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European bank and bond restructurings – a practical guide

With European high yield default rates at historic lows, the structures that have developed over the last few years have been subject to only limited review in the context of a European restructuring. A number of European high yield transactions, however, have recently been and now are being carefully analysed from a restructuring perspective, both by existing creditors and new investors looking for opportunities. Clifford Chance has produced a guide which helps clients to navigate the increasingly complex area of restructurings when both high yield and loans are present, and below experts discuss European high yield's idiosyncrasies and how those might play out in the event of a credit problem.

The European high yield restructuring landscape is a fast-evolving beast. In light of unstable macroeconomic conditions, the sheer scale of high yield issuance in Europe in recent years has put the topic front of mind for both existing investors looking to protect their positions, and new investors seeking opportunities. The European high yield market has had successive record breaking years since 2012 with 2014 seeing more European high yield issuances than ever before.

2014 was another record-setter year, but while the supply keeps coming to satisfy investor demand for yield, it is creating challenging credit issues in the form of weakening credit quality, jurisdictional risk and covenant erosion. This means that from a restructuring perspective there is a pipeline building.

"These dynamics provide opportunities for those in the secondary market who might seek to invest in these deals at the distressed stage," says John MacLennan, a Clifford Chance restructuring partner. "Also, for investors at the front end, understanding how these restructurings might play out is key to protecting their interests and minimising risks."

Defining European high yield

Whilst originally a US product, the European high yield bond has now developed to such an extent as to be viewed as distinct from its American forefather. European issuers are typically incorporated or formed in Europe, they are subject to European insolvency regimes, often with a number of subsidiaries in Europe that each provide guarantees and security subject to local law limitations. They have credit agreements and intercreditor agreements that are typically governed by English law and a range of key stakeholders that would not be seen in the US context, such as pension trustees and works councils.

Michael Dakin, a Clifford Chance high yield partner, says: "High yield has grown and developed its own identity in Europe that is fundamentally different to the US. In the US we rely on Chapter 11 across all 50 states to apply uniformity to the insolvency process. It's very different in Europe with each member state having its own insolvency law and that has a critical impact."

Some key features of high yield that affect the restructuring process are:

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> Michael Dakin, Partner, Clifford Chance, London

- **It is a publicly traded debt security** – which means it is listed, securities law applies, and there are restrictions on the type of and timing of the information that can be provided to investors.
- **It is a contractual arrangement whereby covenants are incurrence-based** – so it does not impose affirmative requirements on an issuer to do anything, unlike maintenance-based covenants that call for certain conditions to be met to avoid default. As a result, it is very difficult for an issuer to involuntarily default which limits the ability of creditors to impose solutions.
- **Documents are precedent-driven** – so there is no single-form documentation, and every deal is contracted differently. The result is a significant variation in terms, and in a restructuring situation the specifics of every deal must be looked at carefully.
- **Today's structures see high yield notes as senior secured obligations, sitting side-by-side with loans and other creditors and are often the majority of the outstanding debt** – giving bondholders a real seat at the table in restructuring negotiations, a position which is a new phenomenon in Europe.

The European structure

In terms of senior secured notes, there are two main structures that have developed for European high yield deals. First is the super senior revolving credit facility (SSRCF) structure, where the term debt in the structure is a high yield bond, there is no other senior secured term debt in the structure, and there is a relatively small revolving facility providing working capital that sits alongside it but at a super senior level.

The second structure is the *pari* deal, where the term debt is a combination of high yield and leveraged loans, and in those structures, the loan and the bond sit alongside each other and share a common security package on a *pari passu* basis.

Most European deals have tended to use the SSRCF structure in recent years in quite large volume, and Clifford Chance estimates there to have been more than 40 such deals done in 2014.

There are four key features of these SSRCF deals:

- **Relative size** – The SSRCF is typically relatively small at 5-30% of the total senior secured debt quantum. That should mean that things have to go very wrong before value in the restructuring is going to break within the revolver.
- **Covenants** – In a super senior deal, the covenants in the SSRCF typically follow the bond, with incurrence rather than maintenance-based covenants that do not call for quarterly or annual testing. The key exception is that the revolver will typically have at least one financial maintenance covenant, such as a minimum EBITDA or a total net leverage, set with significant headroom but which may only be a draw stop.
- **Ranking** – The bond and revolving debt and guarantee claims typically rank *pari passu*, so everyone has a senior debt claim, but the revolving facility comes out first with respect to proceeds from security enforcement and, in some cases, distressed disposals in the waterfall.
- **Enforcement rights** – There are two creditor groups with senior claims, both are free to accelerate in the event of default. Typically the bonds have a 25% voting threshold before they can accelerate, while the revolving facility will usually have two-thirds. Broadly the high yield bonds control security enforcement for the first six months, and then, if it has not been completed, the SSRCF lenders may take over.

> "These super senior structures have evolved over time, so that while there is now a reasonable degree of consistency, historically there's been a lot of variation in the detail."
>
> James Boswell, Partner, Clifford Chance, London

James Boswell, a Clifford Chance banking partner, says: "These super senior structures, as with precedent-based high yield deals generally, have evolved over time, so that while there is now a reasonable degree of consistency in the general architecture, historically there's been a lot of variation in the detail."

