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General Chapters:

1	**An Effective Insolvency Framework Within the EU?** – Tom Vickers & Megan Sparber, Slaughter and May	1
2	**Developments in Directors' Duties under English Law** – Alicia Videon & Louise Bell, Olswang LLP	4
3	**Liability Management as a Restructuring Tool** – Chris Beatty, Sullivan & Cromwell LLP	10
4	**Fund Lenders: Potential New Challenges for the Next Wave of Loan Restructuring Transactions** – Jat Bains & Paul Keddie, Macfarlanes LLP	16

Country Question and Answer Chapters:

5	**Australia**	Gilbert + Tobin: Dominic Emmett & Alexandra Whitby	21
6	**Austria**	Schindler Rechtsanwälte GmbH: Martin Abram & Florian Cvak	28
7	**Belgium**	Strelia: Bart De Moor	33
8	**Bermuda**	Sedgwick Chudleigh Ltd.: Alex Potts & Nick Miles	39
9	**Brazil**	Pinheiro Neto Advogados: Luiz Fernando Valente de Paiva & André Moraes Marques	48
10	**Bulgaria**	Yonev Valkov Nenov: Todor Nenov & Pavel Tsanov	53
11	**Canada**	Thornton Grout Finnigan LLP: Leanne M. Williams & Michael Shakra	59
12	**Cayman Islands**	Campbells: Guy Manning & Guy Cowan	66
13	**Cyprus**	Soteris Flourentzos & Associates LLC: Soteris Flourentzos & Evita Lambrou	72
14	**Denmark**	Gorrissen Federspiel: John Sommer Schmidt & Morten L. Jakobsen	79
15	**England & Wales**	Slaughter and May: Tom Vickers & Megan Sparber	85
16	**Finland**	Roschier, Attorneys Ltd.: Toni Siimes & Tuomas Koskinen	92
17	**France**	Bredin Prat: Nicolas Laurent & Olivier Puech	98
18	**Germany**	Hengeler Mueller Partnerschaft von Rechtsanwälten mbB: Dr. Ulrich Blech & Dr. Martin Tasma	104
19	**Hong Kong**	Gall: Nick Gall & Ashima Sood	112
20	**India**	Dhir & Dhir Associates: Nilesh Sharma & Sandeep Kumar Gupta	117
21	**Indonesia**	Ali Budiardjo, Nugroho, Reksodiputro: Theodoor Bakker & Herry N. Kurniawan	124
22	**Italy**	BonelliErede: Vittorio Lupoli & Lucio Guttilla	129
23	**Japan**	Nishimura & Asahi: Yoshinori Ono & Hiroshi Mori	137
24	**Kazakhstan**	GRATA Law Firm LLP: Marina Kahiani & Shaimerden Chikanayev	143
25	**Korea**	Kim & Chang: Chiyong Rim & Jin Yeong Chung	153
26	**Montenegro**	Bojović&Partners: Marija Bojović & Miloš Radonjić	158
27	**Norway**	Kvale Advokatfirma DA: Stine D. Snertingdalen & Ingrid E. S. Tronshaug	165
28	**Poland**	Kubas Kos Gałkowski: Dominik Gałkowski & Konrad Trzaskowski	171
29	**Puerto Rico**	Ferraiuoli LLC: Sonia Colón & Gustavo A. Chico-Barris	177
30	**Russia**	INFRALEX: Artem Kukin & Stanislav Petrov	182
31	**Serbia**	Bojović&Partners: Marija Bojović & Milomir Matović	188
32	**South Africa**	Brian Kahn Inc.: Brian Kahn & Nicqui Galaktiou	196
33	**Spain**	Uría Menéndez: Alberto Núñez-Lagos Burguera & Ángel Alonso Hernández	202
34	**Sweden**	White & Case LLP: Carl Hugo Parment & Michael Gentili	212
35	**Switzerland**	Lenz & Staehelin: David Ledermann & Tanja Luginbühl	218
36	**USA**	Paul, Weiss, Rifkind, Wharton & Garrison LLP: Alan W. Kornberg & Elizabeth R. McColm	226

