# Negotiated Transactions

## Leveraged Buyouts

### LBO Restructurings: An Overview

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Recent news of troubled Irish telecommunications company Eircom needing to find a solution to its debt crisis once again raises questions as to whether we will see a fresh batch of LBO restructurings in the eurozone this year. Leveraged credits in eurozone countries, where sovereign difficulties have been well publicised, may come under pressure, particularly if financial covenants tighten and underlying performance remains, at best, flat.

If we do see a flurry of LBO restructurings this year, what should stakeholders, insolvency practitioners and their advisers focus on when a leveraged credit hits the skids? The factors below, many of which are intertwined and interrelated, ought to be considered when encountering a new restructuring situation, as they will help inform potential consensual and non-consensual restructuring proposals alike. While this article focuses on issues relevant to European LBO deals, many of the issues which it addresses are applicable to LBO deals generally.

**Key Stakeholders and Participants**

From the outset, it is vital to gauge stakeholder/participant sentiment and to try to ensure that discussions can take place in as efficient a manner as possible.

- ***Sponsor.*** The attitude of the incumbent sponsor (the private equity firm that owns and runs the business in question) can be a decisive factor in how a restructuring plays out. Even if the incumbent sponsor does not end up putting more equity in (*e.g.*, if fund rules do not permit this on the terms required by the other stakeholders), an engaged sponsor often provides structure, focus and a benchmark for competing proposals, all of which can lead to swifter resolution of restructuring situations.

- ***Steering Committee.*** The appointment of a lender steering committee by the debtor in difficulty is vital. A steering committee can act as an information conduit, a sounding board or gatekeeper to the lenders whose interests it represents and (in some cases) drive the entire structuring process in terms of strategy and ultimate outcome. Its composition may well be a key factor in determining the feasibility of any restructuring.

- ***Security Agent.*** If a potential restructuring proposal involves the enforcement of security, the involvement and cooperation of the security agent (the party that holds the benefit of any security interests on trust for a syndicate of lenders) will be required. The security agent will need to be comfortable that it has:

a. the necessary power and authority to carry out precisely what it is instructed to do;

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b. received appropriate instructions from the creditors for whom it acts as agent;
c. received adequate and appropriate information (*e.g.*, valuation evidence), indemnities and protections; and
d. received its own independent legal advice in relation to these issues, as well as in regard to its common law duties and obligations.

These requirements will need to be factored into timetables and work streams accordingly.

- ***Creditors.*** An obvious driver to any successful restructuring proposal is the acceptability of the proposal to the key stakeholders. Certain creditors will be constrained by (1) their legal constitution; (2) regulatory or legal requirements; (3) internal/policy requirements; and/or (4) the relative accounting treatment of potential solutions. An understanding of the creditor landscape is essential in putting together a workable proposal. The prevalence of funds holding collateralised loan obligations (CLOs), collateralised debt obligations (CDOs) and similar instruments has brought this aspect into sharp focus since they are often restricted with respect to the terms to which they may agree (*e.g.*, some funds holding CDOs and CLOs are not permitted to hold equity instruments). In addition, attempts to accurately determine the composition of the creditors may be hampered by the existence of sub-participations and derivative contracts, meaning that the lender of record may not always be the party holding the economic interest.

- ***The Pensions Regulator/Pension Protection Fund.*** If an entity or group of related entities undergoing a restructuring process has an English defined benefit pension scheme arrangement in place, consideration will need to be given to the manner in which the restructuring will affect the position of the pension trustees as creditors. Negotiations may need to be conducted with the pension trustees, The Pensions Regulator (TPR) and/or the Pension Protection Fund. A recent decision by the English High Court (*Bloom & Ors v The Pensions Regulator (Nortel, Re) [2010] EWHC 3010 (Ch)*) held that amounts due in respect of Financial Support Directions or Contribution Notices issued to Nortel and Lehman companies by the TPR ought to be treated as ranking ahead of unsecured creditors, floating charge holders and even an administrator's own costs. While an appeal of this decision can be expected, the judgment serves as a timely reminder that the TPR's powers need to be borne in mind and can have wider ranging effects than might first be anticipated. The effects have the potential to be particularly acute in a leveraged finance deal where much of the security held by lenders will, in practice, amount to a floating charge rather than a fixed charge (the distinction being that a fixed charge holder will have absolute control over the assets charged whereas a floating charge holder will not). There may also be similar issues that arise in connection with pension schemes in other jurisdictions.

**Nature and Complexity of Capital Structure**

The capital structure, and in particular the various tiers of debt and the entities borrowing/guaranteeing such debt, will be different in each case. Complex structures will raise alarm bells as finding restructuring solutions will be challenging where the rights and interests of divergent creditor groups need to converge. Subordinated debt at the operating company level, where release provisions (see below) are sub-optimal, can also present difficulties.

**Contractual Framework**

A thorough review of the contractual framework will be essential. As a guide, the following areas of the documentation must be considered in depth:

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- ***Amendment Provisions.*** A key aspect when considering potential restructuring options will be to determine what can be accomplished within the terms and structure of the existing contractual framework and with what level of consent from the relevant parties. In particular, the actions that are permitted with majority lender consent will differ significantly from one deal to another (and some deals may provide that certain or all "majority" decisions are to be decided on less than a 66 2/3% basis). A thorough understanding of such provisions and appreciation of what is permissible can also help identify areas where individual or small groups of creditors may hold the balance of power. For example, the existence of hedge providers in the creditor group could skew voting dynamics. Therefore, it is important to know the circumstances, if any, in which hedge providers have voting rights, and when precisely their vote would be calculated.

