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Getting inside each other's heads

Understanding the approach of lenders and DB pension trustees in stressed multi-creditor refinancings and restructurings

2023

Introduction

As we continue to navigate through economically straitened times, we are likely to see more challenging multi-creditor refinancings involving companies and groups with defined benefit ("DB") pension schemes. These situations can become extremely complex – and understanding the perspectives of bank lenders, bondholders and DB scheme trustees is vital if a satisfactory outcome is to be achieved; and unnecessary value destruction avoided.

With this in mind, this paper seeks to enable lenders and DB trustees to understand each other's likely position in a stressed refinancing or restructuring transaction from both commercial and legal perspectives.

The aim is to help mitigate value destruction through the parties failing to agree appropriate terms due to misunderstandings or misperceptions around the positions and priorities of other stakeholders - in turn leading to the further demise of the corporate borrower/DB scheme sponsor.

Whilst this paper has been written in challenging economic times, its principles apply in relation to any stressed corporate refinancing or restructuring involving multiple creditors, including lenders[1] of various forms and a UK DB pension scheme.

The paper explores the perspectives of differing stakeholders in a refinancing or restructuring scenario by considering the position of a "fairweather" company which is performing well – and then, using a fictional case study (starting on page 8) involving a group called "Steadyco International PLC" considers how various parties may behave during progressive periods of corporate stress.

1. The paper considers the likely positions of a range of different lenders – including syndicated, club or bilateral bank lenders; quoted or private placement bond / noteholders; and specialist lendaers such as Asset-Backed Lenders ("ABL's") or "special situation" funds. Collectively, the paper will refer to all of these and similar parties as "lenders" – but where appropriate will distinguish between each lender class.

The starting point: the position of a “fairweather” company

Motivations and legal obligations of different stakeholders

To understand the likely position of each class of creditor in a stressed refinancing or restructuring, it is helpful to understand their initial motivations and legal obligations when a company is performing satisfactorily.

Bank lenders

The nature and terms of bank lending vary – but may include a Revolving Credit Facility (“RCF”) for day-to-day funding purposes; and more structural “term loans” forming a key part of the borrower’s capital structure.

Bank lenders may act individually; as a “club” of, say, three lenders; or as a syndicate comprising a number of lenders: for larger credits, syndicates may comprise a large number of banks.

The key motivations of lenders when the corporate borrower is performing well include preserving the corporate relationship in a highly competitive lending marketplace whilst earning a satisfactory margin on their loans.

Lending agreements will contain a range of conduct provisions including (usually but not always) financial and other covenants designed to protect the lenders’ position in the case of off-plan financial performance. However, in relation to “fairweather” corporate borrowers, there is usually significant headroom in the financial covenants when they are set, meaning that associated events of default are (at that time) unlikely.

The consequences of an event of default are likely to depend on the corporate’s financial health and bargaining power: a “technical breach” such as an administrative error is likely to be waived without fuss; a more fundamental breach, for example, of a financial covenant, may result in more substantial impacts. These are discussed in the scenarios below.

Listed bond holders

Companies may issue listed bonds as part of their structural capital. Bonds may be listed on the London Stock Exchange or an international exchange; and are typically rated by one or more rating agency (including Fitch, Moody's and Standard and Poor's). Given their listed status, bonds are usually subject to the "inside information" requirements that apply to listed shares (whether or not the issuer's equity is listed). Listed bonds are generally held through the ICSDs (International Central Securities Depositories or "clearing systems") of Euroclear and Clearstream. As a result of the rules of the clearing systems, the identities of the bondholders are not available to the issuer.

Listed bonds are typically unsecured obligations, although bonds may also be issued on a secured basis, collateralised by specific assets or cash flows. In the case of listed bonds issued by investment grade corporates, it is often the case that the bonds do not include financial or operational covenants, other than a negative pledge clause. However, some bonds (particularly in certain sectors) do include covenants, such as interest cover ratios and asset cover ratios.

The bond documentation may provide for the bondholders to be represented by a trustee, although this is not required except in the case of secured bonds. If the bond documents do provide for a trustee, the trustee will generally be reactive rather than proactive, and will expect to be instructed and indemnified by bondholders before taking any steps on their behalf.

In addition to the traditional investment grade bond market, there is a market for non-investment grade (or "high yield") bonds. These bonds typically include a covenant package, including restrictions on incurring additional debt and detailed operational restrictions. Investors in non-investment grade bonds may be seeking to achieve a return from both the bond yield and any change in bond pricing (and rating) due to positive developments related to the borrower.

US private placement ("USPP") noteholders

USPP notes are bilateral notes providing issuers with longer term structural capital, typically from three to 15 years, although longer durations (up to 30 years) are sometimes available. USPP transactions may include multiple tranches of USPP notes in a variety of currencies, with swap arrangements put in place for non-US dollar tranches either by the issuer or the noteholders.

USPP notes may be issued to a single investor and its affiliates in bilateral transactions or to multiple investors (and with majority noteholders directing voting/amendments). Investors in USPP notes are primarily insurance companies, as well as some pension funds and private investment funds, which utilise a "buy and hold" investment strategy. Given the relatively small pool of active USPP investors, the long durations of USPP debt and the bilateral structure of USPP transactions (i.e. there is no agent acting on behalf of the noteholders as is the case with syndicated bank loans), issuers with multiple USPP issuances in the market have the opportunity to develop long-term working relationships with USPP noteholders.

The terms of USPP notes are governed by note purchase agreements based on the American College of Investment Counsel's ("ACIC") model form note purchase agreements (the "Model Forms"), including separate "Model X Forms" for non-US issuers. Therefore, there are broad similarities across USPP transactions, with negotiations typically focusing on the covenant package and other deviations from the Model Forms. Financial covenants in USPP transactions will typically align with the issuer's RCF or term loans. Note purchase agreements are frequently governed by New York law, as well as English and French law.

Private placement notes are typically unsecured. USPP investors strongly prefer pari passu senior note structures and, in cases where the issuer's RCF or other principal debt is secured, the terms of the note purchase agreements will require that the USPP noteholders share the same collateral package as the issuer's bondholders or bank lenders. Secured USPPs are typically issued under a platform structure with a common terms agreement, together with a pared down note purchase agreement.

