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Distressed disposals to the rescue!

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The use of distressed disposals as a way of implementing restructurings has increased in prominence in the last year, owing to challenges faced by companies seeking to implement restructuring plans where cross-class cramdown is being utilised. In our role as security agent, we are increasingly seeing parties look to distressed disposals to effect restructurings instead of traditional court-based restructuring tools.

In this article, we explore the distressed disposal regime in an intercreditor agreement, highlight important considerations for parties looking to use these mechanics in their restructurings, and provide a case study showing how this mechanism works in practice.

What is a distressed disposal?

The Loan Market Association form of intercreditor agreement ("ICA") contains a mechanism which facilitates the sale of shares in, or assets of, a borrower group in a distressed scenario, free of liabilities. This is known as the "distressed disposal" provision, and the security agent is squarely at the heart of its operation. In restructurings of larger capital structures, distressed disposals are an important tool to right-size a group's balance sheet, and can be used to implement complex restructurings, including debt-for-equity swaps.

On the occurrence of a distressed disposal, a security agent has extensive powers under an ICA to release the liabilities and guarantees of, and security granted by, the entity being sold and those of its subsidiaries, as well as security over any assets being disposed of. No debtor or creditor consent is needed, other than instructions from an instructing group of creditors, which are usually the majority senior creditors under the ICA.

The disposal is usually undertaken by the security agent enforcing its security over the shares or assets and selling them, either to a third party or to an SPV which is set up by the creditors of the group, in the case of debt-for-equity swaps. However, distressed disposals also capture disposals undertaken by a company during circumstances of distress; in our role as security agent, we have seen borrower groups use these mechanics in recent months. The proceeds of the disposal can be cash and, depending on whether the ICA allows it, non-cash (e.g. shares in the restructured group).

The distressed disposal regime also gives the security agent the ability to conduct a debt disposal. In other words, when shares in a borrower group are being sold, the security agent is able to transfer liabilities owed by the group to another party, therefore changing the creditor group. This is often the entity that is buying the shares in the restructured group, and in practice, allows junior debt to be restructured on an internal basis and without adverse tax consequences.

Because of the significant powers a security agent has under the ICA to operate releases, the ICA often contains safeguards to ensure that stakeholders (in particular junior creditors) are protected. The main safeguard is for the proceeds of the disposal to be fair from a financial point of view. Depending on the contractual terms of the ICA, this could be demonstrated conclusively by the security agent obtaining a fairness opinion from an independent valuer or financial adviser. If the disposal is being conducted via an

enforcement process, the fairness opinion usually sits alongside a valuation obtained by the security agent to satisfy the requirements of the local law enforcement process.

ICAs also often contain "safe harbours" that the security agent can rely on to demonstrate that the transaction was for fair value. Typical safe harbours include a sale of the shares or assets by a liquidator, administrator or receiver, pursuant to a court order, or pursuant to a public auction.

Other safeguards may include a requirement for any super senior creditors to be paid fully in cash, the need for non-cash consideration to be valued by an independent financial adviser, or for any non-instructing group of creditors to be consulted by the security agent before the distressed disposal is effected. The distressed disposal must also take place during circumstances of distress (i.e. where there is an event of default under the debt documentation) and the proceeds of the disposal must be applied in accordance with the waterfall in the ICA, which all parties agreed to at the outset of the transaction.

Please see our case study at the end of the article for an example of how a distressed disposal can be used in practice.

Benefits of using the distressed disposal regime

A distressed disposal is a relatively simple mechanism which allows releases to be delivered outside of a formal court process, which would usually involve two court hearings (for example, in schemes of arrangement or restructuring plans). This generally results in lower up-front transaction costs for the parties. It also allows restructurings to be implemented outside of formal insolvency proceedings (e.g. administration) which can be optically challenging and potentially value-destructive. The instructing creditor majority under an ICA also tends to be lower than for a restructuring plan or a court-based restructuring tool, often requiring a simple majority or 66% (two-third) of senior creditors.

