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UPDATE: Cross-border Leveraged Lending – Consider Changes Needed to US Intercreditor Agreements for Financings with European Elements

Hybrid US/European restructurings can lead to unexpected commercial outcomes because of different practices in intercreditor agreements.

The US loan markets continue to attract European borrowers whenever US pricing dips below its European counterpart. Over the last twelve months the number of credits coming to the US loan market with significant European components has continued to increase. While the terms and conditions of US credit agreements may not need substantial adjustment to reflect the inclusion of European loan parties, there likely will be some provisions borrowed from European loan documentation, particularly with respect to the guarantee and collateral package. More significantly, however, structuring issues will arise that will not be immediately apparent to market participants more familiar with US financing structures and documentation. The document that best illustrates this is the intercreditor agreement, in which the approaches on the two sides of the Atlantic differ dramatically. This article discusses modifications to US-style intercreditor agreements that would be desirable if European loan parties are involved, whether as borrowers or guarantors.

The underlying reason for this cross-border duality is that the US Chapter 11 of the US Bankruptcy Code provides many restructuring tools, with an automatic stay on steps to enforce claims, valuation principles, the ability to sell the bankrupt business free and clear of any remaining claims and debtor-in-possession financing — all of which are made applicable by operation of law. In the absence of consistent equivalent statutory provisions across Europe, the European intercreditor agreement provides for many of these principles contractually.

This contractual response in European deals is meant to address the continuing concern that insolvency processes in Europe have the real potential to destroy the value of the debtor company. Certainly not all such processes do, and many European jurisdictions have taken significant steps to introduce more restructuring-friendly and rescue-driven laws, often based on Chapter 11. But both European debtors and creditors retain a far greater sensitivity to the negotiating leverage that the various creditor classes may have to force an insolvency filing, thus potentially threatening the whole restructuring and the likely recoveries of all creditors. This leverage can be exercised by junior creditors pressuring a distressed borrower through demanding payment and threatening other actions, not only against the debtor itself but also against the members of the debtor's board of directors who may in certain circumstances in many European countries face personal liability for continuing to conduct business while their company is insolvent. This leverage can sometimes leave directors little option but to put their company into a formal bankruptcy proceeding, which likely will be considerably more value destroying than lenders in the US would expect and will lead to poorer economic outcomes for all creditors. Indeed, a significant feature of

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the restructuring market in Europe for many years has been the use of extra-statutorial or non-statutorial techniques that junior creditors, particularly buyers of distressed debt, adopt in order to get a seat at the table.

Typical Provisions Included by Contract in Europe

To address this phenomenon in the absence of the Chapter 11 framework, the typical European intercreditor agreement explicitly provides — by contract — for a number of features that local European commercial and insolvency laws do not consistently provide, including:

- **Standstill** Comprehensive standstill on the enforcement not only of liens on assets, but also on making claims on the underlying direct debt obligations and guarantees

- **Scope of creditors** More extensive range of creditor parties included as parties to the agreement, *e.g.*, swap providers and banking service providers, shareholder subordinated debt providers and, sometimes, equity investors who make loans or invest in preferred shares, as well as intra-group creditors — if their intercompany receivables exceed a threshold designed to establish a materiality benchmark; indeed, in recent months, a growing trend has even required that third party financial creditors of subsidiaries of the borrower sign up to the intercreditor agreement

- **Release of junior debt claims** Provisions that effectively automatically release junior debt claims — with respect to the direct underlying debt claim itself and also with respect to any liens that secure the debt — upon the occurrence of "distressed dispositions," which can include both disposals by way of enforcement of liens in the collateral as well as consensual disposals during a restructuring process; these are typically accompanied by forced transfer provisions in which, as an alternative to outright release of the claims, the security trustee can acquire the creditors' claims (to avoid the adverse tax effect that otherwise might result from outright forgiveness)

- **Limitations on amendment** Restrictions on modifications of the tranches of debt that are subject to the intercreditor arrangements

- **Debt purchase option** Provisions are included to enable junior classes of creditors to buy out senior classes at par upon, and in some cases prior to, enforcement

Significant European Differences

Although many of these features will be familiar to many US loan market participants, other aspects of the European credit landscape to consider when structuring a cross-border financing differ significantly from the US and include the following:

- **Variations in recourse** Significant variation in upstream and cross-stream recourse under guarantees due to local corporate benefit issues, meaning that structurally senior creditors lending to subsidiary operating companies can have better recourse than lenders to acquisition vehicles higher up in the corporate organizational structure

- **Financial assistance laws** Providers of acquisition financings may not have direct recourse to the value at the target and its subsidiaries

- **Personal liability** Board members' personal liability if the company continues to incur debts when insolvent

- **Collateral package issues** Complex and variable collateral packages across Europe reflect several issues that mean collateral packages in some jurisdictions often can be incomplete; in some jurisdictions such as the UK and Ireland comprehensive collateral is easily available; in others, collateral may be limited either due to cost, *e.g.*, registration fees and notarial fees, or practicability, *e.g.*, due to the need to specify individual items of equipment when acquired or where collateral interests over physical property require possession; the widespread use of “agreed security principles” (effectively, carve-outs from the collateral package to address local law limitations and also to recognize limitations on the practical utility and commercial value of taking security relative to the cost of perfection and enforcement)

- **Fear of bankruptcy** The continuing concern, despite some changes in bankruptcy laws, that being subject to a formal bankruptcy proceeding is likely to destroy value

- **Typical bankruptcy protections inconsistent** Standstill (*i.e.*, mandatory stay on enforcement) and release provisions may now be more available by operation of law in certain jurisdictions since the time European intercreditor agreements first began developing, but not sufficiently consistently to avoid the need to adopt explicit contractual protections in intercreditor agreements.