Specialist lenders

A corporate may take out other forms of short or long term debt to meet its day-to-day working capital or longer term needs. Examples include property leases; and other Asset Backed Lending including supply chain finance or invoice discounting arrangements.

The terms of these arrangements will be bilaterally agreed but often include some element of security over an underlying asset or class of assets.

DB scheme trustees

Trustees of UK DB occupational pension schemes owe various fiduciary obligations to the members and beneficiaries of their scheme. The trustees' primary responsibility is to ensure that the pensions and other benefits payable to the members and beneficiaries under their scheme can be paid on time and in full.

The trustees of a DB scheme must manage the funding of the scheme in accordance with the scheme's trust deed and rules; and in line with statutory requirements and regulatory guidance. Under the statutory funding regime, trustees are required to ensure that their scheme has sufficient assets to cover its liabilities (referred to in the legislation as the scheme's "technical provisions"), where those liabilities are calculated in accordance with an actuarial method and assumptions set by the trustees on a prudent basis (usually with the agreement of the scheme's sponsoring employers).

The assumptions used to value a scheme's liabilities will usually take account of the strength of the "covenant" that stands behind the scheme. This will encompass the strength of the scheme's sponsoring employers as well as the value and enforceability of any contingent security that has been granted in respect of the scheme. Trustees will typically obtain independent covenant advice to help them assess the strength of the covenant in respect of their scheme.

Trustees are required to prepare an actuarial valuation to assess the extent to which their scheme has sufficient assets to cover its technical provisions at least once every three years. Where a scheme has a deficit, trustees are required to put in place a recovery plan setting out how the deficit will be cleared and over what period[2]. The recovery plan will usually need to be agreed with the scheme's employers.

As well as agreeing the funding arrangements for their scheme as part of the triennial actuarial valuation process, trustees will wish to ensure that any corporate actions taken from time to time which may be considered "materially detrimental" to the covenant or the scheme are appropriately mitigated[3]. Actions which might be considered materially detrimental could include:

- the sale of a material part of a sponsor's business without a payment being made to the scheme;
- the payment of dividends which materially weaken the sponsor's balance sheet strength; or
- the granting of security to a third party creditor which has the effect of weakening a scheme's unsecured claim on insolvency[4].

Company directors (and lenders) also need to be mindful of taking action which could be materially detrimental to a DB scheme, as this could potentially constitute a criminal offence[5] or provide the Pensions Regulator with grounds to impose a financial penalty[6] or exercise its anti-avoidance powers[7].

2. The majority of UK DB schemes are closed to new members and to future accrual. Where a scheme remains open to accrual, trustees also need to agree contributions to meet the ongoing costs of accrual.
3. Commentary in relation to materially detrimental events and the application of specific "moral hazard" tests is provided by the Pensions Regulator at: Code 12 Contribution Notices: Circumstances in relation to the material detriment test, the employer insolvency test and the employer resources test | The Pensions Regulator
4. See the Employer Insolvency Test under the Pensions Regulator's guidance at Note 3.
5. Under sections 58A or 58B Pensions Act 2004.
6. For example, under sections 58C or 58D Pensions Act 2004.
7. This refers to the Regulator's powers to issue a contribution notice or a financial support direction under the Pensions Act 2004.

The Government is planning to introduce additional funding requirements for DB schemes in the near future[8]. These new requirements will be supported by a new funding Code for DB schemes[9], to be published by the Pensions Regulator. In very broad terms, these new requirements are designed to reduce the reliance of DB schemes on their sponsoring companies as a scheme matures by requiring trustees to develop and implement a funding and investment strategy, which is designed to ensure their scheme is fully funded on a "low dependency basis" by the time it is "significantly mature"[10]. Low dependency means broadly that, under most circumstances, the scheme is not expected to need further contributions from the employer.

For some schemes the new funding requirements may significantly increase the scheme's funding target and accelerate the pace at which the scheme's employers need to clear any deficit within the scheme.

Directors

Directors owe general duties under the common law and under the Companies Act 2006 to act in the interests of the company. As noted above, these duties must be exercised with an awareness of the criminal offences under the Pensions Act 2004 and the powers of the Pensions Regulator to issue financial penalties or exercise its anti-avoidance powers where any actions are taken which could be, broadly speaking, materially detrimental to a DB scheme.

Other stakeholders

Depending on the nature of the borrower, other stakeholders to consider may include various Governmental entities (for example, in relation to unpaid tax and/or Covid-19 loans); shareholder loans (typically in private equity structures); surety bond and credit insurance providers; and activist shareholders.

In insolvencies, certain parties – such as employees and HMRC in respect of certain unpaid taxes – are likely to have preferential claims.

Inter-creditor arrangements

It is not uncommon for corporate borrowers with multiple lending arrangements to agree an inter-creditor agreement governing the respective rights of creditors (such as lenders) as regards matters such as the priority and order in which the various debts will be repaid; access to information; the status of any security; the conduct of any enforcement of security; and the "waterfall" order in which recoveries are distributed in an insolvency.

Importantly, inter-creditor agreements will also often govern the required majorities of lenders that must be obtained in order to make any particular decision (such as the exercise of a discretion by the facility or security agent or an amendment to the underlying finance documents). Decisions will typically require either a simple majority, a two-thirds majority or a "super" majority of 90% of the holders of any particular tier of debt.

DB scheme trustees will need to consider their position in any inter-creditor agreement carefully and take specialist advice. As part of this, they may agree separate bilateral contractual arrangements with the sponsor governing matters such as information flows.

