Risk Reward
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The Basel III Accord – What Is It For?

Also in this issue

- REASSESSING AND UPDATING CREDIT ANALYSIS AND MODELS
- CLIENT RELATIONSHIP MANAGEMENT – REMEMBERING THE BASICS, EVEN IN A RECESSION
- THE IMPORTANCE OF UNDERSTANDING DEBT STRUCTURES AND DOCUMENTARY POSITIONING
- YES, YOU HAVE A BUSINESS CONTINUITY PLAN …. BUT WILL IT WORK?
- CENTRAL COUNTERPARTIES FOR DERIVATIVES – MYTH OR REALITY

ARE BANKS BUILDING UP A DEADLY PORTFOLIO OF UNDERPERFORMING LOANS? PART 3 –

THE IMPORTANCE OF UNDERSTANDING DEBT STRUCTURES AND DOCUMENTARY POSITIONING

The first two papers in this series covered the expectation of increasing levels of distressed debt in the market over the coming years together with a number of themes the players face when dealing with a restructuring. In this third paper in the series, banker Simon Ling-Locke, MBA, FCIB, DipFS Director of Credit Risk Services at Risk Reward Limited, looks at the importance of appreciating debt structures and the documentation used, particularly over the last few years, to highlight some of the areas of increased complexity and, as a result of that, the increased risks parties are likely to face due to potential misunderstandings of rights and powers of different lenders.

These issues can most notably be seen in the leveraged loan market which had both grown exponentially and metamorphosised during the boom years driven in particular by Private Equity and the Institutional Investors. Indeed there has been very recent case law (HHY Luxembourg SARL and another v Barclays Bank plc and others) where the issue of structure was the key point (I will revert to this case later in this paper to illustrate the point of when a structure goes wrong).

A borrower can very often be a holding company, a sub-holding company or otherwise a specially created funding vehicle for a group. The reason for such structures can vary but might be due to geographical, legal, accounting, tax, business or other financial management considerations. The assets of such companies will mostly consist of equity held in subsidiaries and intercompany loans.

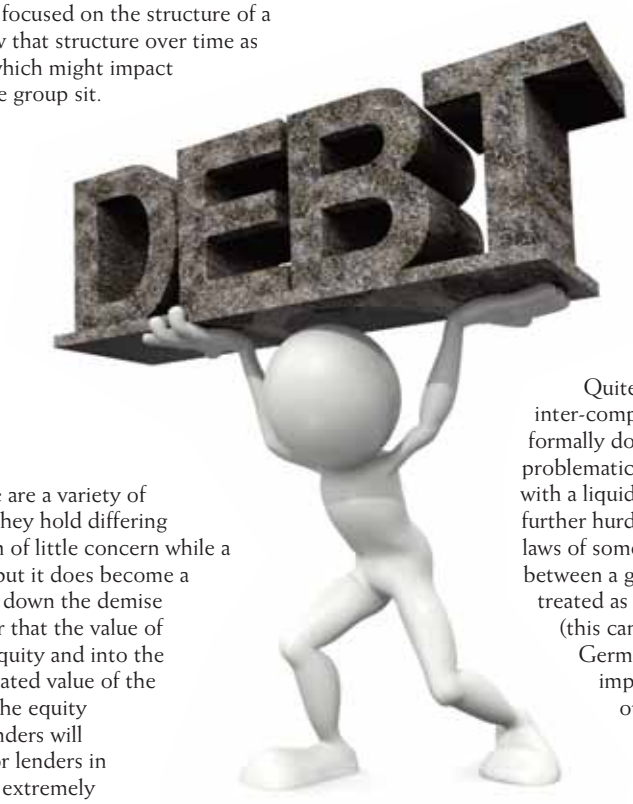
It should be noted that under English law each individual limited company (whether a private or a publicly quoted company) has its own independent legal status and will not be held to be responsible or legally liable for the liabilities of another company unless it has satisfied all of the following conditions: a) it has the power to commit the company to the

THE IMPORTANCE OF UNDERSTANDING DEBT STRUCTURES AND DOCUMENTARY POSITIONING CONTINUED

liabilities of another, b) the commitment has been authorised, correctly approved under its internal articles of association and actually given, and c) the laws of the country in which the company is incorporated also so allow that extension of liability. Without such liability being extended the 'corporate veil' will prevent a lender or group of lenders from being able to claim against the assets of anything other than those of the borrower itself which could be little more than the shares held in subsidiary companies (equals equity risk) and (usually on an unsecured basis) loans provided by the holding company to its subsidiary (and potentially ranking behind other creditors).

