Capital Thinking
Banks, unitranche and intercreditor agreements

How will intercreditor provisions play out in the COVID-19 world?

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How will intercreditor provisions between banks and unitranche play out in a COVID-19 world?

Unitranche structures and the intercreditor agreements (ICA) underpinning them are about to be tested like never before. Banks and debt funds, as the significant parties to the intercreditor agreement, will soon discover whether structures negotiated in buoyant credit markets are fit for purpose in the current stage of the credit cycle.

The last decade has been characterised by an extraordinary rise of private debt and in particular, the unitranche structure, aided by a proliferation of borrower-friendly terms and an excess supply of credit.

We are now at a different stage in the credit cycle which, due to COVID-19, is seeing increasing levels of distress and likely to see a subsequent rise in default rates. The next 12 months will present lenders and shareholders with difficult decisions as to whether to support their borrowers and portfolio companies. Where this is not possible, it is inevitable there will be enforcement scenarios.

Under an enforcement scenario, the intricacies of the ICA, which documents the unitranche structure, will be tested, particularly in the context of the UK's new Corporate Insolvency and Governance Act 2020 (CIGA Act). This is unchartered territory.

This article seeks to inform debt professionals – bank lenders, debt funds, sponsors, shareholders, regulators and advisors – what some of the key considerations and practicalities are when considering how intercreditor matters will play out.

"We have seen an unprecedented volume of lending from banks through CLBILS, CBILS and other government-backed schemes both in the UK and across Europe. As some of that debt begins to fall due for repayment, and as other government and tax support is set to unwind, there may be further new money requirements from borrowers. Whether current stakeholders will support such requests will vary on a case-by-case basis and company valuations may not justify further capital being provided or the current level of debt being serviceable.

Intercreditor dynamics and the agreements which underpin them will be seriously tested, with the difference this time being the prevalence of bank and unitranche structures which have proliferated since the last global financial crisis. An appreciation of how the intercreditor agreement works is necessary for navigating this next stage of the credit cycle. The possibility of cross-class cram down or cram up under the new Restructuring Plan in the UK (and its new European equivalents) will also need to be considered for new and existing intercreditor agreements.

Christopher McLean, Partner, Restructuring and Debt Advisory

Intercreditor agreements primer

As a brief refresher, we summarise the salient points of the intercreditor agreement.

Intercreditor agreements are typically used where there is more than one secured lender to a group. Unsecured lenders may become a party to the ICA but only to confirm their debt ranks behind all the secured lenders' claims.

The primary purpose of an ICA is to ensure that each type of debt in a deal bears a risk commensurate with its pricing. The key provisions of the ICA are briefly:

- the ranking of claims and distribution of enforcement proceeds according to the payment waterfall (payment cascade is a more accurate description)
- specifying the 'instructing group' i.e. which party controls enforcement and the enforcement strategy
- enforcement standstills (these apply to lenders who are outside the instructing group and are designed to give the 'instructing group' time to effect the enforcement)
- the 'intercreditor release mechanism' permits the agent to release security and claims of the lenders to enable the security agent to maximise disposal proceeds by realising the assets free of security, guarantees and all claims
- the option to purchase is designed to protect junior lenders and gives them the right to acquire the senior debt for a make- whole and thus gain control of the debtor
- restrictions on payments to junior creditors (payment stop notices). Note these tend not to apply in unitranche deals.