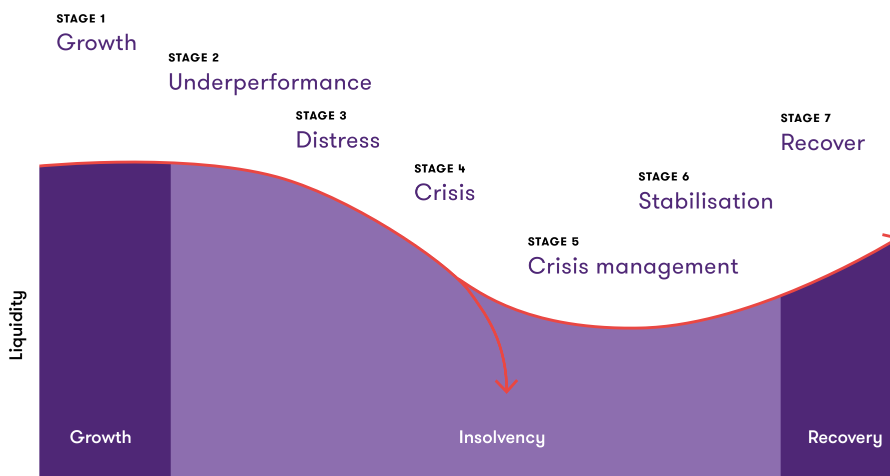
8. At the time of publication, it is expected these new statutory requirements will come into force on 1 October 2023.
9. In December 2022, the Pensions Regulator initiated a consultation in relation to the new Funding Code. Consultation published by TPR on new DB funding code | The Pensions Regulator
10. Some DB schemes may already be passed or fast approaching the point of "significant maturity", the meaning of which will be set by the Pensions Regulator in its new DB funding Code.

When corporate fortunes change…the "demise curve"

A number of authors and commentators refer to a corporate "demise curve" – when corporate performance starts to weaken, moving a company either towards insolvency or, ultimately, to some form of recovery, possibly with a restructured balance sheet.

Implications of moving down the "demise curve" include changes to stakeholder decision-making bodies (for example, the involvement of bank "workout" teams or the appointment of a professional DB pension scheme trustee): these are discussed in more detail later in this paper.

One diagrammatic representation of the corporate demise curve is set out below:



Sliding down the demise curve – "Steadyco International PLC"

The remaining elements of this paper explore how lenders and DB pension scheme trustees might behave at different stages of a corporate's demise using an illustrative and stylised case study, based on the experience of Steadyco International PLC, a (fictional) UK listed industrials group. Background information is as follows:

As at 1 January 2023, Steadyco's equity market capitalisation was some £1.4bn. It has been a consistently strong-performing group. Its senior management team is comprised of experienced industry executives who have worked in a range of high-performing companies over their careers. The CFO has worked at a number of major international corporations with investment grade debt.

Steadyco had an unsecured RCF of £250m with a maturity of 30 June 2024; three unsecured bond programs of varying maturities totalling £700m and issued at par; several series of unsecured USPP notes with varying maturities totaling £450 million issued to 18 investors pursuant to a single note purchase agreement; and a DB scheme with assets of £1.2bn. There is no inter-creditor agreement in place.

The DB scheme's last actuarial valuation revealed a deficit on a technical provisions basis of £125m based on a "Tending to Strong" covenant rating – although the next actuarial valuation is due as at 31 March 2023. The "Tending to Strong" rating reflected some concerns around Steadyco's total "debt stack" – notwithstanding its strong historical operating performance. The scheme is closed both to new members and to future accrual. The trustees have an Information Sharing Protocol ("ISP") in place with the company.

Four hypothetical phases around an assumed deterioration in Steadyco's financial position are considered below:

Phase 1 – Significant corporate performance weakening but no lending event of default.

Phase 2 – Further deterioration with lending covenant breaches.

Phase 3 – A solvent consensual refinancing.

Phase 4 – Outright insolvency.

Jurisdictional issues

For the purposes of this paper, unless otherwise indicated, the analysis set out assumes English law as the governing law for all the relevant arrangements – including lending agreements; pensions law; and insolvency law.

In practice, it is not uncommon for multi-creditor situations to be multi-jurisdictional – for example, with a UK corporate borrower and DB scheme sponsor forming part of a US listed group which has issued US bond debt. The implications of cross-border lending and other arrangements clearly require specialist legal and professional advice.

Phase 1 – Significant corporate performance weakening but no lending event of default

Supply chain pressures and rising input costs lead to a significant deterioration in Steadyco's profitability and cash flow.

On 3 March 2023, Steadyco publishes a trading statement referring to "challenging market conditions" and indicating that earnings for the 6 months ending 30 June 2023 are likely to fall materially short of market expectations. However, the company confirms that it expects to remain fully compliant with its various lending covenants.

The share price falls 18%. The bond prices fall to a range of 92-95 pence from trading around par. There is no updated rating report at the time of the announcement.

Implications

At this point, there is no event of default in Steadyco's various lending arrangements.

However, it is distinctly possible that the company will go onto the RCF lenders' "watchlists"; and rating agencies may prepare updated reports in relation to the bonds, possibly downgrading the credit rating or placing the ratings on "negative watch".

The RCF Agent Bank may receive queries from syndicate participants and seek clarifications from Steadyco – recognising sensitivities with Steadyco being a listed group.

The USPP noteholders may also exercise their rights under the note purchase agreement to request further information about the business or financial condition of Steadyco, subject to any negotiated provisions in the note purchase agreement limiting this obligation (e.g., for research and development materials). Note purchase agreements also often contain provisions that require issuers to provide to the USPP noteholders any information that has been provided to their bank lenders; therefore, any information that Steadyco provides to the syndicate will likely have to be provided to the USPP holders as well. Steadyco will also have to be mindful of any "BIG event" provision (i.e., an interest rate step up triggered if the issuer's rating falls below investment grade) in its note purchase agreement to the extent the ratings downgrade results in a below investment grade rating.

The management team and lenders will be watching to see whether Steadyco's credit insurers "pull their lines" – an early warning sign for corporate distress.

The DB pension scheme trustees' covenant advisers will likely flag the announcement to the trustees, suggesting that they look at the position in more detail as part of the forthcoming work for the actuarial valuation. The advisers and trustees may already be aware of developments as a result of information disclosed under the terms of the ISP. The covenant advisers may signal caution around any possible lender response to further deterioration - and that they are worried about Steadyco's financial trajectory. The mood amongst the trustees may become a little more nervous – but not acutely so.

