CREDITOR-ON-CREDITOR VIOLENCE IN EUROPE

Fertile ground or safe harbour?

A generation has now passed since the great financial crisis (GFC)

Quantitative easing and ultra-low interest rates, the twin responses of Western central banks, have permanently altered the shape of global finance. The effects could not be more evident in the leveraged finance market which witnessed unprecedented growth as financial sponsors seized upon the opportunity to acquire large portfolios of businesses. In tandem, the increased competition between those who allocate and manage debt capital resulted in a move to a "covenant-lite" market.

While defaults remain very low overall, in this paper, we highlight some of the ways in which creditor protections in credit documentation have evolved since the GFC, how this can have an impact on sponsor behaviour when a borrower struggles to refinance its debt, and some of the key differences in the way US and European leveraged finance markets respond to these challenges. Those distinctions lead us to conclude that debt investors in Europe are better insulated against the risk of losing value to some of the more aggressive tactics seen today (known colloquially as "creditor-on-creditor" violence).

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When underwriting any investment two fundamental questions we must ask ourselves as debt investors are: will the borrower be able to repay us? And if not, how feasible is it for us to be able to enforce our claim over the debtor's assets in order to satisfy our debt? It is this second question that, since the beginning of the post-GFC credit cycle, has become increasingly complicated for credit professionals.

Certain contractual assurances regarding the operation of debtor's business and its corporate organisation (known as "covenants") have softened as a result of the move to covenant-lite documentation. For example, if certain criteria are satisfied a borrower may be allowed to remove assets from either the collateral package[1] and/or a "restricted group" of corporate entities (which is otherwise designed to keep assets within the easy reach of lenders).

Such changes to the lending landscape have impacted market behaviour, and in particular the way in which companies will look to address upcoming debt maturities in times of financial stress.

In the US bond market, as a means of avoiding costly Chapter 11 proceedings, issuers have historically managed maturities via buy-back programmes or exchange offers in which bondholders are invited to swap existing claims for newly issued instruments with amended terms and extended redemption dates (referred to as "Liability Management Exercises", or "LMEs"). Such deals are usually offered below par to capture some or all of the discount reflected in the market price of the relevant instrument.

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As the loan market has adopted "incurrence" covenants found in bond documentation, LMEs have emerged as a mechanisms for stressed companies to manage upcoming maturities in leveraged finance markets, predominantly in the US.

This trend took an interesting (not to mention unexpected) turn in 2017 when the lenders to J.Crew, (a US fashion retailer) learned that the intellectual property attributable to the core brand had been transferred out of the restricted group and pledged in support of new finance used to repay an entirely different group of lenders, thus setting the stage for a tense stand-off between creditors[2]. As debt markets watched on, participants were left to ponder the uncomfortable prospect that other sponsors might consider similar manoeuvres in the future. In response to the these risks investors have demanded the introduction of stronger contractual protections, but LMEs have also continued to evolve.

[1] The collateral package, or "security", is formed of specific assets which have been pledged by the borrower to satisfy creditor's claims.

[2] The legal dispute that ensued was settled, but J.Crew ultimately filed for bankruptcy in 2020 as its performance suffered during the COVID pandemic.

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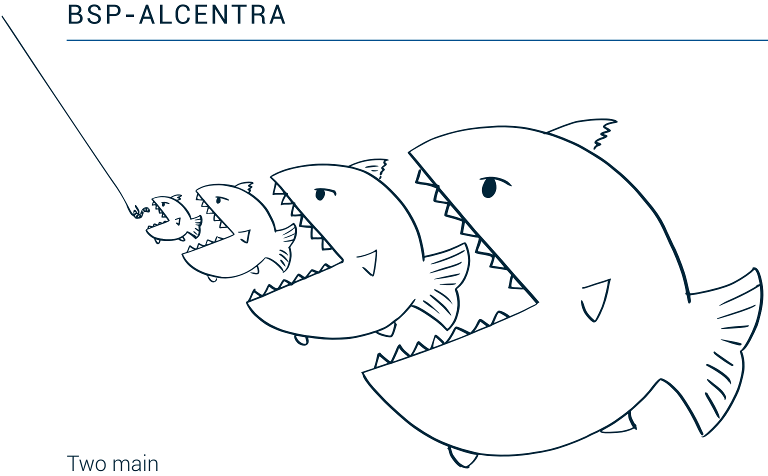

Two main categories have developed in recent years. The first kind (of which the aforementioned J.Crew transaction is an early example), known as a "drop-down" involves the removal of valuable assets out of the collateral package and/or the restricted group (and therefore away from the reach of lenders) and subsequent transfer into a separate legal entity which then raises fresh capital (the proceeds of which can be used to discharge the existing or third-party debt). The second, an "uptier" transaction involves the creation of new debt tranches which benefit from a senior claim over the proceeds of collateral. Multiple variations of these structures have emerged in recent years in the US, though what they all have in common is that they extract value from existing creditors.

A common tactic to incentivise participation in the LME is to require a majority of creditors to vote in favour of amendments to the terms of the existing debt (known in the bond context as "exit consents") which dilute or otherwise remove completely the covenants and/or collateral package. Debt investors, remembering the second question above, may think they have little choice but to play along – holding on to a par claim may not seem attractive when fellow creditors are being placed ahead of you with better quality collateral (even if it is at a discount to par). Moreover, it pays to be large and to be an early mover: it has become increasingly common for debt investors to jostle with each other in a bid to drive negotiations with the sponsor and capture a greater share of the economics in the form of commitment or work fees. This practice earned itself the unenviable nickname "creditor-on-creditor violence" (so called since one group of investors stands to gain at the expense of the rest).