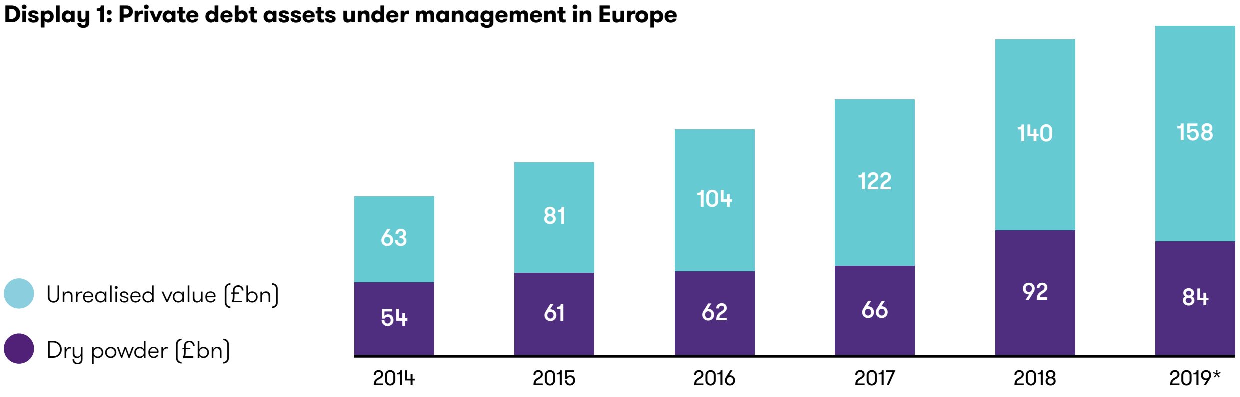
Simply put, the role of an ICA outside the US is to protect the ranking of senior secured lenders vis-à-vis other more junior lenders, both pre and post distress.

Against this background, ICAs incorporate some of the key features available from Chapter 11 in the US; in particular the 'Absolute Priority' rule (reflected in the payment and proceeds waterfall) and the ability to sell assets free of collateral under s363 of the Bankruptcy Code (reflected in 'intercreditor release mechanism').

Whilst there is an intercreditor template produced by the Loan Market Association (LMA) and precedent transactions are influential, each ICA is ultimately a commercially negotiated document between different parties.

The direct lending – or unitranche – market in Europe has continued to evolve and mature since our first edition of Capital Thinking on unitranche in 2014.

Display 1: Private debt assets under management in Europe



*2019 data includes months to July
Source: Preqin Global Private Debt Report 2020

Unitranche – then and now

Unitranche has experienced dynamic changes since its arrival in Europe. The original or 'classic' structure has evolved to embrace a wider range of structures which can be more attractive to both banks and alternative lenders, mainly comprising debt funds.

The original 'classic' unitranche structure

In European unitranche deals, the loan facility agreement typically comprises a revolving credit facility (RCF), invariably provided by banks, and the unitranche facility itself, provided by an alternative lender. For the purposes of this article we assume this alternative lender to be a debt fund. To avoid confusion between the various facilities and the loan agreement itself, this article will use the term 'Credit Agreement' to describe the loan facility agreement.

Many of the larger deals also include other uncommitted facilities, for example, an incremental facility (also called an accordion) and possibly a CapEx facility too. The Credit Agreement is broadly based on the LMA's recommended form of facility agreement for leveraged acquisition finance transactions (the LMA Precedent). In some cases, the RCF may be replaced with asset based lending (ABL) facilities which would be in a separate loan agreement.

Despite its many advantages, the original 'classic' structure holds disadvantages for both banks and the debt funds.

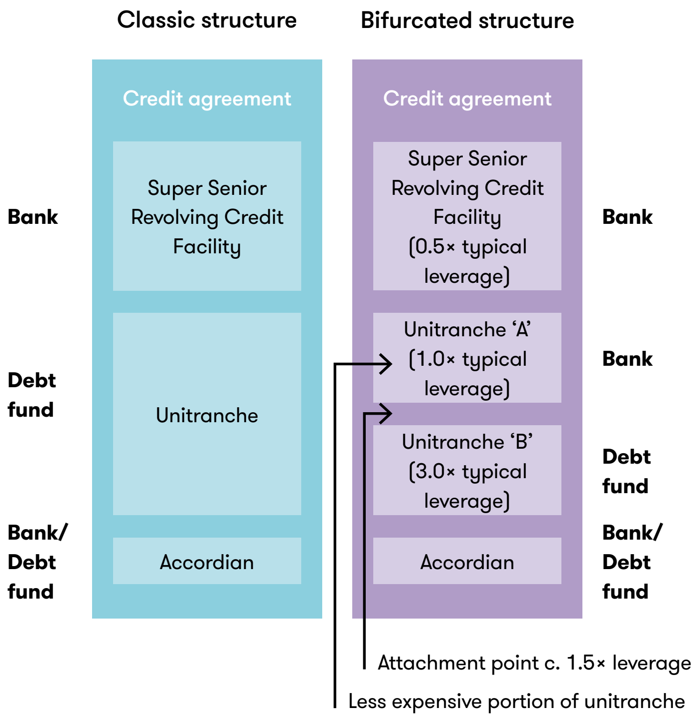
In these structures, the banks were restricted to providing the RCF which usually comprised only a small portion of the debt (usually < 0.5× leverage). This made little economic sense given the greater complexity of these deals as well as the regulatory requirements regarding capital adequacy and liquidity which apply to RCFs. For the debt funds, providing the 'senior' and less risky portion of the unitranche effectively averaged down the margin they were able to achieve on their debt.

