
Intercreditor Issues in European High Yield – Bondholders’ Perspective

By

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Introduction

Structuring intercreditor rights among high yield bondholders, senior lenders and trade creditors of a corporate group is one of the more complex aspects of high yield finance. This article outlines an approach to understanding the key intercreditor dynamics in this area.

Senior Credit Facilities vs. High Yield Terms

A capital structure that uses high yield debt frequently also uses senior credit facilities from a bank syndicate. The senior facilities are characterized by so-called “maintenance” covenants, including financial ratios, and by security packages covering substantially all the assets of the main borrowing company and its material subsidiaries that are either direct borrowers under, or guarantors of, the senior facilities. Upon the early signs of financial distress (for example, failure of the company to maintain a coverage or leverage ratio), financial ratio covenants, in particular, give senior lenders rights to call a default, accelerate their loans and enforce their security interests based on covenant breaches. Senior lenders use the negotiating leverage arising from these rights to force the company into consensual restructuring discussions early in a distress situation.

In contrast, high yield bonds are characterized by so-called “incurrence” covenants, meaning covenants that may be breached only if the company takes certain affirmative actions, such as incurring additional debt, selling assets, making investments or paying dividends. The bonds often are unsecured or secured only in second priority to the senior lenders. High yield bonds are also characterized by subordination to senior lenders in right of payment by the company and by its subsidiaries that are borrowers or guarantors under the senior facilities. In addition, high yield bonds may be structurally subordinated to the claims of trade creditors of subsidiaries absent upstream guarantees from those subsidiaries in favor of the high yield.

In effect, absent a company action that breaches an incurrence covenant, the structure of the high yield terms effectively provides bondholders a right to accelerate and enforce remedies only upon a missed interest payment on the bonds. The senior lenders, on the other hand, can have negotiating leverage over the company and its equity investors (a “seat at the table”) on the basis of potential or actual senior credit defaults under maintenance covenants well before the high yield bondholders, as long as interest payments are being made on the high yield bonds.

In addition, under so-called “payment block” provisions, if defaults such as financial ratio breaches exist under the senior facilities, the senior lenders typically have a right to block payments on the high yield, customarily for up to 179 days, unless the senior default is cured or waived sooner. Thus, even though no payment default may have occurred under the senior

facilities, the existence of other senior defaults can give senior lenders control over the decision as to whether an interest payment is made on the high yield bonds.

Impact of Insolvency Laws

If interest is not being paid on high yield bonds due to a payment block or otherwise, the outcome in European deal structures can be significantly different from the outcome in typical U.S. structures.

In the United States, if interest payments are missed on a high yield bond, bondholders may accelerate and enforce remedies immediately (after, customarily, a 30 day grace period), without being subject to any standstill periods. Unsecured bondholders have the right to initiate a court-supervised restructuring process under Chapter 11 of the US Bankruptcy Code, during which secured senior creditors are automatically stayed from exercising their remedies, including their security interests. Moreover, high yield bondholders under Chapter 11 have the right to vote as a separate creditor class with other unsecured creditors on the plan of reorganization eventually put forward. This right gives them, in effect, the ability to vote against and, in most cases, defeat a plan of reorganization, except in circumstances where the so-called “cram-down” rules can be used to impose restructuring terms on the high yield bondholders (although this is a risk to the high yield only if the equity holders of the company and any debt holders junior to the high yield will receive nothing under the plan). Finally, in Chapter 11, the high yield bondholders are entitled to receive not less than they would receive if the company were liquidated. Faced with these potential Chapter 11 protections for high yield bondholders, senior lenders, the equity holders and the company have an incentive to take into account the high yield bondholders’ views in any consensual restructuring negotiations. As a result, in the U.S. high yield bondholders clearly have a “seat at the table” after a missed interest payment and effectively have a “seat” well beforehand as a payment default on their bonds becomes likely.

The situation in Europe can be quite different. Many jurisdictions have insolvency regimes that are more senior lender friendly than in the U.S. These regimes can effectively deprive high yield bondholders, as subordinated creditors and particularly if they are unsecured, of the negotiating leverage that Chapter 11 provides them in the U.S. The senior lenders in European deals have until recently enjoyed the full benefit of such pro-creditor insolvency regimes given the way in which deals have been structured. Moreover, in European deals, high yield bondholders are often also subject to a standstill on acceleration and enforcement even after a missed interest payment or other default under their bonds. These standstills typically last for a period of 179 days after notice of the default is given to senior secured lenders, unless an insolvency occurs earlier.