Lenders therefore have to be focused on the structure of a group i) at signing and ii) how that structure over time as that structure could change which might impact on where the real assets of the group sit.

So, how might a lender gain the seniority it wants and achieve the desire of having priority to the assets of a group over say second lien lenders, mezzanine lenders, high-yield bond investors or indeed vendor loan note providers or general unsecured trade creditors? And what about the rights of other players such as hedge providers?



Group structures where there are a variety of interested players, assuming they hold differing rights over assets, might seem of little concern while a borrower is fully performing but it does become a real worry when a group slips down the demise curve and the parties discover that the value of the group breaks below the equity and into the debt (i.e. the remaining estimated value of the assets of a group is less than the equity meaning that not all of the lenders will achieve a full recovery). Junior lenders in this situation will be focusing extremely carefully on where that assumed value break falls and will be analysing whether they can enhance their recoveries due to documentation or structural inequalities which might potentially give them higher rights and better recoveries. Indeed the 'value break' is a very significant area of controversy and difficulty in a restructuring but this paper will not explore the intricacies around company valuation except to note that there has been fairly recent case law in England on this issue (IMO Car Wash in 2009) where the judge, Justice Mann, set a precedent by throwing out the junior lenders' argument for the use of forward valuation techniques (which based on two more creditors assumptions indicated higher recovery rates) in favour of the use of more predictable valuations now. This precedent for English courts, and hence much of the leveraged loan market in Europe (as primarily governed by English law) could potentially result in a different outcome to those in the USA where the US courts have appeared to be more open to considering forward valuation approaches.

These creditors who have some but not full economic interest are known as the 'fulcrum lenders'. They are likely to impose the most pressure and tension into the situation to try to maximise their own returns. As such, this is when the parties create additional complexity in a restructuring since not only will there be need to focus on operational restructuring and the overall potential supportable debt load but also on how the value is apportioned between the parties whether that be through an eventual consensual restructuring or through a court driven process.

So, coming back to my earlier question of how priority of some lenders over the rights of others is achieved. Certain lenders can take security (fixed and floating charges in England) but if the borrower is a holding company what are those charges actually over? It is likely to be primarily shares in subsidiary companies and hence equal to an equity investment ranking behind all creditors in that subsidiary and/or a charge over an inter-company loan. But has that inter-company lending been properly documented with contractual terms and repayment obligations? Quite often lenders discover that the inter-company lending has not even been formally documented! That can prove problematic if the debt has to be proved with a liquidator. However, there is a further hurdle to consider in that under the laws of some countries the debt owed between a group of companies will be treated as subordinated to other creditors (this can happen in countries such as Germany and Spain to name just two important markets). Therefore, other ways of achieving priority of some parties and subordination of others are needed. The subsidiaries might well be required to provide upstream guarantees and possibly security as well to strengthen the position of the lenders to a holding company. As with intercompany lending, the status and validity of such guarantees has to be considered since not all subsidiaries will have the legal power to provide a guarantee and/or security (the laws in some countries are more restrictive than in others). The other methods, which are likely to be used in conjunction with the above steps, to achieve priority rights revolve around contractual subordination and structural subordination.

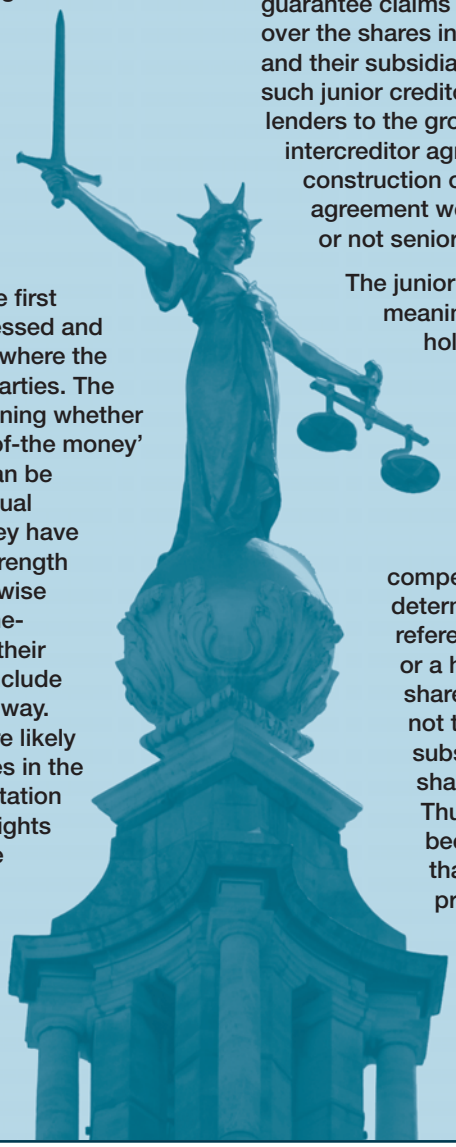
Under contractual subordination, the lenders set out their respective rights in an intercreditor agreement. This is a written contract which is signed by or on behalf of each party refer to in the agreement (and which will also bind any secondary buyers of that debt) but will not bind any other lending facilities which have not been included in the intercreditor agreement. Until the breach of a loan covenant, representation, event of default or actual non-payment, the intercreditor agreement effectively lies dormant with the borrower having full control over its cash distributions to