The first-out, last-out (FOLO or bifurcated) unitranche structure

Over the last few years, these disadvantages have been reconciled to a large extent by the emergence of a first out, last-out unitranche structure (or bifurcated structure) which has gained traction in certain markets and with certain debt funds.

Here, the unitranche debt is split into two separate facilities; Unitranche A (i.e. first-out), typically provided by the bank that also provides the RCF, and Unitranche B (i.e. last-out) provided by the debt fund. The result is that the Credit Agreement now contains two 'unitranche' facilities, each with their own pricing. The RCF and Unitranche A (together the super senior lenders) rank *pari passu* together with any hedge and enjoy priority ranking re the enforcement proceeds vis-à-vis the Unitranche B provided by the debt fund.

Display 2



Documenting the unitranche

Unitranche deals typically comprise the Credit Agreement, an ICA and the security documentation. The LMA does not have a specific loan facility precedent for unitranche deals but it has published an ICA.

This ICA assumes the Credit Agreement is broadly based on the LMA Precedent. Because all facilities are in the same agreement, they all share a common set of representations, undertakings and events of default and, significantly, all facilities vote *pari passu*. This means the minority are bound by any vote of the majority lenders (typically 66.6% but 50% in some deals), which is the key threshold as it governs the right to accelerate and enforce collateral as well as the ability to sanction amendments and waivers.

Bearing in mind that the super senior lenders typically comprise a small percentage of the total debt, these lenders require additional safeguards to protect their minority position. This is because they lack the voting power either to accelerate or enforce collateral, or prevent amendments and waivers being passed by the debt fund which could be disadvantageous to their rights.

In this context the market has introduced additional modifications to the LMA Precedent to provide the super senior lenders with enhanced protection. These modifications fall into three parts (although there is no market standard position and they are heavily negotiated):

1. the creation of a new class of events of default described as Material Events of Default (MEDs) which are solely for the benefit of the super senior lenders and allow them to accelerate despite not having 66.6% of the voting rights in the Credit Agreement;
2. veto rights over certain amendments and waivers to the Credit Agreement which could affect the super senior lenders' priority adversely; and,
3. disenfranchisement of the last-out lenders of any stake they acquire in the super senior lenders' loans. This is to prevent the debt fund from acquiring a blocking stake in the first-out debt, thus preventing the super senior lenders from accelerating following a MED. In practice, anecdotal evidence suggests many debt funds resist disenfranchisement being included in the documentation particularly in the classic structure. In the case of bifurcated structures, this aspect is more hotly debated but even here the debt funds are wary of including such concession directly in the documents but if they do concede the point they tend to prefer to incorporate this in a side letter.

The super senior lenders do retain the benefit of the other Events of Default (EoD) in the Credit Agreement which are available to all lenders. However they are unable to trigger these on their own since they fall short of the voting thresholds required to do that.

In practice, this is not as detrimental as it appears since any EoD of any fundamental issue is invariably also a MED (e.g. payment breach).

"The innovative unitranche intercreditor together with the enhanced protection for super senior lenders introduced into unitranche credit agreements aim to reconcile the greater exposure of the debt funds with the super-priority of the banks. The extent to which these measures will succeed will be tested in the months ahead."

Michael Dance, Senior Advisor, Restructuring and Debt Advisory

One aspect worth mentioning is that the MED financial covenant breach (for the super senior lenders) is usually set back ±15% vis-à-vis the financial covenant EoD available to all lenders, thus giving the debt fund some additional leeway before the super senior lenders gain acceleration rights.