Clifford Chance has worked with the Loan Market Association and the AFME High Yield Division on standardised documentation for these deals, but this will not apply to the huge body of deals already in existence.

High yield restructuring technology

Europe is now entering the first wave of high yield restructurings where bondholders are in the money, with a seat at the table, and that represents a whole new paradigm. But while the restructuring technology is still developing, the fundamentals are now there and we can see the direction of travel.

The first message to investors is not to panic. Some characteristics of these deals generate a degree of urgency, such as the 25% acceleration threshold, incurrence covenants, and the fact that bondholders are really only "driving the enforcement bus" for six months. But the first steps should be as they are in any restructuring – to stabilise the situation using standstills, to bring together the various stakeholders, and if a deal can be achieved to implement it, potentially through the use of cramdown mechanisms. Many of the key challenges are logistical, in that the instruments involved are held widely through clearing systems.

Secondly, while the process will look different and the way the stakeholders interact and coordinate will be different, the substance of a restructuring is the same as any other.

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Iain White, a Clifford Chance restructuring expert, says: "Co-ordination is key but very complex, because the product is very widely held through clearing systems. Even when you know who your noteholders are, getting the information to them is subject to market abuse and insider dealing rules, so they will not want to receive information because they will want to preserve their ability to trade."

But the process can and does work. Typically an *ad hoc* committee of bondholders comes together and acts like a coordinating committee in a loan restructuring. Legal and financial advisers will effectively represent the bondholders in the negotiations until a "go-private" period of a few weeks when the noteholders are brought in, receive the information, and hopefully secure a restructuring.

Finally, when it comes to implementation, most restructurings have had to use some form of cramdown mechanism. In the UK that means a court-driven scheme of arrangement whereby 75% in value and a majority in number can impose a deal on the remaining 25%, but this is where jurisdictional risk is key, and understanding the local insolvency regimes can have a big impact on the outcome.

Michael says: "One of the biggest challenges in these restructurings is just the lack of a roadmap. Under Chapter 11 there is a roadmap of where you are going to go and how you will get there, but in Europe, there is no single path. You don't know exactly where you are ultimately headed, and you set out a game plan and it will change 50 times during the process. But these processes can end up very well and work out positively for the creditors."

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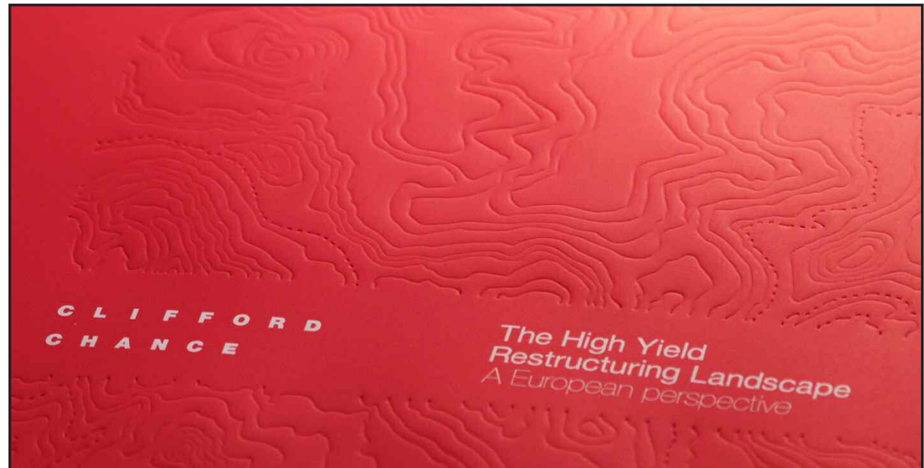
Iain White, Partner,
Clifford Chance, London



"When looking at restructuring any European high yield bond deal, the key message is to understand the European high yield market, the European jurisdictional risk and the European restructuring landscape."

John MacLennan, Partner, Clifford Chance, London

The future

From an issuer's perspective, there is no better time to be a high yield issuer in Europe, with people able to refinance and negotiate longer maturities thanks to high investor demand. The challenge is in dealing with a fundamentally different class of creditors, with whom issuers have little or no relationship on an ongoing basis.

The future appears to hold more issuance from peripheral Europe, with recent deals out of Bulgaria and Serbia. Moving away from Europe, more issuances out of Africa will add further complexities in the event of restructurings. We also see the growth of covenant-lite loan deals, with no bonds but still with incurrence rather than maintenance-based covenants. These, too, will give rise to new challenges should restructurings occur down the line.

We also expect to see more forum shopping going forward, as debtors and creditors seek to choose the jurisdiction in which to implement their restructurings. For example, within the last 12 months we have seen non-English debtors accessing English cram-down procedures in reliance upon COMI shifting, the introduction of an English obligor into the structure and/or, most recently, changing the governing law of the finance documentation to English law.

John says: "When looking at restructuring any European high yield bond deal, the key message is to understand the European high yield market, the European jurisdictional risk and the European restructuring landscape."

The unprecedented number of new issues, with different ownership types and from a wide range of industries means this is an increasingly complex area. Our guide, 'The High Yield Restructuring Landscape – a European perspective,' provides detailed guidance based on real life experience to help clients navigate the pitfalls and identify the opportunities in bank and bond restructurings.

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