creditors but as soon as a default has occurred then the intercreditor agreement comes into operation with a pre-agreed waterfall of funds coming into effect. This arrangement will result in one creditor not being paid by the debtor until another creditor of that debtor has recovered its debt in full or until amended terms have been agreed by all the parties. During any negotiation period it is usual to see stop notices and standstill periods being imposed on the junior tiers of lenders which stops payments of interest and principal and prevents them from commencing legal proceedings against the borrower to recover their debts for a period of time (the terms of the specific intercreditor agreement would need to be viewed to understand the exact rights in any particular case). Such arrangements are used especially in Europe to provide breathing space whilst creditors and the borrowing group try to find a consensual restructuring plan. This can be different to the situation in the USA where heavier reliance is placed on the formal procedures of organisations going through the Chapter 11 recovery process of their bankrupcy code.

Case Study:

HHY Luxembourg SARL (the European Directories Group of companies) was a leveraged deal involving a hierarchy of lenders with their respective rights governed by way of an intercreditor agreement. The group had been struggling under a very heavy debt load and had a pressing requirement to restructure this debt which stood in excess of Euro 2 billion.

Restructurings are at the best of times fraught as some or indeed all of the parties face losing a portion of their claims or other rights. Thus in any consensual restructuring the first issue which has to be addressed and agreed upon is to establish where the value breaks amongst the parties. The second key issue is determining whether junior parties who are 'out-of-the money' based on the value break can be excluded from the 'consensual restructuring' or whether they have some form of negotiating strength which could thwart or otherwise cause the more senior 'in-the-money' creditors to amend their proposed restructuring to include the junior creditors in some way. Junior creditors are therefore likely to be searching for loopholes in the structure or in the documentation which governs the various rights of lenders to find if there are ambiguities which could give them this negotiating leverage against more senior in-the-money creditors. Indeed this was the crux of the case of HHY Luxembourg SARL and another v Barclays Bank plc and others.



Namely, when enforcing at the holding company level did the senior lenders have the ability to see that the operating companies could be sold free and clear of any security, debt and guarantee claims held by any junior creditors over the shares in those operating companies and their subsidiaries against the wishes of such junior creditors? The rights of the various lenders to the group were governed by an intercreditor agreement and so the construction of the provisions in that agreement were crucial in deciding whether or not senior lenders did have such rights.

The junior creditors focused on the meaning of the words "Obligor or any holding company" in the agreement (the standard loan agreement definition of an obligor is 'a borrower or a guarantor'). The judge in this case acknowledged the court had been choosing between unnatural and competing meanings but in the end determined that the meaning of this reference only covered the Obligor or a holding company whose shares were to be disposed of and not to other companies, i.e. subsidiaries of an Obligor whose shares were being disposed of. Thus the junior creditors had been able to persuade the judge that the intercreditor agreement provided for only 'one layer of release', i.e. the release of the liabilities of the Obligor itself where its shares were to be sold but not of the liabilities of its subsidiaries.

