flow is uncertain or unstable, a group would need to consider possible liquidity avenues in the form of a capital injection from the shareholders, additional facilities being made available by the existing lenders, external borrowing or, to the extent still relevant, government programmes.

If the value of the group no longer exceeds the value of its external debt, then some form of debt restructuring is likely required.



Confidentiality in private markets

Unlike public or quasi-public debt or equity issuers, where exchange rules dictate the prompt disclosure of inside information, sponsors and their portfolio companies are not required (and may be incentivised) to keep details of a restructuring out of the public domain. However, private credit funds are as equally exposed as borrowers to an information leak, particularly if they face additional scrutiny from LPs or creditors or if they are perceived as having difficulties raising additional funds. Ordinarily, credit agreements contain "one-way" confidentiality clauses that bind lenders to keep company information confidential, but not vice versa. At the outset of discussions for a restructuring, credit funds should consider whether existing confidentiality arrangements are suitable or whether new mutual obligations would better protect the GP and investors from unwanted public disclosure.

Evaluating the problem

While privacy and confidentiality have the advantage of keeping the lenders of these credits out of the glare of the public domain, they also deprive it of the market's view of the value of a company. As a private investor in an illiquid asset, there is no easy exit via public markets and no ready barometer of value. Instead, the fund must reach its own conclusions. It can only do so based on reliable and fulsome financial and business disclosure. Therefore, any deficiencies in financial reporting or disclosure must be addressed as early as possible in the process. Understanding the group's debt service capacity and enterprise value will enable the lender to make an informed decision. Consensual restructurings will generally be preferred by private credit funds (particularly where there is a sponsor relationship to be preserved); nevertheless, whether a consensual or non-consensual path is followed, without access to accurate data, investors cannot make basic economic decisions.

Planning ahead

Waivers can provide a stopgap for time to assess the adequacy of information available and to identify potential next steps. Short-term cash flow forecasting is an essential data point where cash is tight and there is therefore a heightened risk of creditor action and an unplanned insolvency filing. Where there is concern around the long-term viability of a capital structure, sponsors and lenders must look further ahead. The company's credit agreement may contain generous permissions negotiated in connection with the original financing that would no longer be appropriate given the distressed nature of the credit. Debt incurrence permissions (particularly for non-guarantor entities or through priority debt baskets), acquisitions, disposals and permitted payments (including dividends and other distributions) are all obvious areas of focus. In addition, relaxing transfer restrictions (a heavily negotiated point in recent transactions) to give investors greater flexibility to exit in the secondary market is also worthwhile.

Less straightforward to address after funding into the original (more healthy) corporate structure are issues such as ensuring a single point of enforcement or remedying deficiencies in security documentation or the intercreditor agreement. Nonetheless, instructing lawyers to review the transaction documentation for material issues that would impede an enforcement will inform lenders' negotiating strategy when the time comes.

In some (but not all) cases, lenders will have concerns around governance arrangements. Those concerns may be logistical since management is often more focused on trying to manage the business recovery to focus on a restructuring. In these cases, supplementing the board with experienced independent directors (or even a chief restructuring officer) can help free up time for the executives to focus on the business. In other cases, sponsor-appointed directors may face conflicts of interest and corporate decision-making around the capital structure needs to be vested in a subcommittee of the board.

New independent directors should not be employees or directors of the lender to avoid the potential for their duties to come into conflict with those of the lender; they should be independently advised and they should take their own decisions to avoid shadow directorship and other lender liability risks.

Local knowledge

In many jurisdictions, lenders must be aware of issues unique to the legal, economic and geopolitical environment of the creditor group. For example, bankruptcy and insolvency regimes vary wildly from jurisdiction to jurisdiction and may help to dictate the relative negotiating power of parties. Another consideration is the potential to become liable to third parties for actions in the lead-up to the insolvency of a counterparty. These concerns should be assessed on a case-by-case basis and local law advice should be taken early to ensure any such issues are properly addressed.

Identifying plan B and any structural or documentary issues

When assessing a potential enforcement strategy, it is vital to check for any pitfalls in either the structure or the documentation. Does the lender have a single point of enforcement (i.e. share security at a level that allows the lender to take the group away from the sponsor)? Are those shares in a jurisdiction where security can be easily enforced without the requirement for an auction or private sale? Does the intercreditor agreement provide the lender with key contractual protections?