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Fund Lenders: Potential New Challenges for the Next Wave of Loan Restructuring Transactions

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The Emergence of Credit Funds as Lenders in the UK

The last wave of loan restructuring, which broke after the credit crunch of 2006–07, was predominantly bank-led, as it was those financial institutions which provided the bulk of credit during the debt boom which preceded that period. Key features of the time included a greater willingness by banks to provide forbearance through 'amend and extend' deals, and a preference for the taking of equity in viable businesses, in return for a reduction in debt, to help borrowers to avoid falling into an insolvency process. A willingness to take these steps meant that transactions were more complex and required greater time and energy on the part of the banks. At the same time, banks faced new regulatory requirements, imposed in response to some of the perceived causes of the crisis, and also had to battle round upon round of litigation and investigation which was linked to some of the excessive behaviour of the past decade. These factors combined to cause them to provide less credit to the market whilst they were focused on strengthening their balance sheets and, in a few cases, they are still works in progress.

During that time, the gap in the UK corporate loan market was increasingly filled by alternative lenders – in particular credit funds. They were able to offer their investors relatively high returns as a consequence of the ability to charge higher margins for scarce debt, particularly in the mid-market, and so enjoyed rapid growth during a low interest rate environment. Although banks have returned to play an important role in the loan market more recently, credit funds are now well-established participants and are routinely seen on leveraged financings where they are often able to offer greater leverage, speed of execution and flexibility on both financial covenants and on negative covenants such as those in relation to the borrowing of additional indebtedness, and the making of acquisitions and disposals.

Although credit funds invest in a range of industries and products such as senior debt, mezzanine financing, unitranche financing, PIK notes and equity, this chapter will focus upon loans, and in particular the increasingly common unitranche product. We will consider how those credit funds might approach the next wave of loan restructurings, whatever their cause might be, given the different way in which they are set up, how they are regulated and the deals structures that they often invest in.

Fund Structures: Flexibility and Limitations of Credit Funds

Many credit fund managers will raise and invest several funds, targeted towards different sets of investors, in order to maximise their assets under management, which may also include the raising of managed accounts for larger investors alongside their funds. They will therefore potentially have significant resources at their disposal, enabling them to provide follow-on lending for borrowers which are suffering from cash shortfalls, if desired. Managers are given a wide discretion to act in the best interests of their investors, and the investment strategies for their funds and managed accounts will often overlap, so they will, for example, be free to utilise funding from several investment sources for the same deal, to maximise their ability to invest. They will also usually be free to swap debt for equity on a restructuring, without restriction under their fund terms.

Although there are some open-ended and hedge funds in the market, one common limitation between many credit funds will be that they are not 'evergreen' and will typically have a fund life of six or seven years. Consequently, they will usually never enter into a facility agreement which matures after that time. This potentially poses a problem if a borrower is nearing the end of its financing arrangement and is in some financial difficulty, making it difficult to refinance with a third party. Whilst a credit fund may agree that it is sensible to extend the maturity date in order to enable a turnaround, they may be restricted from doing so by the terms of their fund.

Given the various pools of capital which are often available to a credit manager, one option may be to refinance a debt advanced by one fund with new financing provided by another. That decision will obviously depend upon the attractiveness of the new investment in the interests of the investors in the second fund, and be subject to there being no conflict issue.

An alternative solution is that a fund manager will often be empowered to extend a fund's life without investor consent for up to two years, so there can be a little flexibility. However, that may not be of much help to a borrower, for example where it is seeking to have its statutory accounts signed off by auditors on a 'clean' basis and for those purposes would wish to have its debt maturity date fall more than 12 months beyond the date of the accounts. A two-year extension will only offer relief for a short time. If that is insufficient, the credit fund may need to go on a roadshow of investors in order to seek to persuade them to agree a further extension. This is a time-consuming process which may not be practical if a borrower has an urgent restructuring need. Furthermore, depending on the size of the financing arrangement which has fallen into restructuring (potentially alongside other financings), the cost of such a process may outweigh the benefit to the credit fund.