Rights to Sell the Company

The situation in European transactions can be further complicated by the importance that senior lenders place on their right, when enforcing security interests, to sell the main borrowing company and its subsidiaries as a going concern rather than breaking the corporate group into parts or liquidating its assets. As part of assuring their ability to sell the entire

company as a going concern without interference by subordinated bondholders, senior lenders at the outset of the European high yield market insisted on some type of structural subordination of the high yield bonds to the senior credit facilities.

The result in some deals left the high yield bondholders with little to no negotiating leverage to force the senior lenders, the equity investors and the company to take into account their views in the restructuring process. In some deal structures, the high yield bondholders were completely isolated with claims only against a structurally subordinate holding company, even after a missed interest payment and lapse of an enforcement standstill period, and had only the threat of possibly adverse publicity for the company to get their views heard. These high yield bondholders were left in an unhappy position where senior lenders and other creditors, the equity investors and the company's management could negotiate with little urgency while the value of the company and the high yield bonds slowly eroded.

The European high yield market's response to the risks of weak leverage has been an on-going effort to level the playing field between senior and subordinated debt with various structuring solutions. One key solution has been to give the high yield bondholders a right, following the lapse of an enforcement standstill period, to force the sale of the company as a going concern. This right to control at least the timing of such a sale allows them to cut off the equity investors and mitigate the risk of further erosion of the value of their bonds if an enforcement sale would otherwise be deferred or never initiated by the senior secured lenders. This right, arguably, gives negotiating leverage back to bondholders and, as a result, the coveted "seat at the table" lost in earlier deal structures.

Achieving this solution can be difficult, however. Different insolvency regimes require different structures. Moreover, although senior lenders may give the high yield a right to force the start of the sale process, they will retain the right to control that process by exercising their security interests if they so choose.

Trade Creditors vs. High Yield

More recent deals have also addressed the issue of structural subordination of bondholders to trade creditors. Imitating U.S. practice, European deals have begun incorporating, where legally permissible, upstream guarantees and other credit support in favor of the high yield bonds from the borrowers and guarantors under the senior facilities. Although these upstream guarantees typically are subordinated to claims of senior lenders, they are *pari passu* with claims of trade creditors against the guarantors. In some cases, these upstream guarantees have been senior to trade creditors because they have been supported by second lien security interests over assets of the relevant guarantor subsidiaries, making these guarantees second in priority to claims of senior lenders but senior to claims of trade creditors by virtue of the second security interests.

Senior secured lenders in European deals have, however, refused to compromise their right to sell the company as a going concern free of liabilities to high yield bondholders under upstream credit support. To this end, senior secured lenders customarily require that all credit support and related security in favor of the high yield be released automatically upon an

enforcement sale. High yield investors achieve some protection in this regard under requirements that their claims release only upon an enforcement of security by the senior secured lenders involving a sale of the company for cash at a fair market value, determined by a well recognized investment bank, and only if all claims of the senior secured lenders are also released simultaneously with the high yield claims.

Yet the question remains as to whether these features of more recent European high yield transaction structures give bondholders the same leverage relative to trade creditors that they have under a typical U.S. structure with the benefit of Chapter 11. U.S. deals commonly are structured with subordinated guarantees from all domestic subsidiaries in favor of the high yield. However, if consensual restructuring negotiations give trade credit a preferential benefit and bondholders do not agree, bondholders can protect their *pari passu* claim by pushing the negotiations into a Chapter 11 proceeding.

In Europe, on the other hand, the release of the upstream credit support could jeopardize the ability of the high yield investors to ensure *pari passu* or senior (in second security structures) treatment in relation to trade creditors. A sale of the business as a going concern by the senior lenders and release of upstream credit support leaves trade creditors in place with the prospect of repayment in full from a recapitalized and restructured business. Senior lenders are repaid, in priority, from proceeds of the sale. But the high yield bondholders receive only what remains, if anything, from the proceeds of such a sale. As a result, only in a liquidation of the company will the claims of high yield bondholders be truly *pari passu* or senior (if secured) to claims of trade creditors. Yet liquidation is outside of their control and may be an unlikely scenario, depending upon the jurisdiction and the business in question. Some businesses simply are not good candidates for liquidation as the best way of achieving value for creditors. Thus, high yield bondholders in European structures still may find themselves with compromised negotiating leverage in relation to trade debt.

Conclusion

The structuring of European high yield transactions has come a long way since the early days of simple structural subordination. In certain pro-creditor insolvency jurisdictions, however, careful analysis and structuring is required if the intercreditor rights of high yield investors in relation to senior lenders and trade creditors are to be as strong as they are in the U.S. market.