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Restructuring in the Next Recession

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Introduction

Restructuring professionals can be accused by their colleagues of gloomily, or possibly even gleefully, predicting that the next recession is just around the corner. Nonetheless, in the UK, it has been a decade since the last recession and seems reasonable to suggest we are now closer to the start of the next recession than the end of the last one. It may therefore be timely to consider what the next wave of restructurings might look like.

Here, we should avoid the mindset of an old general planning to fight the next war in the same way as the last. It should not be assumed that restructurings in and after the next downturn will follow the pattern of the restructurings that occurred in the aftermath of the global financial crisis of 2007–2008. It is important to consider how loan terms and the loan markets have developed since then, as it is possible that loans being made now will feature heavily in the next wave of restructurings.

It is clear that the loan market has become more borrower-friendly. However, the extent to which it has moved in borrowers' favour and the way in which this has developed over the past decade differs between mid-market borrowers and large borrowers. This raises a question as to whether there will be a knock-on divergence in restructurings between the two market segments.

This chapter focuses on leveraged finance rather than investment-grade corporate lending. It is difficult to define exactly where the boundary lies between mid-market and large borrowers. For the purpose of this chapter we will regard a mid-market borrower as one with around £75 million in earnings before interest, tax, depreciation and amortisation ("**EBITDA**"). We appreciate of course that, in reality, there are borrowers who may have lower EBITDA than this who are nonetheless treated by lenders as if they were a large-cap borrower and *vice versa*.

Cov-Lite Loans

The majority of leveraged loans, in the US and increasingly in Europe, to large borrowers have been on so called "cov-lite" terms. These borrower-friendly terms originated in the US high-yield bond market but have spread geographically to Europe and have migrated across products into loans. The convergence has been driven by a common set of institutional investors moving from the bond to the loan markets in search of yield and the opportunity to deploy large stockpiles of "dry powder" capital that they have raised but need to invest. At the same time, low interest rates and an imbalance between the supply of lending capital and the demand for loans has pushed the market decisively in favour of borrowers. This is particularly the case for borrowers owned by large, well-known private equity sponsors, as these sponsors offer debt investors the prospect of repeat business and the opportunity to invest large sums in a single transaction.

Whereas a "conventional" loan may contain multiple financial covenants including a cash flow cover ratio and a limit on capital expenditure, a cov-lite loan will only have a single financial covenant, usually a leverage to EBITDA covenant. In addition, a cov-lite loan does not require the borrower to maintain compliance on an ongoing basis by testing covenants at regular intervals. Instead, covenant testing for a cov-lite loan is on an incurrence basis. This means that the financial covenant is only tested when the borrower is taking certain actions, such as making an acquisition or making a distribution, so that the timing of the covenant test is within the borrower's control.

P.G. Wodehouse tells the story of a golfer who, troubled by his inability to play his favourite 18-hole course in fewer than 100 strokes, devised a series of calculation aids to improve his tally. For example, he determined that it was no longer necessary to record tee-shots which landed in the lake rather than on the fairway as part of his total. By this ingenious method, he finally achieved the double-digit scores he so desired.

With similarly inspired practices, the definition of EBITDA used in the remaining leverage test for cov-lite loans is often heavily skewed in the borrower's favour with the inclusion of so-called "add backs". For example, "one-off" costs and synergies which management subjectively expect to achieve but have not actually yet achieved in practice, may be added back to inflate EBITDA. The overall effect is that for the purpose of testing a leverage covenant, the leverage ratio may be much lower than that calculated by a conventional method. Add backs are neither new nor confined to the large-cap lending market. However, they are more prevalent there. In the mid-market, add backs are often subject to greater controls, such as a cap on the overall amount of add backs that may be used or a requirement that add backs based on projected synergies be certified by the chief financial officer or even by the external auditors.

The undertakings in loan documents have also been weakened by expanding the range of permitted transactions that can be entered into without lenders' consent. Permitted transactions covenants will usually feature a stated monetary value, or "basket", of permissible transactions. The value of a transaction, either alone or as part of the aggregate value of transactions undertaken, must exceed this basket before it ceases to be a permitted transaction. Strong borrowers will push for these baskets to grow, often in line with EBITDA, the same EBITDA that those borrowers have already inflated by including add backs. The interaction between different types of permitted transaction has also become more complex, which can make it difficult for lenders to fully understand exactly what borrowers are able to do. Infamously, the retailer J Crew was able to combine various transactions which were each individually allowed under its loan agreement to transfer most of its intellectual property, its most valuable asset, to a new subsidiary that was beyond the reach of its senior lenders.