Intercreditor dynamics

There are a number of additional considerations for a senior lender in either a unitranche/super senior RCF or a first-out/last-out (also known as FOLO) structure with an agreement among lenders. In the latter case, the sponsor will not have direct visibility on which class of creditor controls enforcement and, therefore, it must negotiate with both constituencies.

The following are some examples to consider:

Acceleration voting: Unitranche lenders typically control enforcement — at least for a period of time while the super senior must stand still. It is nonetheless important to ensure that the unitranche can accelerate the debt under the credit agreement. This will usually be the case where it contributes over two-thirds of the secured debt, but incremental super senior debt may have been incurred so it will be necessary to check.

Value protection: The liabilities release provisions in market standard intercreditor agreements typically include certain fair value provisions requiring that the super senior lenders may only release the unitranche liabilities if super senior enforcement is: (i) by way of a competitive sales process run by an internationally recognized investment bank/accountancy firm; (ii) a process approved or supervised by a court; or (iii) where a financial adviser has delivered a fairness opinion (stating that the enforcement proceeds are "fair from a financial point of view taking in to account all relevant circumstances, including, without limitation, the method of enforcement or disposal"). There are usually no fair value provisions on a majority lender-controlled process provided that the super senior liabilities are paid out in full and in cash. Lenders need to consider how they intend to satisfy these conditions and take steps to ensure that any contingency planning makes provision for these.

Option to purchase: Unitranche lenders typically have the option to purchase the super senior liabilities (and, depending on the documentation, any super senior hedging liabilities) at par following the occurrence of an event of default. While rarely used in practice, if there is a troublesome first-out or super senior lender that is threatening to take preemptive action, the unitranche lender may exercise its option to buy out the super senior lender (particularly given that the first-out is typically a smaller part of the overall debt capital structure). Any super senior revolving facility is likely to be fully drawn at this point and, therefore, would not present the usual operational concerns associated with revolving facilities for debt funds. Ensuring that the intercreditor agreement includes an option to close out the hedging or to transfer the hedge liabilities to third parties is crucial to avoid the need for a debt fund, whose constitution may prevent it from acquiring hedging liabilities, having to request a waiver and therefore depleting its leverage over the super senior lenders.

Plan A vs. plan B

Plan A — the consensual deal

Plan A is a consensual arrangement with shareholders — whether it is a recapitalisation led by the shareholders or, in more extreme cases, the orderly handover of ownership to the lender. The consensual deal — if it can be struck — will always be preferable as it eliminates the risk of a long tail of litigation (however speculative) and provides certainty to all parties moving forward. Nevertheless, it often comes at a price and evaluating risks inherent in plan B are key to establishing how to price plan A.

Plan B practicalities

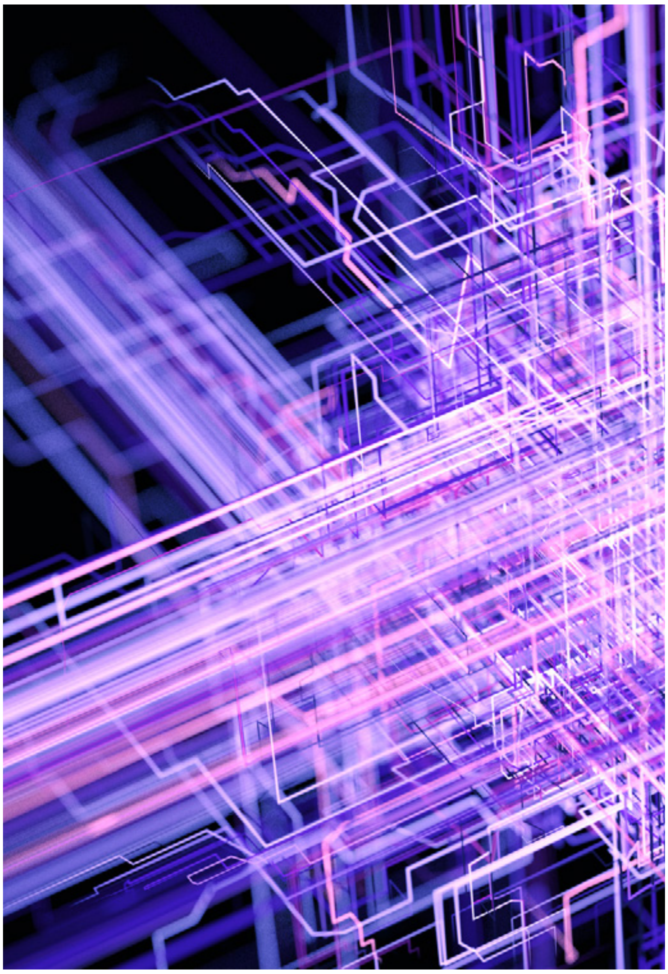
A debt fund may be reluctant to take formal enforcement action against a sponsor portfolio company for a number of reasons. The potential adverse effect on its reputation and relationship with key stakeholders certainly has some influence on a debt fund's strategy and its decision-making in relation to a non-performing credit. However, as noted above, to be in a position to act quickly and to preserve value where a consensual deal with the sponsor is no longer viable, a senior lender should consider "dual tracking" an enforcement strategy at a relatively early stage.