Anecdotal evidence suggests that in a small but increasing number of deals, the RCF is replaced with an ABL line which has its own separate agreement and usually a separate pool of collateral over the assets it provides (typically receivables and inventory). The use of ABL raises additional complications in distress, since they approach the credit from a different perspective to cashflow based lenders, focussing on the headroom between their collateral and their exposure.

"Whilst established debt funds have basic intercreditor terms pre-agreed with most banks, it still surprises us how much time and effort is spent negotiating these bespoke points on each deal – something that borrowers should factor into their planning."

Alexander Griffith, Partner, Private Credit Group, Proskauer

The key issues in the Unitranche ICA

ICAs become live in distress. Their primary role in unitranche deals is to provide the debt funds with the ability to effect an orderly restructuring of the borrower so as to maximise recoveries whilst ensuring the super senior lenders retain appropriate remedies to preserve their priority position post-enforcement. Underpinning this are a range of issues which can impact lenders' returns and we consider these below.

Ranking pre and post enforcement

We have already discussed that the ranking between the various lenders is achieved via an ICA which is based on the LMA intercreditor precedent for super senior/senior (i.e. unitranche) deals which was published in 2018 (the Unitranche Intercreditor or Unitranche ICA).

As the LMA user guide notes, this precedent is not standard form to be followed rigidly for each deal but 'a document which will be used as a starting point for drafting the intercreditor'. In particular, this precedent is not designed for bifurcated unitranche deals.

As is common in most leveraged transactions, all the secured lenders (including the hedge parties) share the same security package with a common facility and security agent. Unlike the standard ICA for senior and mezzanine deals, the Unitranche ICA ranks the hedge parties, the super senior lenders and the unitranche debt *pari passu* prior to enforcement. The ranking comes into play only post enforcement when the proceeds are distributed by the security agent according to the payment waterfall set out in the ICA.

Prior to acceleration and enforcement, the ranking of proceeds from mandatory prepayments (especially disposals) will vary from deal to deal. This aspect is highly negotiated and is one of those aspects where the super senior lenders may require their specific approval in the case of disposals above a 'permitted threshold'. This may be forthcoming only once they are satisfied the disposal proceeds will be applied in a manner which is not to their disadvantage (i.e. by retiring the more junior unitranche).

Who controls enforcement

The last-out lenders (i.e. the debt fund) control enforcement *ab initio* for a specified period during which the super senior lenders are subject to varying enforcement standstills. Appointing junior lenders (i.e. the debt fund) as the initial instructing group is a novel (if not unique) feature of an ICA. This is diametrically opposite to standard practice and, in particular, senior/mezzanine ICAs where the senior lenders are invariably the instructing group and thus control enforcement. It should also be emphasised that these rights do not alter the payment waterfall as any disposal proceeds are received by the security agent on behalf of all secured creditors and must be applied via the payment waterfall as set out in the ICA with the super senior lenders first in line.

These standstill periods which apply to the super senior lenders are blank in the Unitranche ICA, but the market generally follows the historical convention typically used in senior/mezzanine deals, namely; 90 days for payment breach, 120 days for a financial covenant beach and 150 days for any other type of MED. These enforcement standstills are designed to give the debt fund a window to maximise the value of the security proceeds since, being last out, they invariably have the most to gain by doing so.

The payment waterfall is reinforced by the 'turnover of receipts' clause in the intercreditor. This requires any lender, who has received any proceeds which is not in accordance with the payment waterfall, to account for those proceeds to the security agent to enable them to give effect to the payment waterfall.

"Valuations and fairness opinions are key parts of any multi-creditor restructuring process across Europe, particularly those involving a scheme of arrangement or share pledge enforcement. The new Restructuring Plan makes those assessments even more critical, with a requirement for robust and properly considered valuations, fairness opinions and entity priority modelling because the court needs to be satisfied, amongst other requirements, that none of the dissenting classes would be any worse off under the Restructuring Plan than compared to the 'relevant alternative'."

Senthil Alagar, Partner, Restructuring and Debt Advisory

Enforcement standstills and step-in rights

On expiry of the relevant super senior standstill period, the ICA postulates two options regarding the composition of the instructing group.