THE IMPORTANCE OF UNDERSTANDING DEBT STRUCTURES AND DOCUMENTARY POSITIONING CONTINUED

Contractual subordination achieves its intention so long as:

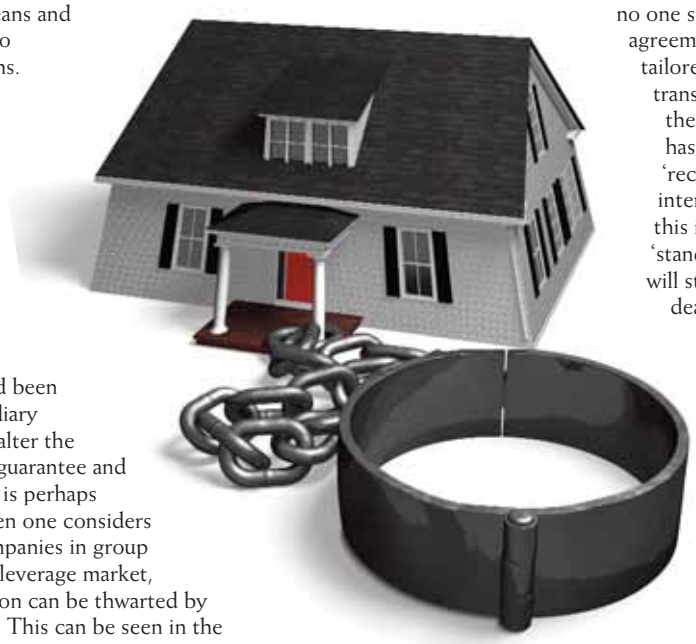
a) the intercreditor agreement has been clearly worded without ambiguity and unfortunately with no one standard document in the market the risk of error is always possible as can be noted from the case study I explain in the box opposite;

b) there is restriction on operating companies from being able to raise finance or provide guarantees to ensure that external debt raising is controlled;

c) there is control over which subsidiaries can receive inter-company loans;

d) there is control over the group structure to ensure that growth in areas of the group which are not part of the security and guarantee package are brought into those arrangements (bearing in mind that there could be legal restrictions under the laws of the local country).

Structural subordination, on the other hand, uses the basic premise of the corporate veil, i.e. one company is not liable for the debts of another unless it has so agreed to by contractual means and secondly has the power to so commit by contractual means. Thus, lenders providing secured debt to a holding company level, where the borrower then uses all of the proceeds to acquire shares in another company and has no other assets, will merely have security over equity which would rank behind all the creditors of that subsidiary unless a contractual arrangement had been put in place with that subsidiary company and its lenders to alter the common law structure (i.e. guarantee and intercreditor agreement). It is perhaps therefore not surprising when one considers the number of different companies in group structures, especially in the leverage market, that contractual subordination can be thwarted by unforeseen structural issues. This can be seen in the very recent case of HHY Luxembourg SARL and another v Barclays Bank plc and others.



In terms of take-aways from this case and intercreditor agreements in general, the following comments can be made:

- It would appear that the courts will base the intention of the parties upon the wording of the clause and will be unlikely to enlarge on the wording of the clause unless there is very significant ambiguity. Where there is ambiguity, the intent of the clause will be in accordance with the reasonable interpretation by a commercial person of the wording of the clause which might well not be what that clause was originally intended to have achieved.

- Intercreditor agreements, signed at the start of a lending package, effectively lie dormant whilst a company is performing and only become relevant when something has gone wrong. Thus for many lenders the dye is already cast since it will be only for newly created intercreditor agreements where lawyers will be able to clarify wording beyond doubt (I can hardly imagine junior lenders willingly giving up that benefit where they have it now unless some valuable benefit is given to them in return!).

- Therefore for newly created lending facilities where intercreditor agreements are required, absolute clarity in that agreement will be essential to prove the intention of the junior lenders to have given up or excluded their legal rights over guarantees from subsidiaries.

- Lenders need to look carefully at intercreditor agreements to understand how the wording applies in their agreement and the implications for rights of differing parties. It is important to remember that there is no one standard form intercreditor agreement and that each is tailored to the particular transaction (note: since 2008 the Loan Market Association has produced a 'recommended form' intercreditor agreement but this is not equivalent to a 'standard' form as various terms will still be tailored deal by deal).

Thus the 'value break', 'documentation rights' and 'structural subordination' are perhaps the most important financial factors which have to be considered and resolved when dealing with a restructuring where there are differing layers of creditors. For both creditors and advisers clarity across these issues helps to determine:

1. the differing rights which lead to differing levels of negotiating leverage;
2. the process (through a consensual out of court settlement or otherwise through liquidation or court enforcement); and
3. an optimal restructuring solution based on the particular circumstances of the case.

For further information please contact:

Dennis Cox – CEO
telephone: +44 (0)20 7638 5558
email: DWC@riskrewardlimited.com

Lisette Mermod – New York
telephone: 1-914-619-5410
email: LM@riskrewardlimited.com

Simon Ling-Locke
telephone: +44 (0)20 7638 5558
email: SLL@riskrewardlimited.com