If that consent to an extension is not sought or not forthcoming, then there will be an obligation to liquidate the fund. The worst case outcome for a borrower is perhaps a dividend in specie by a credit fund of its loan assets to its investors, which would leave that borrower with many more lenders with whom to negotiate a restructuring. However, that outcome seems unlikely in practice,

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particularly given that investors in the fund would not wish to receive it, and where alternatives such as a debt trade are likely to be available. Potential distressed debt purchasers in the market may then look forward to engaging with a forced credit fund seller in these circumstances, but there is usually no specific timeline for the liquidation under the fund formation agreements. A fund manager is given the power to weigh value for their investors against timing – although they may not hold on to a credit indefinitely and are unlikely to agree to lengthy extensions to a financing when bearing in mind the return rate that they are required to achieve for investors.

In recent years, one approach to the challenge of extending a credit facility where a fund lender's constitution prevents it from agreeing to it has been the use of a scheme of arrangement. This is considered later in this chapter and, for the reasons given below, may be an even more complex solution than it has been in the past.

The Regulatory Regime: A 'Lighter' Regime for Credit Funds?

The greatest areas of regulatory difference between a bank and a credit fund will result from the regulatory permissions that each will hold.

Given that a bank will require a deposit-taking permission, it will for example be subject to regulatory capital requirements which can potentially inhibit its lending activity and prevent it from supporting a debtor which is in distress, depending upon the regulatory capital treatment. In any event, a bank will have a much higher regulatory profile, due to its holding of customer money, and therefore be subject to greater scrutiny in relation to the conduct of business rules of the Financial Conduct Authority (FCA).

In contrast, a credit fund will not usually seek a licence to take deposits, and the activities of advancing and restructuring loans are not regulated by the FCA. Borrowers may be reassured, however, that credit funds are nonetheless regulated and will therefore be expected to comply with the FCA Principles, which include:

- Principle 6: a firm must pay due regard to the interests of their customers and treat them fairly; and
- Principle 8: a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

A breach of such principles could render a firm liable to disciplinary sanctions, which could be a significant effect upon its ability to continue its business. A credit fund which is not subject to conduct of business rules will consequently have greater flexibility to provide support through new lending on a restructuring if it wishes, provided that it has sufficient uncalled commitments from its investors, or to be more aggressive in relation to a restructuring, depending upon its risk appetite with respect to the FCA Principles.

One should also note that, aside from the formal rules, the attitude of a credit fund will also be dependent upon its business model and attitude towards reputational risk. Many credit fund managers in the market are keen to be seen as trusted relationship lenders by equity sponsors, and have had to refute any suggestion that their strategy includes an element of 'loan to own' which could pose a threat to equity interests. Consequently, a credit fund may be very wary about taking enforcement action which potentially negates the business message that it is seeking to communicate when making new loans in future, and so that may affect their approach in a restructuring situation.

Deal Structures and the Potential Impact of Intercreditor Issues

The way in which a financing is restructured will obviously depend a great deal upon how the underlying arrangement has been put together. A very common product in the current market, particularly for credit funds, is the unitranche facility.

A unitranche facility is a product which originated in the US and migrated to the UK and rest of Europe in the late 2000s and early 2010s. It aims to consolidate a traditional senior and mezzanine structure into a single term loan which is provided under a single set of finance documents, thereby giving speed of execution and presenting greater simplicity to a borrower. That said, it is common for the single unitranche loan to be re-tranched into so-called 'first out' and 'last out' tranches. That may be achieved through an 'agreement amongst lenders' to which the borrower is not a party, or within the intercreditor agreement to which the borrower will be a party. This arrangement will, amongst other things, reallocate margin payments to reflect the different risk profiles of the first out and last out tranches, although so far as the borrower is concerned they will make a single payment of interest.