First, if the debt fund has already initiated enforcement action prior to the expiry of the standstill period, they remain the instructing group and the super senior lenders are subject to a further standstill period. This is to give the debt fund additional time to realise the security and it is only on the expiry of this additional standstill period that the super senior lenders become the instructing group.

Alternatively, if, on expiry of the enforcement standstill, the debt fund has not initiated enforcement action or has initiated token enforcement only, the super senior lenders become the instructing group.

The ICA also includes additional step-in rights to protect the super senior lenders if the debt fund has been dilatory in taking enforcement action and/or in realising the security. In this context, this covers the failure by the debt fund to take any enforcement action, as well as initiating only a token enforcement or halting enforcement action that has been commenced.

These step-in rights allow the super senior lenders to instruct the security agent (i.e. they become the instructing group) if they have not been repaid in full within a period of typically between 6-9 months after the original enforcement instructions were initiated, or if the debt fund, having initiated enforcement action, have ceased to follow through for a period ranging between 3-6 months. These rights are designed to protect the super senior lenders from being 'gamed' by the debt fund who could potentially run down the clock by failing to take appropriate enforcement action which could impair the value of the security to the potential detriment of the super senior lenders.

Protecting value in distress

The identity of the instructing group is of critical importance to junior lenders (in this case the debt fund) in an enforcement scenario for two reasons.

First, since they are 'last out' they bear the first loss (hence the debt fund's piece is sometimes described as the first loss piece) and secondly, senior lenders (in this case super senior lenders) have little incentive to maximise value beyond their own exposure given they are first in the payment waterfall. In this context the ICA has adopted a raft of measures imported from the LMA intercreditor for senior/mezzanine deals to ensure fair value/price is achieved. These measures (which trigger only after a super senior step-in event) include:

- the distressed disposal is made pursuant to a competitive sales process
- the distressed disposal is made pursuant to any court approved process
- the distressed disposal is at the direction of or under the control of, a liquidator, receiver, administrative receiver, administrator or analogous officer or finally, and/or that a fairness opinion on the value and/or method of enforcement has been provided by a financial advisor
- a financial advisor appointed by the agent has delivered a fairness opinion and/or valuation opinion in respect of the assets to be sold.

The super senior lenders do bear some risk when the debt fund is the instructing group and prior to the exercise of their step-in rights. To mitigate this, the ICA provides that there can be no distressed disposal unless the super senior lenders have been repaid in full (or will be repaid in full) from the disposal proceeds.

Intercreditor release mechanism – why and how it matters

One final aspect which is highly relevant in light of the discussion in the next section, is the role of the intercreditor release mechanism.

The Unitranche ICA, like the senior/mezzanine counterpart, is structured to provide for both a sale of assets and shares by the agent. As a rule, the sale of a group as a going concern (via a single point of enforcement of Target or Holdco shares) will generally realise greater value than a piecemeal sale of discrete assets.

The release mechanism permits the security agent, on enforcement in the case of a distressed disposal, to release the transaction security against all companies in the restricted group to enable the agent to maximise the proceeds on disposal for the secured creditors. The release covers all liabilities under the finance documents (i.e. borrowing liabilities, guarantees and security) as well as claims of intra-group lenders and any other subordinated creditors. This leaves the secured creditors with no claims against those companies and their sole recourse is for the proceeds to be distributed by the agent pursuant to the proceeds waterfall.

The direct lending market has developed dramatically since the credit crisis in 2007 and this, coupled with atypical features incorporated in the Unitranche ICA, must introduce a level of uncertainty as to how these restructurings will play out as these structures are tested in extremis. We explore how the various key players in these deals are likely to respond to the impact of COVID-19 should enforcement actions become necessary.

ICAs in action: how will the various players respond in distress?

The complexity of unitranche deals, coupled with the competing interests of the various players and untested nature of the ICA, will raise some uncertainty as to how each of the players will respond in distress, particularly where there are new money requirements.

How will sponsors and management react

Historically, the RCF is usually the first port of call for borrowers in distress as it is a committed facility at a fixed margin and, until the funds are actually deployed, there is no change in leverage. However, for these reasons it is likely to have been fully drawn early on in any liquidity crunch. Even if this is not the case, the RFC is unlikely to provide sufficient cash to meet the needs of borrowers who have endured a protracted collapse in revenues. Recent public examples of this have occurred in a number of pari-loan/bond structures which have permitted the incurrence of incremental Super Senior RCF facilities; for example; Matalan, Swissport and Codere to mention a few.