Steadyco's management focus has turned to cost control and liquidity management – although their collective experience has not exposed them to such sudden financial challenge in the past.

Phase 2 – further deterioration with lending covenant breaches

Trading market conditions deteriorate further and, although Steadyco has not made a further announcement, the share price has drifted down.

In early August 2023, Steadyco is forced to publish a trading statement which states that performance has fallen well short of expectations and that its full interim results will be delayed pending ongoing "constructive" discussions with its lenders as a result of covenant breaches (both RCF and bonds) at the half year date.

The share price plummets 40% - with the market capitalisation now just some £450m (compared with £1.4bn as at 1 January 2023). Steadyco's various bonds trade in the 75-80 pence range.

Implications – overview

Clearly, a considerable amount of activity has taken place "behind the scenes".

In the space of five months Steadyco has moved from under-performing relative to market expectations to being in breach of its lending covenants.

From Steadyco's perspective, the position for the management team – who have not experienced this degree of financial challenge previously in their careers – may have become close to overwhelming: whilst seeking to manage the business and respond to the trading downturn, the CFO and their team will likely be inundated for information requests from a range of parties including lenders; equity analysts and the pension scheme trustees' covenant advisers. A considerable focus for all parties will be on Steadyco's "13 week" cashflow forecasts – which will now be absorbing considerable finance team time.

Against this backdrop, the viewpoints of the various key creditors around the time of the announcement are considered below.

The RCF lenders' viewpoint

The extent of performance deterioration and covenant breaches will clearly be of considerable concern to the RCF lenders.

The covenant breaches will have significantly shifted the balance of power between Steadyco and its lenders. In extremis, the RCF lenders could accelerate (call in) their loans. However, such a move is likely to be value-destructive absent strong underlying asset security; and it is likely that the RCF lenders' interests are best served by helping the group recover.

Nonetheless, given the covenant breaches, it is likely that the RCF lenders will have (i) moved control of the case from their "relationship" teams to their "workout" departments; and (ii) formed a Steering Committee of, say, three banks to represent the syndicate's interests. Depending on their view of Steadyco's outlook, they may have commissioned an Independent Business Review ("IBR") from an accounting or other specialist firm which will consider the group's business plans; "stressed" sensitivities and scenarios; possible outcomes on insolvency; and outline contingency plans. The RCF lenders will also have instructed specialist legal advisers to help them negotiate their position and draft the necessary documentation for any amendments.

The RCF lenders' focus will have shifted to value recovery – albeit that they will probably seek increased margins and fees for agreeing to any stressed refinancing arrangements. They may also consider seeking some form of floating or fixed charge security over the group's unencumbered assets, although they will be mindful that such additional security may be vulnerable to challenge as a "preference" if the company subsequently enters insolvency proceedings. This may place them squarely at odds with the DB pension trustees (see below). Finally, they may put in place tighter reporting requirements from the group; and reduce Steadyco's flexibility to undertake actions such as incurring further indebtedness or executing certain corporate activity unless agreed with the lenders.

All of this means the nature of the relationship between the syndicate and Steadyco will have changed markedly – and is likely, whilst not outwardly adversarial, to be robust and business-like.

One variation to the RCF lenders' position may be any influence of "secondary lenders" – specialist investors or lenders who buy out "par lenders'" positions with a view to making a return on any recovery. To the extent that secondary lenders are able to block "all-bank" or "majority bank" decisions, they may hold considerable power over the terms of any refinancing arrangements.

Where non-RCF lenders have uncommitted facilities in place, there will be pressure from those lenders to limit or remove those and at this point a divergence in approach may arise between those with undrawn or partially-drawn committed lines; and those with significant drawn positions. Depending on the need for uncommitted lines to remain in place to support trading, this may become a material issue.

The bondholders' viewpoint

The nature of bonds as tradeable instruments subject to "inside information" rules, potentially held by a wide investor base, means it is unlikely that there will be a day-to-day relationship between Steadyco and its bondholders. Steadyco may be required to hold periodic bondholder update calls and to provide certain prescribed information.

As professional investors (pension funds, insurance companies, investment trusts etc), the bondholders' viewpoint will be financially driven, without the wider commercial context of relationship banking which is relevant to Steadyco's bank group.

In this case, there has been a lending covenant breach in relation to the bonds as well as in the RCF. Where bondholders are required to make collective decisions (such as in relation to potential waivers or restructurings), this can be done by resolutions passed at bondholder meetings. These meetings are generally conducted through the clearing systems, with bondholders exercising their voting rights by proxy and without any requirement for bondholders to attend in person. The quorum and voting thresholds required to pass a resolution will be set out in the bond documentation. There are generally higher quorum requirements to pass resolutions which affect the key commercial terms of the bonds.

In some cases, certain bondholders may form a committee to negotiate the terms of any waiver or restructuring with the bond issuer. As mentioned above, bondholders' access to information will be governed by relevant provisions applicable to listed instruments and "insider dealing" laws.

From the perspective of all parties, it is crucial to understand the bondholders' powers – in particular any "holdout" powers to block a consensual refinancing other than on attractive terms for them.

The USPP noteholders' viewpoint

Given the alignment of financial covenants across Steadyco's RCF and note purchase agreement, any covenant breach under the RCF will result in a covenant breach under the note purchase agreement or, alternately, a cross default. As in the case of Steadyco's bank lenders and bondholders, the covenant breaches will be of considerable concern to the USPP noteholders.

As USPP noteholders are not represented by an agent, Steadyco will be required to appoint legal counsel acceptable to the noteholders to represent them in connection with any wavier process. Once appointed, the noteholders' legal counsel will coordinate noteholder meetings, requests for information and comments on any documentation.

With 18 USPP noteholders, even if one or two anchor investors take the lead, the negotiations related to Steadyco's covenant breaches could be protracted, with the potential for holdouts. Regardless, the USPP holders will likely require waiver fees, as well as additional financial covenants and monitoring covenants (e.g., quarterly noteholder calls, monthly management reports, etc.) in consideration for granting any waivers.