Features of a unitranche loan involving a credit fund include the following:

- Tenor: loan facilities will be non-amortising, with a bullet repayment and longer tenors than traditional bank lenders can typically offer, usually five to seven years.
- Interest rate: the margin will be higher than that which one would see for a senior facility, but lower than that which one would see for a mezzanine facility, reflecting a 'blend' between the two. It is also common to see the margin split between a cash pay margin, which must be paid on a current basis, and a PIK margin which is capitalised and added to the principal amount of the loan on each interest payment date. A portion of the margin may also 'toggle' between cash pay and PIK. In addition, the floating rate portion of the interest rate, which will refer to LIBOR or EURIBOR, will usually be subject to floor protection of between 0.75 to 1.50%.
- Call protection: in order to enable a credit fund to meet its return targets, it will require a combination of a 'make-whole' payment which will usually apply to the first two years of a financing and a prepayment fee in the event of an early repayment by a borrower thereafter.
- Working capital facilities: borrowers will usually need to have access to ancillary facilities such as letters of credit and overdrafts or to hedging for the purposes of their business, and may also need access to a revolving credit facility if their model requires cyclical access to credit for working capital purposes. Credit funds are not able to provide these types of facilities and so a bank is usually involved in a financing for this reason. Where these facilities are provided on a secured basis, they will usually share in the same guarantee and security package as the term credit fund lender but on a 'super senior' basis pursuant to an intercreditor agreement.

'Super senior' means that, on an enforcement of guarantees and security, the proceeds will be used to repay all amounts owed to revolving credit, hedging and ancillary facility providers (referred to in this chapter as super senior lenders) in priority to amounts owed to unitranche (i.e. credit fund) lenders. It is also worth noting at this point that, in the current market, super senior lenders will often also provide part of the term debt on a super senior basis. Given its ranking, this super senior term debt will attract a lower margin, which enables credit funds investing in the unitranche debt to achieve a better return for their portion.

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Intercreditor arrangements for these combined super senior and unitranche structures are relatively untested in the UK market at present. Their features include the following:

- Payments: super senior lenders and unitranche lenders will rank *pari passu* through the life of the facilities, prior to an enforcement, with no right to block payments to each other on the occurrence of a default under, or acceleration of, a financing, subject to the payment waterfall on enforcement described above.
- Security: super senior lenders and unitranche lenders will to the extent possible share in a first ranking guarantee and security package.
- Amendments and waivers: given that the general rule is for majority lenders (those who collectively hold over 66.6% of loan commitments) to be able to agree changes to finance documents, and that super senior lenders will not hold sufficient commitments to form a blocking vote, there will usually be certain entrenched rights so that certain amendments cannot be made without super senior lender approval. They will usually include amendments to the material events of default which give rise to enforcement rights (as described below, including the super senior financial covenant), to the payment waterfall, to the right of super senior lenders to take enforcement action and changes to the guarantee and security package. There will also be a market standard set of amendments which require all lenders' consent, such as extensions to payment dates, reductions in margin and increases to loan commitments. The need for super senior lender approval in relation to increases to commitments can be highly relevant where a borrower in distress has an urgent cash need, but one would expect a super senior lender to agree to this if the new money is to rank behind its liabilities – although the return would obviously need to be sufficiently rich and repayment sufficiently certain for a credit fund lender to be willing to advance funds on that basis.
- Enforcement: super senior lenders will have limited enforcement rights. They can usually only enforce if one of a limited number of events of default has occurred, subject to a standstill period. Those material events of default can include:
  - a failure to pay an amount due under the super senior facilities;
  - a breach of financial covenant or failure to deliver evidence of compliance with a financial covenant – although this is usually limited to a specific super senior lender covenant for these purposes, and is usually tested by reference to leverage (with additional headroom) or a minimum EBITDA covenant;
  - insolvency, insolvency proceedings and creditors' process against assets;
  - a breach of the negative pledge;
  - a breach of restrictions on disposals, albeit subject to a *de minimis* threshold such that an enforcement right only arises if the disposal is of companies or assets which generate EBITDA in excess of an agreed amount; and
  - unlawfulness or invalidity of a finance document.

  Standstill periods will typically range from 60–90 days for a non-payment default to 90–120 days for other material events of default. At the end of the standstill period, provided that unitranche lenders have not commenced enforcement action, the super senior lenders may do so. Super senior lenders will also usually have an enforcement right if an enforcement process has been commenced by a unitranche lender as a result of a material event of default as describe above, and the super senior lenders have not been repaid by the end of an agreed period, often 180 days, following which the super senior lenders can take control of the enforcement process.