Similarly, incremental facilities (e.g. accordions) are also unlikely to be available since accessing the accordion typically requires compliance with a financial ratio (usually leverage) which distressed borrowers will not be able to meet.

A third option is to reschedule (i.e. defer) debt service. However, whilst this will help preserve cash it will not provide any additional liquidity since most unitranche facilities are bullet structures. In the same vein, borrowers have historically sought holidays on interest payments by converting cash pay interest to payment in kind (PIK) or pay if you can (PIYC). However, whilst this solution will conserve some cash it is unlikely to address the fundamental issue of injecting new financing to service fixed costs and the restarting of working capital cycles.

Excluding these options means the only viable solution is to seek a fresh injection of ‘equity’ either from sponsors or, failing that, the existing debt fund or failing both, another provider. We consider the ramifications of each option below.

Injection of equity by sponsors

Where a distressed firm requires a cash infusion (as in an equity cure), sponsors typically inject the equity in the form of additional shareholder loans. This is tax efficient as the new funds can be extracted more easily if the business returns to profitability.

In this eventuality it is possible that sponsors would expect the debt fund to provide a quid pro quo for bolstering the capital structure. What this would entail would depend on the gravity of the borrower’s financial situation and the lenders’ anxiety that the business may enter a formal restructuring process which could prove highly value destructive.

One dramatic solution, especially for firms not expected to return to previous levels of profitability and cash generation, would be to require the debt fund to write off some debt to align the capital structures with the anticipated cash flows. In these circumstances the debt fund might expect to receive equity as a quid pro quo which could provide some upside if the business returned to its former state. This would require more detailed discussions between the debt fund, the sponsor and management on the economics of any debt-for-equity swap.

Options for the debt fund

When the borrower is experiencing severe distress, the debt fund faces two primary concerns. First, that the super senior lenders do not seek to terminate the working capital facilities since this is likely to force management to file for some form of formal protection (e.g. administration) promptly to avoid personal liability for wrongful trading (notwithstanding the temporary relaxations in place due to COVID-19).

Secondly, if the debt fund delays taking enforcement action and the super senior lenders become the instructing group, the latter could instruct the agent to accelerate and enforce security. Despite the value protection mechanisms embedded in the Unitranche ICA for the benefit of the debt fund, it is possible the distressed sale could be effected below the value of their loans. This is because the super senior lenders' primary concern will be to recover their debt rather than to delay the sale to achieve a higher price. In addition achieving the optimum price could be more testing in difficult market conditions.

To forestall this, if the sponsor is unwilling or unable to provide the new funds and the debt fund believes the business is viable, the debt fund has various options which are discussed below.

The 'option to purchase' the super senior liabilities

The first option for the debt fund is to consider exercising the 'option to purchase' in the ICA in terms of which they purchase the Super Senior Liabilities. Whist attractive at first blush, this option has been used rarely since it holds various material disadvantages; principally that the option must be exercised at par and with a make-whole for any other amounts due.

A second, equally unpalatable drawback, is that the option to purchase the super senior lender's liabilities also requires the hedge liabilities to be transferred (i.e. acquired) at the same time.

A third impediment is that the security agent will probably require onerous and watertight indemnities from the debt fund exercising that option before they are willing to act.

Last, even if all these obstacles can be overcome, many debt funds do not have the practical capability to offer RCFs or the ancillary facilities offered by banks and, even if they do, there may be regulatory barriers in some jurisdictions to doing so.

The guarantee solution

The challenges of implementing the option to purchase, particularly the practical difficulties of offering banking facilities, prompted some debt funds to adopt an alternative approach in some deals. Here the debt fund provides a guarantee which underwrites the super senior lender's exposure post a MED and encourages them to continue lending. This can be put in place up front, the trigger being a MED or some other milestone or when the borrower is in distress, although this would be infinitely more difficult to arrange. This solution has rarely been seen and is most unpalatable for the debt fund, who may not even have the ability within its fund constitution to offer such a guarantee. However, in a COVID-19 world, we see stakeholders exploring all possibilities so we highlight this as a potential option.