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Given their coercive nature and the potential for tension between creditors trying to stay ahead of the game, LMEs are not uncontroversial, but that has not dampened sponsors' enthusiasm to use them as a way of actively managing over-leveraged balance sheets and plugging shortfalls in liquidity. Aggrieved creditors have not been slow to bring legal challenges in some of the more aggressive cases but, to date, the US courts have generally been unwilling to step in and prevent creditor-on-creditor violence which, from a US (and specifically New York) law perspective, judges have considered to be predominantly a question of contractual interpretation.

The picture in Europe is different: although cases are always fact dependent and can differ from country to country, historically, creditors within the same "class" (that is, creditors holding the same instrument or having similar rights) could generally expect to receive equal treatment in restructurings. And while there have been several LMEs since the end of the COVID pandemic, we believe that idiosyncrasies in the European market mean that the practice is nowhere near as endemic, especially as regards creditor-on-creditor violence.

There are several local factors behind this.

In particular the size of restructuring market in Europe relative to the US, and the nature of finance transactions (which are often private and relationship driven), mean sponsors may be less willing to resort to strong-arm tactics if that might jeopardise future deal-making. Similarly, lending syndicates and bondholder groups (concentrated in financial centres such as London, Paris and Frankfurt) take a collaborative approach, tend to prefer collective solutions (both inside and outside formal legal procedures) and have less appetite to engage in disputes or litigate against one another when compared to their US counterparts. The fees that creditors receive for providing assistance in negotiating restructuring transactions are also comparatively modest[3]. And the adviser community, smaller but well connected, may help to build early consensus when restructuring solutions are in a developmental phase.

[3] Local courts can have a limiting effect in this regard. For example, in the UK, judges will scrutinise the payment of fees in court supervised restructurings. If they are considered material this will complicate the court's ability to approve the transaction.

Domestic (European) laws also play an important role. English courts, for example, have refused to recognise the validity of exit consents (which, as noted above, rely on a majority of creditors approving amendments that will deprive non-participating creditors of protection) on the basis they are a form of abuse of power[4]. In this regard the choice of law (that is, the laws which the parties to the financing transaction select to govern the terms of the documentation and decide any disputes) will have a bearing on the ways creditors can be treated and the way they may behave towards one another[5,6]. As noted above, New York law is more permissive of different treatment of creditors within the same class compared to the laws of European states.

In addition, insolvency laws which underpin directors' duties in many European countries tend to impose greater liability on the officers of companies which subsequently become insolvent (a real possibility if the LME fails to achieve its desired effect). And in the most extreme cases, this can extend to criminal liability. We believe this will continue to have a chilling effect on the boards of European companies contemplating the most aggressive tactics.

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Formal, court supervised, restructuring procedures have also gained much ground in Europe in recent years and offer a comparatively inexpensive means (when compared to the costs associated with Chapter 11 proceedings in the US) of reorganising balance sheets. The introduction of cram down features within the European legal framework is also making it easier to create holistic solutions which can address the full range of a company's indebtedness (as opposed to LMEs whose scope may be tempered by the level of creditor support between financial instruments)[7]. Whilst local procedures differ from country to country, and some jurisdictions are still developing the necessary expertise to deal with more complex transactions, supra-national efforts to modernise and harmonise restructuring laws mean that outcomes in Europe are becoming more aligned. Within this context restructurings will become increasingly subject to some form of judicial scrutiny, and attempts to confer disproportionate benefits to small groups of creditors (at the exclusion of others) will be open to legal challenge. We see this as a growing strength of a market in which investors have sometimes felt uncomfortable about the unpredictability of outcomes (excluding the UK at least) in restructuring transactions.

Conclusion

LMEs have become a well-established feature of the leveraged and syndicated credit markets in the US as a result of more permissible credit documentation becoming the new norm. We note that in recent months there has been growing chatter in the markets about whether some borrowers (and their owners) may explore LMEs in Europe. Occasionally this is accompanied by rumours of private deals being pushed by unidentified actors which threaten to pit creditors against each other. To date, however, we have yet to witness anything similar in scope to the type of activity seen in the US and recent noises may be little more than negotiating tactics designed to unsettle investors.

The issue remains, in our view, that plans to copy some of the more aggressive deal structures in the US will not survive contact with the reality on the ground in Europe. Indeed, we believe that the conventions of the European market as well as the domestic legal regime will act as an important check, continuing to provide debt investors with downside protection going forward.

[4] Known as the "Redwood Principle" after a case of the same name. The English High Court most recently considered exit consents in a 2012 case (Assénagon Asset Management SA v Irish Bank Resolution Corp Ltd).

[5] Choice of law is also important as it often (but not always) will decide the forum of formal restructuring proceedings. A European issuer is of course free to select NY law (which we note has been the governing law of most LME transactions in Europe) but a subsequent restructuring or insolvency procedure could also take place elsewhere, most likely in the country where its primary business is located.

[6] European documentation also offers a degree of additional protection. Intercreditor agreements (a feature of the leveraged loan market) often restrict a borrower's ability to introduce additional tranches of senior "priming" debt without the consent of all affected lenders. "Whitelists", which allow the transfer of debt only to pre-approved lenders, may limit the ability of certain institutions to join syndicates.

[7] In the UK, the "Restructuring Plan", which was introduced during the COVID pandemic, has seen much use. Similar procedures in France, Germany, the Netherlands and Spain, all modelled to varying degrees on Chapter 11, have made their way into in law in recent years.

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