Impact of weak loan covenants on restructurings

The purpose of financial covenants is to serve as an early warning of a deterioration of the borrower's financial condition. A breach of the financial covenant used to be the main trigger for the start of restructuring negotiations, as it would force the borrower to engage with its lenders and give the lenders the leverage to push for the necessary changes. Without financial covenants, or with financial covenants that are difficult to breach, the borrower's management can avoid taking action for longer.

By the time a borrower under a cov-lite loan does try to restructure, it may be much further down the decline curve. At this late stage it is likely to have less liquidity. Indeed, an imminent shortage of cash may be the factor which has eventually triggered the attempted restructuring. This inevitably means the company has fewer options available to it and the prospects of a successful corporate recovery are lower. Consequently, we expect to see a greater number of formal insolvencies in the next cycle, requiring the skills and experience of insolvency practitioners to a greater extent than may have been the case during the previous era of "amend to extend".

The borrowing of cov-lite loans and the issue of similarly cov-loose high-yield bonds is more common among larger companies. This is not to say that mid-market terms have not also weakened over the past decade. However, this is often accomplished by setting financial covenants with increased head room to the borrower's financial base case model, so that a larger deterioration in the borrower's performance is needed to breach the covenants rather than by removing the financial covenants entirely or testing them on an incurrence basis only. Cov-lite terms are occasionally agreed in mid-market lending transactions, but generally the position of lenders is relatively strong in this segment of the loan market so they are able to resist cov-lite terms. Accordingly, the impact that cov-lite loans can cause by delaying the start of a restructuring will be disproportionately felt in restructurings of larger borrowers.

Compulsory Liquidation and Special Managers

The fates of Carillion, British Steel and Thomas Cook, the three largest insolvencies in the UK of the past two years, may be an indication of how future insolvencies of large companies that do not attempt to restructure promptly could pan out. In the past, one may have expected that when such a company became insolvent it would enter administration. Insolvency practitioners appointed as administrators would take over the management of the company. The administrators would have the ability to continue trading while a moratorium on creditor action provided the breathing space for a restructuring and a return to solvency or at least a better result for the creditors than a liquidation.

In the case of each of the identified insolvencies, no private sector insolvency practitioner was prepared to accept an appointment as administrator. Instead these companies entered into compulsory liquidation. As with all compulsory liquidations, the liquidator appointed by the court was the Official Receiver, a civil servant in the Government's Insolvency Service. However, in these cases the court also appointed private sector insolvency practitioners as special managers to assist the Official Receiver by providing additional capacity and expertise.

The shortage of cash may have been a relevant factor in taking an appointment as a special manager, with the payment of the special manager's fees underwritten by the Government, a less risky and more attractive option for the insolvency practitioners involved.

Nevertheless, if compulsory liquidation with special managers becomes the "new normal" for insolvencies of large companies, this could be a blow to the rescue culture. Administration, with its moratorium on creditor action and ability to continue trading, was supposed to be a key enabler of the rescue culture. In practice, it may be possible to run a liquidation in a manner very similar to an administration. This appears to have been the case for British Steel in particular, where its liquidator and special managers have made full use of their limited power to trade in a liquidation where it is beneficial for an orderly winding up. They have been able continue British Steel's business in order to keep a business sale, rather than simply an asset sale, alive. However, this sits uncomfortably with the fact that liquidation is designed to be a terminal procedure rather a tool for corporate recovery. It has been adopted as a tool for certain large corporate recoveries as a last resort.

It does not appear that the trend for compulsory liquidations with special managers will apply to insolvencies of mid-market and smaller companies. These insolvencies are unlikely to have the national economic impact or political saliency that would make the Government willing to guarantee the costs of a special manager. Accordingly, administration may retain its popularity as a tool for restructuring medium-sized companies and add to a divergence of restructuring practice with large company insolvencies.

Transferability of Loans and Loan-to-Own Investors

Before the global financial crisis of 2007–2008, the transferability provisions of a facility agreement were usually only lightly negotiated and there were few restrictions on how lenders could trade their loans. The wave of restructurings that followed in the immediate aftermath of the global financial crisis taught lenders and private equity sponsors two lessons about transferability provisions.

Firstly, the lack of restrictions on the trading of loans meant that in many cases the borrower or an affiliate could purchase the debt on the secondary market. This offered the borrower both a lever to influence the restructuring negotiations and, where the debt traded at a heavy discount, a cheaper way of reducing its debt than repaying it at its full value.

