EUROPEAN Restructuring Outlook: CONSIDERATIONS FOR LENDERS

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As Europe prepared to emerge from the COVID-19 pandemic and navigate the resultant uncertain economic environment, Russia invaded Ukraine in February 2022, plunging the continent into disarray once again. The unprecedented pandemic followed on the heels of Brexit, which itself will have lasting impact on the region. In light of these events, together with recent legislative changes across Europe, the impact on the European credit markets going forward should not be underestimated.

Although businesses have continued to have access to liquidity in the market, ongoing supply chain disruptions, increasing pressure on central banks to tighten monetary policy to counter inflationary pressures, volatile commodity prices, and a brewing energy crisis may nevertheless cause delayed distress to debtors, and lenders are likely to see more opportunities to lead financial restructurings with a view to preserving value and maximising returns.

The Current Credit Environment

Notwithstanding the various macroeconomic shocks, European credit markets have remained buoyant. The accumulation of dry powder during 2020 has meant that liquidity is now more readily available. Private credit, for example, is currently at record levels. According to Preqin, $63.2 billion of private debt was raised in 2021, compared to $51.5 billion in 2020 (**Figure 1**). Similarly, European high-yield issuances recorded by XtractResearch increased by 51 percent between 2020 and 2021 (**Figure 2**).

However, despite the increased dealmaking, there are a number of macro factors that point to a potential rise in distress within the UK and Europe and, consequently, an increase in potential restructuring opportunities.

COVID-19. While vaccination rates within Europe are relatively high, the aftereffects of COVID-19 may still impact borrowers and issuers. The unprecedented levels of government support have artificially propped up a

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Figure 1: Value of Private Debt Raisings between 2017 and 2021 ($bn)

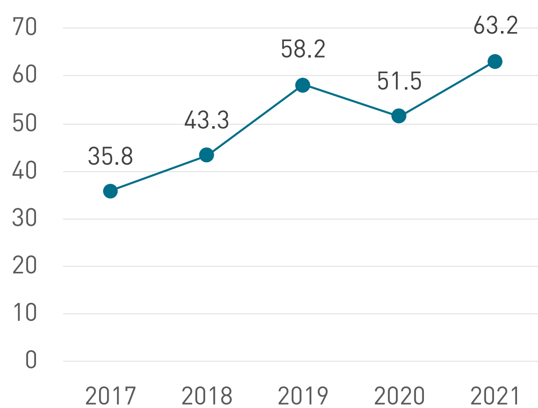
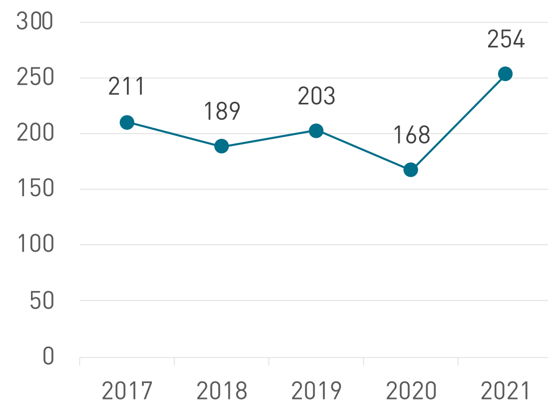


Figure 2: Number of European High-Yield issuances between 2017 and 2021



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number of "zombie companies"—*i.e.*, companies that, notwithstanding COVID-19, were already unviable. The tapering of support measures is likely to compel these companies to consider various restructuring (or insolvency) options as contractual forbearance/standstill arrangements come to an end and creditors, seeking to maximise returns or recoveries, become less inclined to factor in COVID-19 or any potential reputational implications when assessing business viability.

COVID-19 also remains rampant in some parts of the world, most notably in China. Although measures are being taken to keep critical operations open, rising infections may nevertheless compromise European supply chains reliant on Chinese manufacturing for the near future.

Geopolitical Instability. The ongoing Russia-Ukraine conflict and subsequent sanctions have already caused an uptick in restructuring activity in those regions. Whilst sanction regimes have been stifling the ability for Russian issuers to make credit repayments, Ukrainian issuers (often with otherwise viable businesses) have had operations compromised as local transport routes have been gridlocked, exports ceased, and, in some cases, facilities destroyed as a result of military activity. Holders of Russian and Ukrainian paper will undoubtedly be considering restructuring options, with some Ukrainian issuers already engaging with creditors to negotiate waivers, grace periods, and other contractual amendments in light of recent payment defaults.

The ripple effects of the conflict may also impact companies across Europe. The volatile increase in oil prices is a notable example. Not only will a scarce and more expensive oil supply erode margins for companies already having to deal with COVID-related headwinds, but sectors such as automotive/auto parts are particularly exposed, as rising fuel prices may drive down vehicle demand among consumers who are already subject to a cost-of-living crisis as a result of various inflationary pressures.