Any security granted by the RCF lenders will also have to be granted to the USPP noteholders on a pari passu basis in light of the priority debt and security covenants that are found in the ACIC model form. Any new guarantees of the RCF or bonds will also have to guarantee the USPP debt. Where the financial covenants in the note purchase agreement align with the RCF, USPP holders will also not typically grant any financial waivers under the note purchase agreement unless bank lenders have waived any corresponding covenant defaults under the RCF. USPP noteholders will also typically require that any additional fees paid to the RCF lenders are replicated for the USPP.

The DB scheme trustees' viewpoint

Like the lenders, the trustees will have legal advisers to represent them in any negotiations – alongside their covenant advisers who will provide them with ongoing advice on the financial position of Steadyco and the strength of the scheme's covenant.

Similar to the lenders, the DB scheme trustees' interests are unlikely to be best served in this case by an insolvency - which would commence a PPF assessment period and likely result in members and other beneficiaries not receiving their benefits in full. However, they will be acutely concerned about any group of lenders advancing their position(s) at the expense of the pension scheme and, like the lenders, will likely request frequent information updates.

Specifically, the trustees and their advisers will be keen to ensure that nothing is agreed with lenders – in particular, security ranking ahead of the scheme – which is "materially detrimental" to the covenant supporting the scheme or the potential recovery of the scheme on insolvency. Structurally, although both the lender and scheme's creditor positions may be unsecured, the recoveries to different parties may vary depending on which group entities are sponsoring employers to the scheme; and where external debt "sits" within the group.

For efficiency's sake, it may be agreed that the trustees' covenant advisers are given access to the information elements of the lenders' IBR on a "hold harmless" basis.

The trustees will also want to ensure that there is no other covenant leakage in the form of dividend payments to shareholders or early repayment of loans. In light of the Pensions Regulator's draft new DB funding Code of Practice[11], they will also be keen to understand and scrutinise the rationale for any planned investment in the business, the returns this is likely to generate and over what period.

Given the scale of Steadyco, the situation may have elicited the interest of the Pensions Regulator who may have specialists engaged with both the company and the trustees. Ultimately, it would be for the Regulator to determine whether and, if so, how to engage and also whether to launch an investigation to consider whether to exercise any of its statutory anti-avoidance powers, impose financial penalties on any party or bring a criminal prosecution under the Pensions Act 2004.

Irrespective of any "material detriment", it is likely that the deterioration in Steadyco's covenant will have a bearing on the actuarial assumptions that will be used to calculate the scheme's liabilities in the triennial valuation that is currently being prepared. This in turn may result in a larger funding deficit: the trustees will need to agree a new deficit recovery plan with Steadyco setting out how quickly any increased deficit will be cleared – at a time of funding constraint. The trustees will also need to consider the extent to which the expected new low dependency funding requirements should be factored into the valuation[12]. This will be particularly relevant if the scheme is at, or approaching, significant maturity as defined by the Pensions Regulator in its new funding Code.

Given Steadyco's deteriorating financial position and the potential for an increased deficit within the DB scheme, the trustees may seek some form of contingent security from the Steadyco group to enhance the strength of the covenant standing behind the scheme.

11. New DB funding Code - https://www.thepensionsregulator.gov.uk/en/document-library/consultations/draft-defined-benefit-funding-code-of-practice-and-regulatory-approach-consultation/draft-db-funding-code-of-practice
12. Although the valuation has an effective date pre-1 October 2023, the trustees will still be concerned to assess how the new funding requirements are likely to impact the scheme and to calculate the period to significant maturity. Depending on the outcome of this, they may want to take steps as part of the current valuation process to ensure the scheme is on track to meet the new low dependency funding target by the time the scheme is significantly mature.

The need for level-headedness and the risks of chaos

What can surprise people involved for the first time in a situation such as this is the frenetic level of activity and the acute hunger for information by multiple parties. This places enormous pressure on management teams – at a time when parties' best interests are likely served by the management team focusing on turning the business around.

The "heat and light" may be compounded by the number of advisers involved – legal and financial – representing the various parties.

In the case of Steadyco, analysis undertaken by financial advisers shows that the various parties' individual interests are likely best served by Steadyco recovering – not by driving the group to insolvency. However, each party will likely engage bilaterally with Steadyco to seek to advance or protect their position – with the risk that, as one position is agreed, other stakeholders seek to renegotiate theirs unless the terms are fair for all.

The position agreed with each stakeholder will inevitably reflect their leverage in the negotiations: for example, if "new money" is to be introduced to support Steadyco's survival, granting security over this additional funding may be a fundamental precondition of the provider.

One option can be for Steadyco's advisers to seek to hold multilateral discussions with representatives of the various parties with a view to securing a consensual arrangement – potentially with an inter-creditor agreement to govern the ongoing relationship between the parties.

That is not to say there is not a risk of "holdouts" or brinkmanship – particularly by shorter term investors who may be motivated to leverage their positions solely for immediate returns.

Directors

As the company descends into greater distress, directors need to keep under consideration an assessment of where the balance of competing interests between the various stakeholders should lie. The directors' duty to consider the interests of creditors is engaged when the directors know, or ought to know, that the company is insolvent or bordering on insolvency or that an insolvent liquidation or administration is probable. Directors will need to balance creditors' interests with the competing interests of shareholders, giving greater weight to creditors' interests the greater the likelihood of insolvency proceedings becomes.

Directors will also be mindful of liability for wrongful trading, which arises when they know or ought to have known that there was no reasonable prospect of the company avoiding insolvency proceedings and will need to take professional advice on whether it is appropriate for the company to continue to trade in the ordinary course of business. Board decision-making around material transactions must be properly documented. Close monitoring of the company's financial position should be undertaken. Professional advice should be taken sooner rather than later – the right advice may help to avert a distress scenario from ever arising, or from worsening. In respect of some liabilities, there is statutory relief for directors who have acted honestly and reasonably in the circumstances and evidence of reliance upon independent advice could make all the difference.