This practice caused discontent among lenders who perceived it as contrary to the *pro rata* sharing of risk and return among members of the syndicate. They viewed lenders who were affiliated with the borrower group unfavourably, as those lenders had interests that were not aligned with those of the rest of the lender group. The opposition from lenders has resulted in changes to loan terms which have made debt buybacks by borrowers less relevant for future restructurings. This is one of the few areas in loan documentation where the market position has moved in favour of lenders. In Europe, this is in large part due to the Loan Market Association's recommended form of leveraged finance facilities agreement moving from a form which has no restrictions on debt buybacks to a form which proposes two alternatives. The first alternative is a prohibition on acquisition of the debt by the borrower or its group. The second alternative allows buybacks but only under certain conditions, including: i) that there is no default; and ii) that the funding for the debt buyback comes from new shareholder funds or excess cash flow. These are conditions which a distressed company may struggle to meet.

The second lesson about transferability provisions was one that borrowers in particular took to heart. It transpired that so-called "loan-to-own" investors were readily able to buy the debt owed by borrowers. This class of investor sought out distressed debt which was trading at a heavy discount to its par value with the ultimate aim of obtaining equity as part of a restructuring. Private equity sponsors generally viewed the appearance of loan-to-own investors among their lenders with suspicion. Their concern was that instead of supporting a restructuring that would leave the existing shareholders with some value for their equity, the loan-to-own investors would pursue a strategy to obtain the equity for themselves. Where a loan-to-own investor was unable to obtain equity, they were often still able to take advantage of the lender consent provisions in the documents to resist alternative restructuring plans. In this case, other stakeholders may have had no alternative to paying a premium to the loan-to-own investor in order to get them to sell their blocking stake.

Borrowers, particularly larger borrowers with more negotiating power, have since sought to limit the ability of loan-to-own and other distressed debt investors to acquire the borrower's debt without its consent. The new restrictions can take the form of blacklists which prohibit transfers of the debt to certain named investors or white lists which name the specific investors to whom the debt can be transferred without the consent of the borrower. In the European loan market, although not the US, borrowers have attempted to impose blanket restrictions on any investor that has a reputation for following loan-to-own or distressed debt investment strategies. Typically, such restrictions would still fall away upon the occurrence of an event of default. Nevertheless, some aggressive borrowers have managed to keep the transfer restrictions in place until there is a major event of default such as insolvency or non-payment so that even a financial covenant breach may not make a loan freely transferable.

Impact of transferability restrictions

Despite the advantages to a borrower in having transferability restrictions, they reduce liquidity in the secondary market for loans by trapping in existing lenders and discouraging the entry of new lenders. This could impede a restructuring. Lenders who invested at par may be unwilling to support a restructuring which would crystallise their losses. However, a lender that bought into the debt at a low price may have a more supportive attitude. Even if a restructuring values the debt at less than par value, it may enhance the value of the debt when compared to the new lender's purchase price. In addition, certain lenders, including some banks and collaterised loan obligations, may be forbidden by regulation or their own constitution and policies from participating in restructuring steps such as a debt for equity swap or the advancing of new loans. Prospective new participants may well have cash to deploy.

The impact of transferability restrictions is again a factor that disproportionately affects larger borrowers. It is larger borrowers whose stronger position has allowed them to push for more transferability restrictions. The trading of loans to larger borrowers has historically been more important. In the mid-market lending space, liquidity in the secondary market has generally been lower in any case. Lenders to mid-market borrowers are more likely to hold rather than sell down their loans. This is a pattern that has been reinforced by the entry of credit funds into that market since the end of the global financial crisis, as explained in more detail below. Overall, it seems likely that the trading in debt and the involvement of distressed debt investors to force stronger restructuring discussions and offer additional funding, particularly on the larger transactions, will also be delayed in comparison with what was seen in the last cycle.

The Rise of Credit Funds and Unitranche Loans

Until the last recession, banks still dominated mid-market leveraged finance both in the UK and elsewhere. This dominance has now been broken. Among other factors, new capital reserve requirements have made risky leverage lending a punitively expensive activity for banks to bear on their balance sheets. As the banks have retreated, credit funds, fuelled by investors in search of yield, have stepped forward to take their place.

The success of credit funds has also been linked to the popularity of the unitranche loan product. Instead of separate senior and mezzanine loans, credit funds have offered a single term loan with an interest rate positioned between the costs of senior and mezzanine debt. For restructuring professionals this means there are likely to be fewer restructurings involving disagreements between mezzanine and senior lenders.