Figure 3: European Restructuring Regimes - Summary of Key Features

	England and Wales Restructuring Plan	**The Netherlands** WHOA	**Germany** StaRUG	**France** Accelerated Safeguard
Entry conditions	Debtor must have encountered or be likely to encounter financial difficulties affecting its ability to carry on business as a going concern.	Imminent illiquidity required (debtor can reasonably expect that it will be unable to continue to pay its debts).	Imminent illiquidity required (debtor is unable to satisfy its payment obligations within the next 24 months, but not available if already illiquid or over-indebted.)	Debtor must be engaged in a conciliation procedure and face financial difficulties, provided it is already not insolvent.
Jurisdiction requirements	English companies and foreign companies with a "sufficient connection" to England and Wales.	COMI or an establishment in the Netherlands (public plan), or a sufficient connection (private plan).	COMI (public plan) or a registered office or sufficient connection (private plan).	COMI
Debtor in possession	Yes	Yes	Yes	Yes
Cross-class cram-down	Yes	Yes	Yes	Yes
Voting threshold	75% in value of each class (unless cross-class cram down used).	Two-thirds in value of each class (unless cross-class cram down used).	75% in value of each class (unless cross-class cram down used).	Two-thirds in value of each class (unless cross-class cram down used).
Court involvement	Yes – a convening hearing and a sanction hearing.	Yes – ratification hearing required to approve the plan.	Required for complex cases or if the debtor requires an in-court vote.	Yes – court approval is required to commence the proceedings and to approve a restructuring plan.
Moratorium/Stay	Not automatic but can be combined with administration moratorium.	Yes – maximum period of eight months.	Yes – three months (which can be extended up to eight months).	Yes – not applicable to debts incurred to assist with plan implementation or services provided after proceedings commenced.
New money protections	No specific protections.	Court-approved financing available while working toward a plan. Cannot be invalidated if the plan fails.	Court-approved financing necessary for the restructuring. Protected from clawback claims in the event of a subsequent insolvency.	Court-approved financing available or implemented via restructuring plan. Cannot be compromised in a subsequent restructuring and will receive preferred status in a liquidation.
Recognition	Not automatically recognised in Europe. Based on principles of international law.	Automatic recognition of under EU Insolvency Regulation if requested.	Automatic recognition of public plans under EU Insolvency Regulation from 17 July 2022. No automatic recognition for private plans.	Automatic recognition under EU Insolvency Regulation.

Competitive Lending Environment. In light of the increased need to deploy vast amounts of unused capital, credit providers are essentially in competition with each other. A corollary of this increased competition is, at the very least, a continuation of covenant-lite (cov-lite) financing but also a potential shift to even more borrower-friendly terms. This may lead to signals of distress that would normally be detected by traditional covenant packages flying under the radar and invariably placing more risk on lenders (even if these risks are priced into credit agreements).

In 2021, cov-lite deals accounted for 87% of European loans.[1] Ordinarily, traditional covenant packages would include maintenance covenants requiring borrowers to meet periodic financial performance benchmarks with a failure to do so constituting a default under the loan agreement. Though inherently restrictive on borrowers, maintenance covenants would allow for red flags to be identified faster, giving lenders longer lead times to engage with borrowers with a view to agreeing to a solution, whether a waiver, standstill, or a full restructuring.

Cov-lite loans are significantly more relaxed, with minimal or nonexistent maintenance covenants preventing lenders from identifying warning signs on time. Typical cov-lite features include looser restrictions on debt incurrence, both on a secured or unsecured basis, which, absent any contractual priority arrangements between lenders, would dilute recoveries in an insolvency scenario. EBITDA addbacks are another typical cov-lite feature (*i.e.*, the ability to add back certain expenses to earnings figures) that boosts a borrower's EBITDA. Inflated EBITDA levels could enable a borrower to take certain actions on the basis of its leverage ratio being below a certain threshold—*e.g.*, incurring further debt, granting security, or disposing of assets—effectively painting a picture of leverage that is vastly different from the reality.

Although there is an argument to be made that cov-lite loans actually reduce the number of defaults due to covenants not being tripped as often, any signs of distress that go undetected for lengthy periods are more likely to require a full restructuring by the time the severity of the problems becomes apparent to lenders.

With increased restructuring opportunities seemingly on the horizon, both the UK and now certain EU member states have either refined or overhauled their restructuring regimes at an opportune time. However, unlike traditional and frequently utilised English law restructuring tools, such as schemes of arrangement, these new regimes are still in their infancy and their effectiveness, especially from a lender perspective, remains to be seen.

Legislative Changes

In 2019, the EU published its new Restructuring Directive[2] to harmonise restructuring regimes across member states and provide a more robust yet efficient framework to assist debtors in financial difficulties. Although the 2015 European insolvency regulation[3] was a positive step toward improving comity by, among other things, allowing for the automatic recognition of insolvency proceedings across EU member states, the effectiveness of individual restructuring and insolvency regimes still varied greatly. This was further compounded by the fact that the popularity of the English scheme of arrangement meant that European debtors would often "forum shop" to commence proceedings in the UK.