Phase 3a – a solvent consensual refinancing

The parties work to deliver a solvent refinancing. The management team bring in a range of experienced legal, financial and turnaround advisers to support them.

The interim results are finally published in October 2023: they explain that the company has agreed a turnaround plan alongside amended arrangements with its lenders; and has commenced a "deleveraging program" involving a range of asset sales. The announcement also refers to a change of CEO and CFO – with the incumbents being replaced by experienced turnaround finance professionals.

The interims confirm that discussions have been concluded with the DB pension scheme trustees regarding the ongoing actuarial valuation and recovery plan. The scheme is now a party to the Intercreditor Agreement alongside the lenders: this includes details of how disposal proceeds from the deleveraging program will be shared with the scheme.

The share price falls only a little further resulting in a market capitalisation of some £300m. Shortly afterwards, two rating agencies downgrade the bonds to highly speculative ratings on negative watch.

Nonetheless, the group survives and starts the long road to recovery…

Implications – overview

The "biggest losers" from Steadyco's performance deterioration turn out to have been its shareholders.

Crucially, however, the company has agreed a balanced outcome which reconciles the needs of the various lenders and the DB scheme. The balanced outcome is, importantly, a consensual one that did not require the use of the other restructuring tools that were potentially available and would have been considered by directors and creditors (namely, CVAs, pre-pack administrations, schemes of arrangement and restructuring plans – which are considered in Appendix 1). The alternative, if the consensual refinancing failed and the other restructuring tools could not be deployed, would have been an insolvency process which analysis showed would have been massively value-destructive.

The RCF lenders' viewpoint

The RCF lenders recognised that their best interests were served through preserving the group, rather than initiating an insolvency process; and agreed to an amended and restated facility with a maturity date of October 2027; and additional fees and margin. Covenants were reset so as to provide adequate headroom to allow the group flexibility to recover. The RCF lenders are a counterparty to a new inter-creditor agreement.

The RCF lenders agreed ongoing enhanced financial reporting and terms which assume ongoing deleveraging (both through financial covenants which continued to tighten over time and required amortisation of debt). They also agreed constraints on certain business activities outside of day-to-day trading.

Although the syndicate now contains some secondary lenders, their voting rights were not sufficient to block required majority bank approvals.

Although this was not ultimately necessary in the Steadyco scenario, a company's RCF lenders, being the lenders with whom the distressed company has the closest banking relationship, are typically the financiers that it would look to for the provision of additional emergency financing. Emergency financing would typically be a short to medium-term bridge loan to meet a company's immediate cash flow gap. Lenders tend to insist that emergency financing benefits from super-senior priority under the relevant inter-creditor arrangements and would be repaid first in the event of an insolvency. Depending on the terms of the inter-creditor agreement and the relevant finance documents, the injection of additional debt into a distressed company will require the consent of junior-ranking lenders (who will be incentivised to agree to the emergency financing on the basis that it makes an insolvent outcome less likely).

The bondholders' viewpoint

The bondholders' immediate concern at this stage of the scenario will be the reduction in the value of their listed bonds; related to this, they will also be alive to the risk of missed coupon payments. Bondholders will likely have divergent views, depending on the investment strategy of the relevant credit institutions of investment funds and the time when they purchased the bonds. Some bondholders would have acquired the bonds at par/face value when they were issued or shortly thereafter, whereas others might have purchased them at a discounted price. Some bondholders with more defensive strategies may attempt to sell their bonds at the current discounted trading price to buyers who specialise in distressed credit opportunities.

Bondholders will at this stage likely club together in ad-hoc groups or committees to represent their interests. It is not uncommon for more than one such group to form among bondholders. The interests of one group may be to support the company as far as possible with its financial recovery (e.g. by granting necessary waivers and consents to emergency financing) because the lenders in the group intend to realise value through a recovery of the bond price itself. At the same time, another group pursuing a "loan to own" strategy may be interested in negotiating either a conversion of their bonds into shares (a debt to equity conversion), or bringing about an enforcement or (in extreme cases) an insolvency process with a pre-packaged sale (discussed below) in which they can acquire the company's assets by using their bond debt as consideration in a "credit bid".

The USPP noteholders' viewpoint

As with the RCF lenders, the USPP noteholders recognised their interests are best served through preserving the group and are party to the intercreditor agreement. The USPP noteholders also agreed to new covenant levels similar to those in the RCF, as well as additional interest and fees and new reporting and monitoring covenants throughout the waiver period, including quarterly calls with the new CEO and/or CFO. Because of the asset sales incorporated into the deleveraging plan, additional waivers of the asset sale covenants in the note purchase agreement are required. USPP noteholders also negotiate a new prepayment event, which requires Steadyco to offer the noteholders a pro rata prepayment of their USPP debt following the completion of each asset sale.

Following the ratings downgrade, the BIG event provision in Steadyco's note purchase agreement is triggered, requiring that Steadyco pay additional interest on top of the renegotiated interest rate agreed as part of the waiver and restructuring process.

The DB scheme trustees' viewpoint

The DB scheme trustees and their advisers fought hard to protect the scheme's interests in the refinancing; and to agree an appropriate recovery plan in relation to an increased deficit. The presence of the Pensions Regulator at key points in the discussions added weight to the trustees' position.

Lenders' requests for security were resisted by the trustees who contended robustly that such security would be materially detrimental to the scheme: the lenders ultimately accepted this as no "new money" was to be provided; and all creditors remained pari passu as unsecured parties.

The scheme formed part of the inter-creditor agreement; and benefited from a number of provisions regarding access to information and a negative pledge prohibiting Steadyco from granting further security to any party.

The trustee board were surprised by the pace and intensity of the various negotiations – but dedicated considerable amounts of time to delivering a result which aimed to preserve Steadyco's longevity – and, in turn, to protect the interests of the schemes' members.