Unexpected Differences

In addition, some features of European restructuring practice differ significantly from US practices and expectations, with the likelihood that European restructurings will follow a course a typical US creditor might not expect:

- **Single point of enforcement** The enforcement sale of the business by first lien creditors is often the principal tool to establish leverage against both the equity owners of the business and junior creditors, whose claims would be released pursuant to the automatic release provisions contained in European-style intercreditor agreements; and for this reason a “single point of enforcement” is often critical from a structuring perspective (*i.e.*, the ability to sell the business by enforcing a stock pledge over a single entity high enough up in the group structure to capture the value of the business as a whole as a going concern). The importance of this tool is because, first, enforcement of an equity pledge in many European jurisdictions is a swift means of realizing value, and often not subject to any automatic stay or other similar bankruptcy or other statutory rules, and, second, exercising such enforcement rights may be necessary in order to trigger the debt claim and security release provisions contained in European-style intercreditor agreements. Moreover, since in many jurisdictions the collateral package may have significant exclusions due to the operation of the “agreed security principles,” the ability to exercise the right to enforce the equity pledge is often critical in order to capture any value from those assets that were excluded from the collateral package.

- **Dealing with holdouts** The emphasis on out-of-court, consensual processes requiring amendments and waivers under the documents governing the company’s existing debt arrangements does result in senior creditor groups availing themselves of local law processes outside bankruptcy to buttress their positions in restructuring scenarios, in particular to stand up to holdouts (*e.g.*, the UK scheme of arrangement can be used to override provisions that require unanimous lender vote under English law credit agreements, through a debtor-led procedure requiring the approval of at least 75 percent in amount and a majority in number of the relevant class of creditors (which could be the lenders under a single specified credit agreement))

Implications

Just as US lenders may not expect the European-style differences, so US lenders may not anticipate several, often unfavorable, outcomes.

Example: first/second lien deals The second lien product in the US has structural elements that are different from the "classic" European junior debt (*i.e.*, European mezzanine). A typical US second lien term loan has lien subordination, but not subordination of the direct debt claim itself, which means that security interests are ranked in order of priority, but that creditor claims against unencumbered assets not forming part of the collateral package are not ranked and, instead, are treated of equal priority with the first lien debt. In a US intercreditor arrangement, the standstill as it applies to the second lien debt relates only to the right to take enforcement action in respect of the collateral, but does not affect the underlying debt claim. European mezzanine and other forms of junior debt have full lien ***and*** debt subordination and a full standstill (and payment blockage provisions as well). When importing a US second lien structure to Europe, and layering on top of that the sponsors' use of "agreed security principles," often the first lien debt and second lien debt governed by an unalloyed customary US-style suite of credit documentation will, in fact, rank *pari passu* as regards one another in respect of those assets of European guarantors that are excluded from the collateral package. This *pari passu* rank is a very advantageous position for holders of US second lien debt and is not consistent with commercial expectation. Second lien debt claims can be enforced, thus giving second lien creditors whose position is governed by a US-style intercreditor agreement the ability to exercise significant leverage and thereby win a seat at the table. The worst case scenario for the junior creditor may just be a bankruptcy in which they would rank *pari passu* with the first lien on some classes of operating assets and/or real estate that may, for cost and/or practicality reasons, be excluded from the collateral package. Some — but not all — US-style first/second lien financings for European groups depart from the customary approach of US-style intercreditor agreements and add claim subordination in order to most closely approximate the economic outcome obtainable if Chapter 11 were available. By subordinating both the direct debt claim against European borrowers and guarantors and the liens securing those claims, economic recoveries can more closely approach the levels that would be expected if Chapter 11 were available.

An unmodified US-style intercreditor agreement will also allow junior creditors leverage against European loan parties because in many European situations European loan parties enjoy no ability, absent a contractual mechanism, to sell assets free and clear of both debt and security claims. In a domestic US first and second lien intercreditor agreement, the second lien lenders will be obliged to release collateral if the first lien lenders so agree, but these release provisions frequently do not extend to the underlying debt obligations and related guarantees, again providing an unexpected degree of leverage to secured lien lenders in European deals with European guarantors.