This does not mean that intercreditor issues have disappeared. Credit funds are usually unable to provide revolving credit facilities. These are typically still provided by banks on a super-senior basis. The super-senior revolving credit lender and the unitranche lender would rank *pari passu* for payments in the ordinary course, but in an enforcement scenario the super-senior lender would rank first in the payment waterfall. The revolving credit facility in these structures is usually a relatively small proportion of the total debt so intercreditor agreements will typically give the unitranche lender the ability to control the enforcement period. The revolving credit lender would normally be subject to standstill and restricted from enforcing, unless there is a major event of default to give the unitranche lender a window of opportunity to implement a restructuring.

There is also a prospect of another intercreditor structure arising with unitranche loans. The unitranche loan may be re-tranched into a first-out and a last-out tranche. At first sight, this may seem like a return to the old senior and mezzanine debt structure. However, where a unitranche loan is re-tranched, this is normally achieved by an agreement between lenders alone. The borrower will not be party to the agreement and it may not even be aware of its terms, which may impact a restructuring. For example, there is a strong argument that, as the agreement to re-tranche is only between the lenders and as there is no difference in the rights each tranche has against the borrower, both tranches should be treated as a single class for a UK scheme of arrangement. As with many points arising from unitranche intercreditor structures, this has not yet been tested in a restructuring.

It is not just unitranche structures that, as yet, remain untested through a full economic cycle. Most credit funds have not experienced a downturn, at least in Europe, as they were largely established after the last recession in 2009. Restructuring professionals who are used to dealing with banks may have to make adjustments to the different dynamics of a credit fund. For example, compared to banks most credit funds are relatively small and leanly staffed. All but the largest credit funds are unlikely to have a separate work-out department so the origination team may stay involved throughout a restructuring. Some commentators have expressed concerns that, whereas a bank would hand responsibility over to an internal team with the experience and resource to lead or co-ordinate a full-blown restructuring, a lack of an equivalent team within a credit fund may leave a vacuum in the process.

However, the mere fact that a credit fund has relatively less institutional experience with restructurings will not necessarily mean that restructurings will become more difficult. A key differentiator of credit funds from banks is that having made the effort to raise committed capital, credit funds are keen then to keep it invested. Accordingly, credit funds are more likely to retain their loan commitments rather than syndicate them. This is less true for larger loans which are still widely syndicated by the arranging banks, but for mid-market leveraged borrowers the lenders are often all related funds under common management or a small club of lenders. This has the advantage of limiting the parties that need to be engaged in a restructuring. Much of the difficult initial work of a restructuring in agreeing standstills and establishing creditors' committees can be avoided when there are effectively only one or two lenders that the borrower needs to deal with.

It is also worth remembering that, unlike equity, debt investment has a low (and fixed) yield. Provided there are a number of high-performing investments in a fund which invests in equity, that fund can absorb losses on other, failed investments. In a credit fund, however, particularly a smaller fund, a failed investment is a more difficult proposition, and this in itself will incentivise funds to work to avoid an insolvency or even a debt write-down.

There is therefore an interesting balance of positive and negative qualities to this lender type. Whilst there may be concerns that some players in this market may not have sufficiently experienced teams to effectively manage a restructuring scenario, there will be fewer lenders to negotiate with and they are likely to be more creative in finding ways to minimise losses. Credit funds might be viewed as less reliant on the historically common "independent business review" sought by mainstream lenders, and much more willing to form their own view as to whether any business in restructuring is viable and then act on it.

Conclusion

It would be wrong to assume that restructuring in and after the next recession will be just like the previous one; not least because loan documents and the loan market have changed significantly. Over the past decade, loan terms have become increasingly borrower-friendly. It has become harder for a borrower to breach the terms of a loan and any breach that occurs, does so later. The concern is that by the time a distressed borrower is compelled to attempt a restructuring, they will have fewer options or may even be too late.

This effect is more pronounced for large borrowers who have benefitted the most from less structured lending terms, resulting from the convergence of the loan market with the high-yield bond market. A divergence in the fortunes and practice of restructuring between large and mid-market borrowers could open up. The problems for a restructuring that weaker lender protections in loan documents are storing up may ultimately reduce the chances of a successful recovery by a large distressed borrower.

This does not mean that mid-market restructurings will not present their own difficulties; restructuring professionals will have to adjust to the dynamics of credit funds and new debt structures that have developed in the mid-market during the 2010s. However, they should have more options if, as seems likely, these restructurings are triggered earlier.

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Simon continues to act both for troubled companies, their directors and shareholders and for the major financial creditors of such entities. His clients also include distressed debt investors, insolvency officeholders and a variety of other parties with an interest, or potential interest, in the troubled company's business. Simon is the author of the "*Insolvency and Restructuring Manual*", which was first published shortly after the 2008 financial crisis. He has most recently co-authored a third edition of that work, published by Bloomsbury Professional Ltd in 2018.

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