Other restructuring tools (see Appendix 1 for details)

As noted above, in negotiating the consensual refinancing, creditors and directors would have been very alive to the potential need to deploy other formal restructuring tools available in English law. These are, principally, (i) Company Voluntary Arrangements ("CVAs"); (ii) schemes of arrangements; and (iii) restructuring plans. Each of these restructuring tools will become necessary if a consensual restructuring transaction is not possible due to a minority of hold-out lenders which decline to cast their votes in favour of the necessary changes to their finance documents.

Phase 3b – Outright insolvency

Had a successful refinancing or other restructuring not been concluded, the story could have ended rather differently…

Steadyco's trading continues to deteriorate with key customers deserting the company as it does not have the capital to improve its product set. The market capitalisation shrinks to below £100m and its bonds have been trading in the 40-50 pence range. An updated IBR conducted for the bank lenders has suggested that the company is incapable of supporting its current capital structure, The pension scheme trustees' latest covenant report inevitably grades the covenant as "very weak".

Steadyco's directors are concerned that the group does not have the liquidity necessary to meet (already stretched) supplier invoices and the December 2023 payroll. Following a further market update, they formally request that the shares are suspended. They take legal and insolvency advice on a daily basis – finally concluding that they have no choice but to request the appointment of administrators. This triggers the payment of a buy-out debt to the DB scheme, which enters a PPF assessment period…

Implications – overview

Everyone is likely to be a loser in this scenario given the value destructive nature of entry into an insolvency process.

Shareholders are highly unlikely to recover. The appointed administrators or liquidators will work to sell the company's property to enable recoveries for lenders, although unsecured creditors are unlikely to be paid in full. Directors face potential investigations by the administrators as well as potential insolvency claims and/or actions for breach of their duties.

Without the benefit of any form of security (or other contingent asset), the DB pension scheme, as an unsecured creditor, would lose out in the insolvency process with the buy-out debt that would become due to the scheme on insolvency under section 75 of the Pensions Act 1995 not being paid in full. The Pensions Regulator commences investigations into the conduct of the directors and considers whether there are any grounds to warrant the use of its powers under the Pensions Act 2004, which include civil and criminal sanctions. If it were to exercise its anti-avoidance powers this might eventually lead to some additional funds being received by the scheme or the PPF. However, such action is rare and, if any such action is taken it is likely to be contested, meaning any additional payments that may become due to the scheme or the PPF are unlikely to be received for some time.

Conclusions

Multi-creditor stressed or distressed refinancings or restructurings can be immensely complex; expensive and time-consuming. They also risk being massively value-destructive if the various parties do not understand each other's likely requirements – including those of DB pension scheme trustees who are bound both by the governing provisions of their scheme, their fiduciary duties and a broad body of legislation and regulatory guidance.

In Steadyco's case, the company agreed a balanced outcome which meant that it could continue trading: this in turn benefited all of its various lenders and the DB scheme members – in circumstances where an outright insolvency would have resulted in substantial losses.

What this example makes clear is how demanding the turnaround process can be for management teams – whose principal focus would ideally be on running the business as effectively as possible.

In summary, mitigating the demands on management teams so they can concentrate on delivering value; and seeking to arrive at a balanced, consensual and value-preserving outcome requires different stakeholders, including lenders and DB scheme trustees, to "get inside each other's heads".

The costs of not doing so, and of holding out for an undeliverable position, can be extremely value destructive for all parties.

Appendix 1

Selected restructuring tools

Creditors voluntary arrangement (CVA)

A CVA is a statutory compromise or other arrangement between a company and its creditors under the Insolvency Act 1986. It is implemented under the supervision of an insolvency practitioner (the "supervisor") and binds all unsecured creditors of the company who are entitled to vote if the necessary majority of creditors (being 75% by value of the underling debt)[13] vote in favour of the proposals. Typically, this will include a rescheduling or reduction of the company's unsecured debts or other arrangements which will balance the interests of different stakeholders.

In Steadyco's case, the debt owed to the RCF lenders and the bondholders is unsecured and therefore vulnerable to being compromised by a CVA. Many other financing structures include secured debt, such that a CVA is unlikely to be the entire solution to the restructuring. In a case where a company's debt stack includes secured debt, secured lenders could make it a condition of their (otherwise consensual) restructuring that the debtor company first obtains a reduction of its unsecured rental liabilities owed to its various landlord creditors. CVAs have been used to great effect by companies in the retail sector to reduce ongoing leasehold liabilities in this way.

Due to the fact that Steadyco has a DB pension scheme, were it to lodge a CVA in Court, this would automatically trigger a Pension Protection Fund (PPF) assessment period. As a consequence, the PPF would acquire the pension trustee's voting rights in the CVA; and it would consult with the Pensions Regulator before exercising such rights. The PPF will only vote in favour of a CVA where its seven restructuring principles are complied with. These are set out in the PPF's guidance paper[14] and include (among other things) that:

- insolvency must be inevitable (the gateway test);
- the pension scheme must receive more money than in an insolvency; and
- what is offered to the pension scheme in the restructuring is fair compared to what other creditors and stakeholders receive as part of the transaction.

Crucially, the PPF will seek at least 33% of the equity in the restructured company for the pension scheme by way of "anti-embarrassment" protection.

Scheme of arrangement

A scheme of arrangement is a statutory procedure under the Companies Act 2006 whereby a company makes a compromise or arrangement with its shareholders or creditors (or any class of them). In contrast to a CVA, a scheme of arrangement has jurisdiction to compromise secured debts. They are implemented via a two-stage court process[15]. The first court hearing takes place to confirm the composition of classes which the company has determined the scheme creditors should be divided into for voting purposes. Creditors can challenge the proposed class composition in court, if (among other things) they consider they have not been divided into classes whose members' interests are not so dissimilar to prevent them from consulting together with a view to their common interest.

13. There is a further condition that no more than 50% (by value) of any creditors who vote against the proposal (or a modification of it) are creditors who are unconnected with the company.
14. See PPF guidance at: PPF Restructuring & Insolvency Team Guidance Note 4: Company Voluntary Arrangements
15. The extensive involvement of the court makes schemes of arrangement and restructuring plans more expensive than CVAs.