Given that a restructuring process can take several months to work through, whilst lenders aim to understand the causes of the financial difficulty that a borrower is suffering and then explore the potential solutions, including sources of additional capital, a credit fund will naturally be concerned to ensure that super senior lenders do not act too hastily upon the expiry of a fast-approaching standstill period and harm the value of their interests in the financing.

To help combat this, unitranche lenders will have certain protections under the intercreditor, in the event that super senior lenders are in control of enforcement, to ensure that they must obtain best value. An intercreditor will typically provide that the claims of the unitranche lenders may only be released as part of an enforcement process if:

- the enforcement is a court-approved process, such as a scheme of arrangement;
- the enforcement process is a disposal made as a result of a public auction for the borrower group or its assets; and
- the security agent obtains an opinion from an independent financial advisor that the proceeds received as a result of the process represent fair market consideration in the prevailing market conditions for the borrower group or its assets.

If the breach in question relates to a financial covenant, a unitranche lender may also have the ability to provide equity cure monies to a borrower, if the sponsor will not do so. This right is unusual in the UK market but, if it is available, could provide a way for a credit fund to deploy its resources to protect its position in these circumstances.

More commonly, unitranche lenders will also have a right to buy out the super senior lenders. The price for the debt will usually be its face value (i.e. a purchase at par) but the trigger for the right to purchase can vary. In some deals the trigger is an event of default, but it may be narrower and is a matter for negotiation from deal to deal. Consequently, so long as the right has arisen and they are willing and able to exercise it, a unitranche credit fund lender can deal with the enforcement risk associated with super senior lenders in a restructuring scenario by taking out their position in the capital structure.

Schemes of Arrangement as a Restructuring Option for Unitranche Facilities

As mentioned above, a UK scheme of arrangement (a 'Scheme') may provide a useful tool for the restructuring of a financing in which a credit fund is a participant, where the fund's constitution may prevent it from agreeing to an 'amend and extend' restructuring, or more likely, where there are super senior lenders who do not agree with the proposed restructuring solution. For the purposes of this section, we will focus upon a unitranche financing structure, given its prevalence in the current market.

By way of reminder, a Scheme is a court-based process which provides for a company to agree a compromise with its members or with a class of creditors, which will bind all members or creditors in a class provided that, along with court approvals as part of the process, the proposal is approved by a majority in number and at least 75% by value of those members or creditors in the same class who are present and vote at a meeting of that class of members or creditors.

Despite the increase in the use of unitranche facilities in the UK loan market there have not been, to our knowledge, any Schemes of unitranche financings as at the date of writing. However, we would anticipate that class composition on Schemes will become a subject of interest if and when any unitranche financings need to be restructured. This is because there is usually a significant disparity in the amount of debt owed to the first out lenders and the last out

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lenders in a unitranche financing – the last out tranche will usually exceed the first out tranche by a large amount.

One concern, as mentioned above, is that a unitranche lender holding the vast majority of the total debt may not be able to agree to an 'amend and extend' Scheme. Absent a change to the credit fund lender itself or a change in the relevant borrower's debt structure through a debt purchase or a refinancing of whole or part with consent, it is difficult to see how a Scheme could be used as it has been in recent years, where credit fund investors have in the past been part of a minority rather than the majority more commonly seen in the current market. It would be risky to rely upon a credit fund lender abstaining or failing to attend and vote at a Scheme creditor meeting, given their duties to investors, and so it would seem that an 'amend and extend' Scheme will only be available if the unitranche lender who is constitutionally unable to agree an extension can be outvoted by other lenders in the syndicate – which is likely to depend on the size of the relevant deal (and therefore the number of other lenders involved).

Where there is a situation under which a credit fund unitranche lender is willing and able to agree a restructuring under a Scheme, a risk is that the first out lenders will form a separate class of creditors to vote upon a Scheme. They can therefore, potentially, block a Scheme despite only being owed a relatively small amount of the overall debt by the borrower (by virtue of the fact that each class of creditors must vote in favour of the Scheme in the necessary majorities for it to be approved). Conversely, if the lenders all form a single class, the last out lenders would, assuming their claims represented at least 75% of the overall claims under the unitranche facility (and they represented a majority in number of the unitranche lenders), be able to vote to approve the Scheme even if the first out lenders all voted against the Scheme.