However, despite the fact that the parties agree to the inclusion of distressed disposal regime in an ICA, the security agent's use of its powers to release debt, liabilities and security is sometimes challenged. Challenges arise from sponsors or shareholders who are "left behind" in the rump structure following a disposal, or by junior creditors whose debt has been released. As at the date of this publication, there are three ongoing challenges at court *(Selecta; Hunkemöller; Hurtigruten*), following a period of very few court challenges (the last of which was *Galapagos* in 2023). The challenges tend to be in respect of either valuations obtained at the time of the restructuring or abuse principle type challenges i.e the security agent and instructing group have acted in bad faith to the detriment of creditors, or a combination of both.

As distressed disposals continue to be utilised, more challenges are envisaged and the case law relating to distressed disposals will become more extensive and nuanced.

The choice for parties looking to implement restructurings via traditional court tools versus distressed disposals is whether or not to meet the risk of challenge up-front or defer such risk to after the restructuring closes. As challenges to distressed disposals usually arise only after the security agent conducts the relevant releases, deal parties have the certainty that the restructuring will be effected, instead of waiting for any court challenge to be fully resolved before the restructuring can close.

The cost and length of a potential court challenge can also be quantified reasonably easily, given that litigation timetables and processes tend to follow a set path. This allows the security agent to determine the nature and level of indemnification it will need to proceed with the distressed disposal, and agree this up-front with the instructing group and other stakeholders prior to taking steps to implement the restructuring.

For creditors and other stakeholders, this gives certainty as to the amount of costs and the time it might take for a challenge to be resolved. See below for further considerations of this.

Key considerations for the security agent

Given the complexities of restructuring which make use of the distressed disposal regime, it is common for a specialist agency with experience in executing a distressed disposal and who is comfortable with the risks involved to be appointed in place of the incumbent agent. However, the key considerations for the security agent when faced with the prospects of a distressed disposal are the same regardless of the size of the transaction.

The security agent may only act in accordance with the powers given to it in the finance documentation and must be instructed to exercise those powers. A key question is the identity and make up of instructing group that will instruct the security agent to carry out the distressed disposal. Where there is a small lender group, the instructing group is relatively straightforward but often in restructurings involving a more complex capital structure, there may already be a lock up agreement in place guaranteeing the relevant thresholds will be met. The make-up of the instructing group will also give an insight into where any challenge may come from if there are creditors who do not consent to what is being proposed or who are being left behind in the old group.

The security agent will need to understand where the risks in the transaction are and what protections or resources it will need. The security agent is entirely reliant on its contractual protections and does not have the statutory protections given to a court-appointed officer such as an administrator or liquidator. While standard LMA documentation contains indemnities in favour of the security agent from both the company and creditors, where the capital structure is complicated and there is a known risk of challenge, the security agent may seek negotiate standalone indemnities from the instructing group of creditors or the key company in the go-forward group specifically covering the action that is envisaged in the restructuring.

The standalone indemnity would usually be accompanied by a fighting fund in cash which, in the event of a challenge, would be used to pay legal fees incurred by the security agent. The amount of the fighting fund would depend on the anticipated risk of challenge and likely legal fees that would be incurred in defending the challenge. That cash is something that needs to be budgeted for in the company's projected cash flow as it is tying up capital for potentially one to two years.

The security agent will need its own legal counsel (separate to counsel advising the instructing group) to navigate the distressed disposal regime in the intercreditor agreement. The fees should be agreed at the outset and would usually be paid for by the company.