In Steadyco's case, the RCF lenders and bondholders would be in different classes if one group's debts had a different ranking on an insolvency (e.g. if the RCF lenders' debt ranks senior to the bondholders' debt). A scheme requires approval by at least 75% in value of each class of the members or creditors who vote on the scheme, being also at least a majority in number of each class. As such, schemes can be useful where, for example, the amendments necessary to effect a restructuring require unanimous or 90% lender approval and the debtor company falls short of these thresholds. In the second hearing, the judge will consider whether it is fair to sanction the scheme in all the circumstances, giving remaining dissident creditors to make arguments that go to unfairness.

A company is free to elect which creditors will be subject to the scheme. While it would theoretically be possible for a DB pension scheme, as a creditor of a company, to be compromised by a scheme of arrangement, elements of a restructuring that affect a DB pension scheme are more often agreed in a bilateral, consensual deal. This is due to considerations around class composition. A DB pension scheme is ordinarily an unsecured creditor. Therefore, in principle, it would share a class with the other unsecured creditors, where its vote would carry significant weight due to the size of the liabilities owed to it. Companies are therefore often incentivised to offer the pension scheme more advantageous restructuring terms than other unsecured creditors, in which case it would need to be placed in a class of its own for voting purposes and therefore effectively have a veto right in respect of the scheme of arrangement.

It should be noted that proposing a scheme of arrangement, being an instrument under the Companies Act 2006 rather than the Insolvency Act 1986, would not automatically trigger a PPF assessment period.

Restructuring plans

Restructuring plans were introduced in the summer of 2020 and are structurally similar to schemes of arrangement (albeit they are only available to companies facing financial difficulties that may affect their ability to carry on business as a going concern). The key distinguishing feature of a restructuring plan is the scope to achieve a cross-class cram-down whereby a restructuring plan can be imposed on a dissenting class of creditors, provided they are no worse off than in the relevant alternative scenario (in most cases an insolvency process) and at least one class with a genuine economic interest in the company votes in favour of the plan.

Steadyco may have used a restructuring plan if, for example, the bonds were secured, ranked junior to the RCF lenders' debt and, absent a restructuring, Steadyco would enter insolvent administration or liquidation where the bondholders would receive, say, £350m out of their headline debt of £700m. In this case, a restructuring plan may have been used to impose a debt reduction to £400m on the bondholders (such that they are better off than in an insolvency), provided the RCF lenders voted in favour of the plan. Of course, in such a case, the bondholders may have sought to challenge the plan on fairness grounds.

It remains unclear whether a restructuring plan can be used to compromise liabilities owed to a DB scheme. As a matter of principle, it seems likely that pension liabilities (both the requirement to make ongoing contributions and the contingent section 75 debt) are capable of being restructured/compromised by way of a restructuring plan (subject to the approval of the Courts) using the cross-class cram down mechanism.

As in a scheme of arrangement, due to the fact that a DB pension scheme is usually an unsecured creditor it could either be placed in the same class for voting purposes as ordinary unsecured creditors or, if the pension scheme stands to benefit more under the plan than ordinary unsecured creditors, form a class of its own. The pension scheme's voting rights (which would be exercisable by the PPF) would not necessarily offer it the same degree of protection from being compromised as under a scheme of arrangement. This is because a restructuring plan does not need to be approved by every class in order for the plan to succeed. A debtor company could attempt to cram down the pension scheme, which would (subject to the courts' jurisdiction to assess the overall fairness of the plan) be possible if:

- the senior "in the money" creditors (being those with a real economic interest in the company, who would stand to receive significant distributions, if the company were to enter administration or liquidation) vote in favour of the plan; and
- the pension scheme was no worse off under the plan than it would be in the relevant alternative scenario (usually insolvent administration or liquidation).

The confirmation contained in the Pensions Regulator's criminal offences policy[16] that, where a party proposes a restructuring plan which is subsequently approved by the Court, they will likely not fall within the ambit of the criminal offences, removes one of the key hurdles to compromising pension liabilities in this way. However, other hurdles, such as circumventing the broad powers available to the DB scheme's trustees, persuading the Court that this is appropriate and the potential threat posed by the Regulator's anti-avoidance powers more generally remain – although these are mitigated by the fact that it should be possible to devise any restructuring plan such that it delivers a better return to the pension scheme than would otherwise be achieved on insolvency. Once again, it is important to note that proposing restructuring plan, being an instrument under the Companies Act 2006 rather than the Insolvency Act 1986, would not automatically trigger a PPF assessment period.

Pre-packaged administration

A "pre-packaged" administration sale occurs where the proposed administrator negotiates the sale agreement covering the debtor company's valuable assets prior to their appointment, and then signs the asset purchase agreement immediately upon their appointment. This is generally the best way to minimise the potential loss of value in an administration sale, since the business is immediately sold to new owners rather than value eroding in the period where the business is being traded by the administrators rather than a long-term owner and steward of the business.

However, pre-pack sales by administrators are likely to attract a greater degree of scrutiny and additional regulatory requirements will apply. For example, the administrators will have a duty to take reasonable care to obtain the best price which the circumstances of the case, as the administrator reasonably perceives them to be, permits. Following such a sale, administrators must also provide detailed information to creditors in the form of a "SIP 16 Statement", in which they explain why a pre-packaged sale was undertaken and all alternatives considered, to demonstrate that the administrator has acted with due regard for creditors' interests. Sales to connected parties incur yet more scrutiny.

The Pensions Regulator and the PPF have expressed concerns about the potential for pre-packs to be used to 'dump' a company's liabilities, including those owed to a DB pension scheme. Therefore, they will scrutinise any such transaction closely, particularly where the new company is controlled by, or has strong links to, the owners, management and/or investors of the old company that built up the liabilities (a so-called 'phoenix' situation).

While many pre-pack administrations are final efforts by creditors to maximise recoveries, they can also be used as tools as part of wide-ranging restructurings. For example, a pre-packaged sale could be used within the context of a scheme of arrangement to transfer all or part of a company's business to another company in which creditors have equity stakes.

16. See Appendix 2 of the Criminal Offences policy sections 58A and 58B of the Pensions Act 2004.

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