- ***Intercreditor and Priority Terms.*** Different classes of creditors will have different rights enshrined in the intercreditor/priority agreement. It will be critical to understand the nature and operation of those rights. Most intercreditor/priority agreements operate as one would expect in terms of the relative rights and powers of senior creditors and subordinated creditors. However, there are often certain constraints and rights of subordinated creditors that will limit or otherwise mould options for a successful restructuring.

- ***Release Provisions.*** An analysis of the powers of the security agent in the context of any security enforcement will also be important. If, for example, the security agent has the ability to release security and release and/or dispose of liabilities when selling assets as part of a security enforcement, this can be a compelling factor in forcing dissenting/hold-out creditors to consider consenting to a proposal. However, such release provisions have not yet become standardised (although the introduction of a recommended form of intercreditor agreement by the Loan Market Association[1] may help if it becomes widely used in practice[2]). The use of these provisions has been bolstered by a recent English Court of Appeal decision in the European Directories (*HHY Luxembourg SAR and another v Barclays Bank plc and others [2010] EWCA Civ 1248*). The Court of Appeal disagreed with the lower court's literal interpretation of the release provisions and instead gave the release provisions a more purposive interpretation. Consequently, release provisions drafted along similar lines to those in the European Directories case can, in certain circumstances, be used to effect a sale of an entire group of related entities, free of liabilities, at the behest of the senior creditors and without the consent of the junior creditors.

**Jurisdiction**

The centre of main interests of entities within a distressed group, which determines where insolvency proceedings can be commenced, can be vital in determining the legal pressures, remedies or court based options that should be factored into potential restructuring proposals. Some jurisdictions require formal insolvency filings to be made within certain periods of time (*e.g.*, 21 days in Germany), which can result in significant timing pressures and sometimes necessitates finding a temporary solution. In addition, the availability and practical application of cram down (*e.g.*, an English scheme of arrangement) or "pre-packaged" procedures, which are valuable tools in bringing a restructuring proposal to successful conclusion, will depend on whether there is a sufficient jurisdictional link between the country in question and the relevant entities and the extent to which forum shopping may be available to them. Other jurisdiction-dependent legal issues, such as equitable

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subordination (a relevant consideration in Germany, for example, which may arise where lenders are also shareholders), can also come into play when deciding whether a particular proposal is viable.

**Isolating Security**

In addition to a well-drafted release provision, isolating security (where the shares and receivables in a single company can be sold in order to deliver the entire group of related entities to a purchaser) can also be an extremely useful tool in implementing a restructuring proposal. An analysis of the group structure, the collateral package and any legal limitations relating to any isolating security will therefore be an important part of any such analysis. Consideration must also be given to whether court processes, public auctions (*e.g.*, the Netherlands and Germany), moratoria, high fees/costs, or other legal restrictions or time consuming processes will obfuscate the practical utility of isolating security even if it does exist. Some structures have been found to have isolating share security but not to have any receivables pledge. Such structures may prevent any potential purchaser from buying the entire economic interest in the group through a security enforcement, which could hinder restructuring/realisation efforts.

**Security Coverage and Value**

A key consideration in analysing a restructuring proposal is likely recoveries under the restructuring proposal as compared to recoveries that might be expected on a liquidation basis. At first sight, it may appear that the debtor or related debtor group has provided creditors with a significant level of security over its assets. However, a review of the "worst case scenario" should be undertaken to determine the scope and efficacy of that security should the creditors seek to rely on it. As mentioned above, when considering enforcement procedures, it is important to note that a number of jurisdictions in which security is routinely taken do not allow for convenient or timely realisation of the security.

In any event, the reality is that guarantee limitations due to corporate benefit constraints, financial assistance, thin capitalisation rules and/or other tax or legal issues will often mean that liquidation recoveries are fairly bleak. This is perhaps not surprising, since the credit worthiness of leveraged credits ultimately depends on their ability to produce profit rather than the value of their assets. However, this analysis is a useful exercise to conduct since it provides a useful benchmark for stakeholders in considering restructuring options. If nothing more, the prospect of low recovery rates will focus the minds of stakeholders and therefore increase the likelihood of finding a solution to avoid liquidation.

**Tax Analysis**

The tax structuring of the debtor or related debtor group is always a key consideration. While all LBO structures ought to have been set up to be tax efficient from a debt service/exit perspective, it is unlikely that such structures were created with a restructuring in mind. The effect on the tax liabilities of the group will be a key aspect of the decision-making process in structuring a workable restructuring proposal, particularly if such a proposal would involve the break-up of a tax/fiscal group or a release of liabilities.

**Conclusion**

Given the myriad of issues which need to be considered, the complexities of the structures involved and the vagaries of each of the various stakeholders, no two restructurings are ever the same. The eventual outcome will often be unclear as the restructuring process ebbs and flows to conclusion, often with new stakeholders becoming involved and shaping the end result. There are no hard and fast answers when it comes to a restructuring but an appreciation of common considerations will at least assist participants in navigating what can be a challenging process. Forewarned is forearmed.

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[1] The Loan Market Association is a European trade association for the syndicated loan markets. Among other things, it provides recommended documentation for both primary and secondary syndicated loan markets.

[2] The recommended form of intercreditor agreement is available to Loan Market Association members at http://www.loan-market-assoc.com/documents.aspx (last visited March 29, 2011).

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