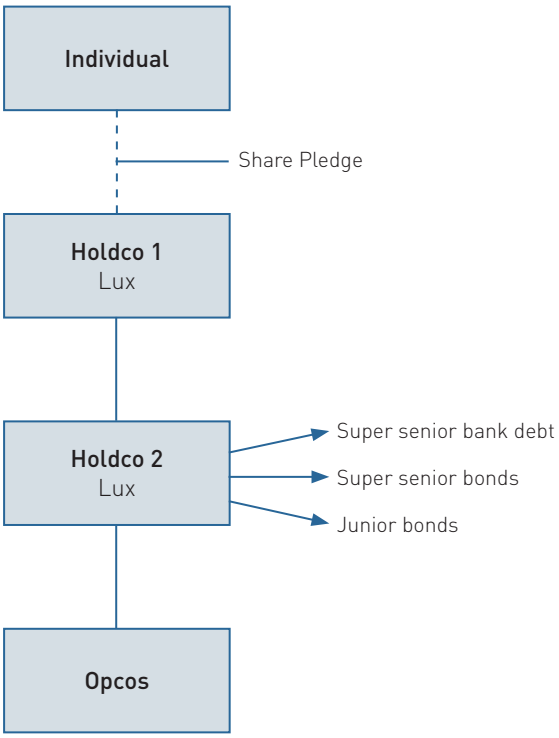
Case study

A holding company incorporated in Luxembourg ("Holdco 1") has a subsidiary incorporated in Luxembourg ("Holdco 2") which is itself the holder of the operating companies ("Opcos") in the group. Holdco 2 is the issuer of senior secured bond debt and junior bond debt, and the borrower of super senior bank debt. The main Opcos have provided guarantees and security, and Holdco 1 has granted a pledge over its shares in Holdco 2, in favour of the bond and bank debt, with the security being held by a security agent. Holdco 1 is ultimately owned by an individual.

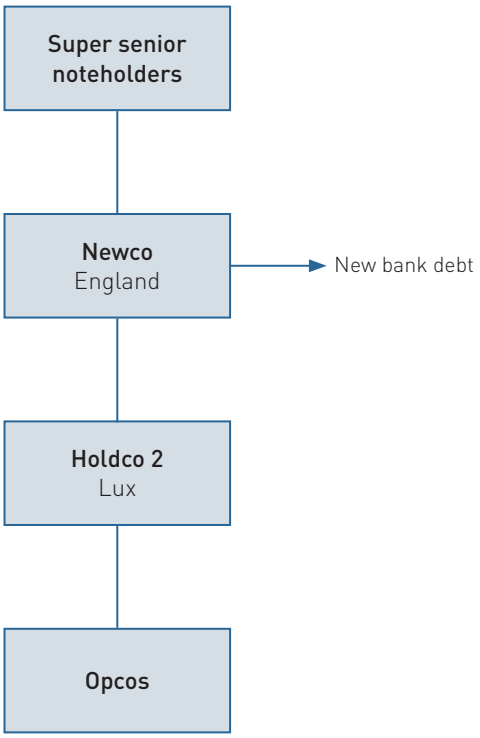
The majority holders of the senior secured bonds are the instructing group under the ICA. The issuer has failed to pay interest under the senior secured bonds on a number of interest payment dates, and the majority senior bondholders instruct the security agent to accelerate the senior secured bonds and enforce the Luxembourg share pledge over Holdco 2.

On instructions and pursuant to its powers under the ICA, the security agent enforces the Luxembourg share pledge and transfers the shares in Holdco 2 to an SPV incorporated in England together with the liabilities under the bond and bank debt. The SPV pays cash (funded by new debt) and issues shares in itself in consideration for the transfer.

Pre Restructure



Post Restructure



The security agent receives a valuation evidencing that the value of the group breaks in the senior secured bonds, a valuation of the shares in the SPV being distributed as consideration and a fairness opinion confirming that the proceeds of the enforcement are fair in the circumstances. On instruction, the security agent releases the guarantees and security granted by the Opcos. The security agent also distributes the cash and the shares in the SPV via the ICA waterfall.

The cash consideration repays the security agent's costs and expenses, the creditors' enforcement costs, and the super senior bank debt in full. The shares partially repay the senior secured bonds, and the senior secured bondholders become the owners of the SPV. The remainder of the senior secured bonds and the entirety of the junior notes (which are out of the money) are written down and cancelled.

Following the distressed disposal, the rump group consists of Holdco 1 and its shareholders, and the restructured group consists of Holdco 2 and the Opcos, with the senior secured bondholders being the new shareholders of Holdco 2. As there was insufficient consideration to repay the junior bondholders, the junior bonds ultimately ended up being cancelled. The existing debt of the group has been restructured and the group has been placed on a more stable footing.

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