There is, therefore, a potential conflict of interests between the lenders in these circumstances: the last out lenders will be likely to want the first out lenders to be in the same class as them for voting purposes so that the first out lenders are prevented from being able to block the Scheme by voting in a separate class. On the other hand, the first out lenders will want to form a separate class so that they can exercise as much influence over the Scheme, and the restructuring it is being used to implement, as possible.

Whilst not strictly concerning a Scheme in relation to a unitranche facility, the court's decision in respect of the Scheme proposed by Apcoa Parking Holdings GmbH provides some guidance as to how the court might view class composition in relation to such a Scheme. In that example, certain of Apcoa's lenders made a super senior facility available to it on an unsecured basis. Some but not all of Apcoa's senior lenders then entered into a turnover agreement with the super senior lenders whereby they agreed to turn over any recoveries made by them to the super senior lenders until the super senior debt had been repaid in full (thus giving the super senior debt the economic effect of ranking ahead of the debt owed to those senior lenders).

The court rejected the non-consenting lenders' argument on the basis that it is creditors' rights against the company, rather than against the other creditors, which matter when determining classes for voting on a Scheme. The turnover agreement in Apcoa modified the rights of the senior lenders and super senior lenders amongst each other, but from Apcoa's perspective, it had no effect on their rights against it. The senior lenders therefore formed a single class to vote on the Scheme.

It is, therefore, possible to draw an analogy between the situation in Apcoa and how the court might be expected to act in relation to a Scheme of a unitranche financing. An agreement amongst lenders (or equivalent under an intercreditor agreement), similar to the turnover agreement in Apcoa, can operate as an arrangement which affects the rights of the first out lenders and last out lenders between themselves, but not against the borrower. Consequently, one can argue that the rights of all the lenders against the borrower are the same and they will, therefore, form the same class for the purposes of voting on the Scheme.

It is, however, difficult to predict with complete certainty how the court will treat such arrangements when the first Scheme of a unitranche financing is put before it. The decision in Apcoa also considered the basis on which a different approach could be taken by the court, on the premise that 'interests proceeding from rights', as well as purely rights, could be taken into account when determining classes for Schemes. It could, therefore, be argued that if this approach is taken, lenders under an agreement amongst lenders (or equivalent under an intercreditor agreement) could form a separate class on the basis that they have economic interests which proceed from their rights against the borrower (i.e. their rights under such re-tranching arrangement) which are sufficiently dissimilar to cause them to occupy a different class.

Given this, whilst Apcoa provides the closest analogy so far, the courts have, in relation to previous Schemes, exercised a wide discretion and so it would be difficult at this stage to predict with any certainty whether super senior lenders subject to an agreement amongst lenders or an intercreditor agreement would form the same or separate class to unitranche lenders under a Scheme.

Conclusions

Provided that a credit fund retains sufficient unspent capital to provide new loans or buy-out unsupportive super senior lenders and/or there is capacity within the life of its funds to give a borrower some breathing space, it can offer great capacity for quick and flexible solutions to a restructuring situation.

That said, given the super senior lender consent requirements for new loans to be provided, it may not always be sensible for a credit fund to be as supportive as it might wish. This brings into focus the lack of a legal mechanism in the UK for new loans to be advanced in a situation where there is a need for credit by a borrower in distress, in contrast with the US where 'DIP financing' can be made in certain circumstances.

Furthermore, where a credit fund lender is a closed-ended fund, the biggest challenge is that the 'amend and extend' approach of the previous wave of restructurings may not be feasible. Schemes also seem unlikely to be as effective a restructuring tool as they have been in the past, given the greater amount of debt likely to be held by credit funds. Consequently, an even greater degree of creativity is likely to be required from professional advisors, which may require some form of restructuring of a credit fund lender as a precursor to the restructuring of an underlying borrower or series of borrowers.

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