The route the senior lender chooses to adopt will depend on its commercial aims and the perceived commercial and timing pressures. If the senior lender's key commercial objective is to obtain ownership of the charged shares at the earliest opportunity, exercising the right of appropriation in accordance with the share charge and the Financial Collateral Regulations is likely to be attractive, at least for a UK company. However, this option means that the senior lender (or its nominee) must become the owner of the shares from the point of appropriation. In contrast, the appointment of a fixed charge receiver may be a preferred interim step that allows the receiver to establish whether there is a cash buyer available that will allow the lender to be repaid without first assuming the burden of full ownership. Unlike a mortgagee sale, a receiver decides when to sell (and at what price).

In addition to assuming the risk of pricing the sale, a transaction effected through receivership will preserve confidentiality for the benefit of all concerned. Receivership is a self-help remedy available to a secured creditor with the receiver's powers determined by the contract giving the creditor the right to appoint them. The receiver owes their duties to their appointing creditor (albeit with a residual duty to the company). By contrast, funds should be aware that in a prepackaged administration sale, administrators are required to disclose their marketing efforts and provide justification for why a transaction is good for creditors to comply with their professional obligations — the "SIP 16" statement.

They are also required to report to creditors on the outcomes of a case, all of which will be filed with the registrar of companies and be publicly discoverable. An administrator is not only answerable to their appointer — they have statutory objectives that they must seek to achieve and duties that are owed to the general body of creditors. However, if the lender's due diligence uncovers a material defect in the receiver's powers, an administrator who has broad statutory powers may be the only route to being able to transact.

Whichever route is selected, an administrator or a receiver will want to be comfortable that a lender-led deal is consistent with their duties. The case law refers to "the best price reasonably obtainable" or a "proper price."[1] To comply with that duty, a market testing process may be required (note the potential for overlap with conditions to the release of security or guarantees in the intercreditor agreement) if time permits or, failing that, a desktop valuation to ensure that they are comfortable to transact. Where cash bids are received that are close to the senior debt, an independent valuation may be sought to give greater comfort and a paper trail to evidence that a sale to lenders is the "best obtainable."



1 See, for example, Cuckmere Brick Co. Ltd. v. Mutual Finance Ltd. [1971] 1 Ch 949.

In the case of European groups, the position will likely require further investigation. Access to security over shares in a Luxembourg company will simplify matters due to the way Luxembourg has implemented the Financial Collateral Regulations insofar as the collateral is shares in a Luxembourg holding company. Elsewhere, the position is often complicated by local law requirements for a public auction and court scrutiny of any sale to creditors.

Be proactive

Restructuring private credit investments can be considerably more straightforward than public issuers, but they bring their own challenges. Without the possibility of an exit in secondary, fund investors often face a scenario where they must either stick or twist: stick with the existing shareholder either through enhanced economics or through a deleveraging event, or twist and take ownership of the asset. The latter course of action may be the only viable course of action where a shareholder has indicated it is unwilling to continue to devote resources to its investment. However, finding the industry expertise and a willing management team at the right price will be key components in executing this strategy as a path to recovery. However, a proactive approach and the early identification of issues and risks can create options for investors to realise returns from non-performing investments over time for the benefit of themselves and their investors.

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