Example: other secured creditors The leverage available to creditors who are not subject to standstills has other consequences. In the US, lender-affiliates who are swap providers or providers of cash management and other banking services typically share in the first lien collateral package, but do not vote on decisions whether to accelerate or enforce remedies and such lender-affiliates do not customarily sign the intercreditor agreement. Such types of junior creditors potentially have more leverage in a workout involving European borrowers or guarantors if the US-style approach is used without modification because the junior creditors are not subject to a standstill on the exercise of their claims and as a result may have the power to force the company into bankruptcy. Notably the European intercreditor agreement deals with these creditors in the opposite manner, by binding them into the intercreditor agreement, and giving them a vote on enforcement, but imposing on them a standstill.

Example: structural priority is critical Other features of US documentation and structures can result in unintended and unexpected effects if imported into Europe without adjustment. For example, debt baskets in the US typically do not legislate where debt can be raised in a corporate family structure. And while the ***concept*** of structural subordination is important in the US, since upstream guaranties in some European jurisdictions are limited in value compared to upstream guarantees provided by US (or UK) based subsidiaries (that is, they often are limited to "free" share capital or cash actually received from the guaranteed financing, and other similar restrictions; and collateral may be surprisingly limited in scope due to exclusions based on the "agreed security principles") concerns about structural subordination in Europe are exacerbated and the effect on recoveries can be more dramatic.

Credit agreements that permit debtors to raise a not insignificant amount of new debt from third-party financing sources (as many do) can result in unexpected consequences when applied to European deals, aside from the question of who has the first claim on repayment. The importance in Europe of release provisions has already been described, but due to the protections Chapter 11 affords secured lenders, the practice in US-style credit documentation does not require that providers of new senior unsecured debt enter into any sort of intercreditor arrangements. In US deals, providers of new debt are not required to sign up to the intercreditor agreement unless they are sharing in the security package. As a result, quite possibly new debt incurred pursuant to a debt basket that permits the raising of unsecured debt will be incurred at a subsidiary of the borrower and therefore be structurally senior to the senior secured facility and, in addition, enjoy an outsize negotiating position by virtue of the fact that the subsidiary is not encumbered by the terms of the intercreditor agreement. In an enforcement scenario, the senior secured creditors could find themselves unable to sell the business as a going concern unless they can reach a consensual solution satisfactory to that unsecured creditor.

These structuring issues are only now receiving attention in Europe as the use of more and more flexible debt baskets and incremental debt becomes more common due to US-style credit agreement provisions being folded into European deals. We see pushback on these structuring issues, but the topic is very much alive. For example, third party providers of debt to subsidiaries, if providing debt over a certain threshold, even if unsecured, may be required to accede to the intercreditor agreement to ensure that as a whole the creditors of the company realize the commercial benefits intended by the intercreditor provisions, such as the release provisions.

Effect on documentation Of course, the key question here is to what extent the above issues are being reflected in US syndicated and documented deals for European groups of companies. At present, the answer is mixed. Unquestionably the market is focusing more attention on these issues than a year ago, but the approach varies, often dependent on a number of factors — including the sensitivity to these issues of the particular arrangers and sponsor and their respective legal counsel. The approach varies from making no, or relatively few, adaptations to customary US-style intercreditor agreements, to adopting full Loan Market Association (LMA)-style provisions that are generally "adapted" to a New York legal drafting style. No market norm exists, as yet, nor have these documents been tested in the crucible of an actual European restructuring. However, although these issues may initially be considered to be more creditor oriented, we consider these changes important to sponsors as well, since providing junior creditors excessive leverage in a workout can come at a cost to the sponsor.

Conclusion

Given the differences between the US and European intercreditor agreements, we would draw some parallels with the historical development of European structures and documentation to show why these structuring and documentation provisions are important. Twenty years ago, a European intercreditor agreement was a relatively standard and simple document, frequently negotiated by different teams at the same law firm separately representing senior and mezzanine creditors, and generally given little attention. Today's European intercreditor agreement have evolved under the influence of unexpected commercial outcomes actually realized in restructuring scenarios that came to pass due to the lack of the sorts of protections that are now commonplace in European structures. Such unexpected outcomes have included instances in which:

- Senior creditors were not able to sell a business freely due to lack of release provisions, thus giving the junior creditors a considerably better economic position in a restructuring
- Creditors not subject to intercreditor agreements have been paid out in full in order to make a restructuring possible (particularly where a creditor is relatively small in the context of the total debt and party to its own separate agreement with the debtor)
- Structural subordination resulted in the first European high yield investor revolt in the early 2000s because high yield was originally issued in a holding company without guarantees from the senior secured bank debt loan parties, resulting in extremely low recoveries on defaulted deals
- The lack of conditions to release provisions meant little value protection for junior creditors if those provisions were effective

The common theme here is that today's European intercreditor provisions resulted from these experiences, which came to light in restructurings of credits with these features. We have not yet witnessed any restructuring of these hybrid US/European deals to bring these issues to light, but European experience indicates such restructurings may be more problematic if the intercreditor agreement does not include provisions dealing with European restructuring issues.

Among the matters discussed in this article, we believe that including European-style "release provisions" and limiting the leverage of junior creditors, if possible, (either through a European-style remedy bar or by subordinating unsecured debt claims against European loan parties) are particularly important.

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