Equity injection by the debt fund

If the sponsors cannot or will not inject further cash then the debt fund may decide to step in and provide equity in order to protect their investment.

Injecting equity by the debt fund could be implemented in various ways. The first solution would be to inject fresh equity into the existing group structure. Typically, this would be provided by a mixture of shareholder loans and a small amount of equity to capture any upside. This would obviously mean dilution of the existing shareholders and would involve potentially arduous negotiations with the sponsor (and management) on the equity dilution. It could also affect the ranking of the new shareholder loans vis-à-vis the existing shareholders loans from the sponsor (or management) since the lender will likely seek to rank their loans ahead of any existing shareholder loans.

A second and more aggressive approach would be for the debt fund to implement a loan-to-own strategy. There are various ways of achieving this aim but a well-trodden route would be via credit bidding in terms of which all lenders relinquish their claims against the borrowing group in exchange for shares in the borrowing group which would be acquired by a Newco set up for this purpose. The share pledge enforcement is usually over the Holdco's shares in the original Target company so the Newco acquires the entire group (as a going concern) via a single point of enforcement. This approach leaves the original shareholders behind with a claim against the now valueless Holdco. Typically, the Newco would be controlled by the debt fund but they would probably need to carve-out minority stakes for the existing management and possibly the banks too.

This option is not without its own challenges. The first would be to retain the support of the existing super senior lenders who provide the working capital facilities. This could best be assured if the debt fund were to inject additional 'equity' into the new group to bolster the capital structure, and with it the position of the super senior lenders. Ideally, the debt fund would have discussed their strategy with the super senior lenders in advance to secure their endorsement and willingness to continue lending to the new group, and could offer improved pricing or other fees as an incentive to continue lending. Failing that, the debt fund would need to refinance the working capital and banking facilities with another bank although this would be difficult to arrange at this stage.

The second issue is that the debt fund would need to incentivise the existing management with an equity or profit share in the new group, since their original (now valueless) equity would still be invested in the legacy group.

One final consideration which the debt fund would need to address is how this aggressive approach would affect the debt fund's reputation in the market. Would it affect the willingness of sponsors to deal with them in the future once markets normalise? Against this background, it seems likely to assume that most debt funds would adopt this more aggressive approach only if the sponsor was unable or unwilling to follow their money, or acted unreasonably.

At a glance: Corporate Insolvency and Governance Act 2020

The Corporate Insolvency and Governance Act 2020 (the CIGA Act) was enacted on 25 June 2020 and represents the most significant reforms to the UK's insolvency framework in a generation. Aside from temporary measures to address the immediate pressures of the COVID-19 pandemic, the CIGA Act introduces three permanent changes:

Restructuring Plan

The new Restructuring Plan is a court supervised restructuring process which is largely modelled upon the existing scheme of arrangement, but importantly with the addition of a cross-class cram down, which was not previously possible under UK law.

The Restructuring Plan is designed to be flexible, with the purpose of eliminating, reducing, preventing or mitigating the effect of a company's financial difficulties.

The cross-class cram down provision will enable the court to sanction a plan where a class (or classes) of creditor has voted against it. However, the company has to be able to demonstrate that the dissenting class(es) will not be worse off under the plan than they would be under other relevant alternative scenarios.

Moratorium

This is a new standalone tool for companies in financial distress, which provides companies with a statutory breathing space from creditors whilst options for survival are explored and developed. The moratorium initially lasts for 20 business days, but can be extended under certain conditions.

Whilst the company remains under the control of its directors during the moratorium, the process is overseen by a monitor who is a licenced Insolvency Practitioner and an officer of the court.

During the moratorium the company is protected from creditor action and insolvency processes and is relieved from paying pre-appointment debts. However, the company must continue to pay for any liability incurred during the moratorium period, including wages/salaries, redundancy payments, rent (for the moratorium period), amounts due under financial agreements (including loan agreements) and the Monitor's remuneration.

Ban on ipso facto clauses

The CIGA Act now prohibits suppliers of goods or services from terminating or varying the terms of their supply in the event that the customer enters into an insolvency or restructuring process. Suppliers are also prohibited from demanding that pre-insolvency arrears are paid as a condition of continued supply.