EU member states originally had until July 2021 to transpose the Restructuring Directive into domestic legislation (since extended to 2022 in many cases), although the economic consequences of COVID-19 accelerated plans for implementation in certain instances. Most notably, the Netherlands (WHOA), Germany (StaRUG), and France (Accelerated Safeguard) have each introduced new or amended regimes (**Figure 3**).

To ensure that distressed debtors had the greatest chance of being rescued on a going concern basis, the Restructuring Directive required member states to implement certain core features, including:

- **Cross-Class Cram Down (CCCD).** Originally developed as part of U.S. Chapter 11 proceedings, this mechanism allows for dissident creditor classes to nevertheless be bound by the terms of a restructuring. While clearly an effective tool in favour of debtors, the restructuring directive seeks to maintain parity between creditors

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and debtors by ensuring that the terms of a restructuring must be an improvement on the relevant alternative, such as a liquidation, for a CCCD to be utilised.

While the introduction of a CCCD mechanism is mandatory, inclusion of the "absolute priority rule" as a means to further protect creditors is only discretionary, although the Netherlands, Germany, and France have each adopted it to varying degrees. The absolute priority rule is the requirement for crammed-down classes to be paid in full prior to a more junior class receiving a distribution as part of a restructuring, which is a core tenet of U.S. Chapter 11 proceedings.[4]

- **Stays on Creditor Action.** To grant greater flexibility and breathing room to debtors during negotiations, the restructuring directive also requires member states to introduce a mechanism preventing creditors from taking action for a period of four months (to maintain a fair balance between debtor and creditor rights) or no longer than 12 months in more complex situations. The extent of this protection is discretionary among member states.

- **New Money/Interim Financing Protections.** For each of the new Dutch, German, and French proceedings, court-approved financing may be provided to a debtor during the restructuring for additional runway. Certain protections are afforded to lenders for taking on this credit risk, such as protection from any potential

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clawback or voidability provisions. In the case of France, any new money financing is carved out from the stay on creditor action and also receives preferential status in a subsequent liquidation, similar to debtor-in-possession (DIP) financing in the United States.

However, the DIP financing framework in the United States has been around significantly longer and is far more established than what the Restructuring Directive seeks to do. Whilst the granting of priority status is optional under the restructuring directive, U.S. DIP financing allows for, among other things, liens to be granted despite the existence of pre-bankruptcy security, as well as super-priority status over pre-bankruptcy claims and administrative expenses incurred during the Chapter 11 proceedings.

Although the UK's exit from the EU meant that the Restructuring Directive was not required to be transposed into English law, the Corporate Insolvency and Governance Act 2020 (CIGA), which introduced the new restructuring plan, was implemented with elements of the restructuring directive taken into consideration, such as the CCCD and a standalone moratorium process (although this is not available for financial indebtedness). The UK government currently has no intention of implementing a DIP financing mechanism or the absolute priority rule, with any priority arrangements or other protections having to instead be negotiated contractually through an intercreditor agreement.

The Balance of Power

The implementation of the Restructuring Directive as well as the English restructuring plan appear to emphasise rescuing distressed debtors, as opposed to protecting value for lenders. This can be seen by the somewhat limited protections the restructuring directive affords to new money lenders (compared to a Chapter 11), and even more so by the reluctance of the UK government to introduce DIP financing as part of a restructuring plan.

Furthermore, the introduction of the CCCD allows debtors to disenfranchise creditors with more ease than previously, as has been seen in recent English restructuring plan cases.[5]

The CCCD enables senior secured creditors to be crammed despite rejecting the plan, provided the two conditions of: (i) a class with a "genuine economic interest" voting in favour of the plan, and (ii) the no-worse off test for the dissenting class in the relevant alternative is satisfied, as was seen in the *Amicus Finance* English restructuring plan, where junior creditors also approved the plan.

Whilst the argument can be made that restructuring proceedings in Europe need to be debtor friendly to appropriately address the current economic environment and avoid a wave of preventable insolvencies, as more restructuring opportunities present themselves, protections for both junior and senior lenders nevertheless need to remain in place through the use of intercreditor agreements to mitigate against the risk of losing all bargaining power.

Distressed lenders at the junior level are at risk if value is considered to "break" within their debt or higher up the capital structure, as a restructuring may result in these creditors being successfully crammed down or excluded entirely due to being out of the money. Senior lenders are also at risk of being "primed" by a super-senior creditor entering the capital structure to provide emergency funding. In *Smile Telecoms*, super-senior financing was provided as part of its first English restructuring plan in 2021, with this super-senior lender subsequently being the only class eligible to vote under its second English restructuring plan, as the remaining creditor classes, including the senior secured lenders, all were out of the money.[6] J

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[1] XtractResearch (Deal Data).

[2] Directive 2019/1023 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.

[3] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings.

[4] However, holdout creditors may tactically rely on this rule to achieve a better restructuring outcome or to provide leverage during negotiations.

[5] For example, *DeepOcean*, *Virgin Active*, and *ED&F Man*.

[6] This ability to exclude out-of-the-money creditors is permitted under section 901(c)(4) of the Companies Act 2006.