The aim of this provision is to prevent suppliers from holding a company to ransom, which could be an impediment to a rescue of the business and is an extension of existing Insolvency Act provisions, which prevented the termination of utilities and certain IT services.

"The Act represents a clear move towards a more debtor-friendly 'rescue culture', aligning UK insolvency law more closely with that in the US, in particular Chapter 11 proceedings. The introduction of the Restructuring Plan, with the option for a cross-class cram down, is a welcome addition to the restructuring toolkit and should help to facilitate more successful restructurings where there are different creditor groups."

Russell Simpson, Director, Restructuring and Debt Advisory

The important role of the security agent

The security agent is the central cog on enforcement as the ICA provides that the secured parties have no independent power of enforcement other than through the security agent.

The role and duties of the security agent were considered at length in the Stabilus case (Saltri III). The judge rejected the junior lender's contention that, in effecting a distressed disposal the agent had acted 'inappropriately' and could have been held liable for loss to the mezzanine had the valuation fulcrum broken in the mezzanine.

The financial advisor role becomes key

In the wake of the criticisms of the agency role voiced in the Stabilus case, the LMA introduced certain amendments into the 2012 Senior/Mezzanine intercreditor which were designed to assist agents to discharge their duties and also to avoid disproportionate liability.

These amendments have also been incorporated into the Unitranche Intercreditor. In summary, these permit the agent to engage, pay for and rely on the services of a financial advisor to provide advice, a valuation or an opinion in connection with a distressed disposal, the application of any proceeds from a distressed disposal or the amount of any non-cash consideration.

When security agents are involved in distressed situations their risk is magnified and, to ensure they avoid liability for exceeding their remit as a trustee, a prudent approach would be to seek appropriate financial and legal advice regarding valuations and fairness opinions.

COVID-19 will inevitably trigger waves of restructurings in the months ahead and, the long the shadow cast by Stabilus, suggests financial advisors will play an essential role in assisting agents to navigate their duties in the restructuring process.

The hedge liabilities

The role of the hedge liabilities can be distinguished pre and post crystalisation.

Pre-crystallisation, the hedge counter-parties effectively have veto rights on a narrow range of key issues which affect only them; for example their ranking. Post-crystallisation, the hedge counter-parties are entitled to vote the value of their closed out amount in the Credit Agreement and this could be a majority stake depending on the yield curve.

Conclusion

With this new stage of the debt cycle, the private debt market will be exposed to issues it has not experienced before. Hard-fought and heavily negotiated ICAs will be tested, and how that plays out will consume much time of the bankers, debt funds, sponsors and restructuring professionals involved.

An added dynamic is that due to the covenant erosion we have seen in the private debt market over the past few years (refer to display 4 in the Appendix), the trigger point for enforcement action is much later. Investors can no longer rely on a covenant default, which typically gives all parties the benefit of a longer lead time to negotiate a solution. Instead, it is likely that some companies will fall directly into payment default, and subsequent enforcement scenario.

In the immediate lockdown period, we saw unprecedented lending by banks, primarily through the CLBIL, CBIL, and BBL schemes and their European equivalents. For those companies that have further liquidity requirements as lockdown eases or a second wave strikes, it seems likely that banks will not extend further new money in every situation. That presents both opportunities and threats to private debt providers and illustrates why an appreciation of ICA mechanics and the options available will be important when addressing such situations.

Appendix
A refresher on current trends and commercial terms

Deal economics and credit erosion decline in tandem

In addition to the evolution in structures, the unitranche market has also experienced a variety of adverse changes to economic terms over the last few years. In particular leverage has gone up whilst financial covenants have declined, magnifying risk for lenders.

At the same time, deal economics have declined, reflecting the highly competitive environment for lenders across the credit spectrum. Not only have direct lenders increased, both in terms of number and size of fund, but the loan and bond markets have also seen their margins under pressure as the weight of money has created a strong surfeit of supply. Added to this, the ECB's corporate sector purchase programme, launched in 2016, exacerbated the supply/demand imbalance and central bank action in response to COVID-19 continues to depress yields.

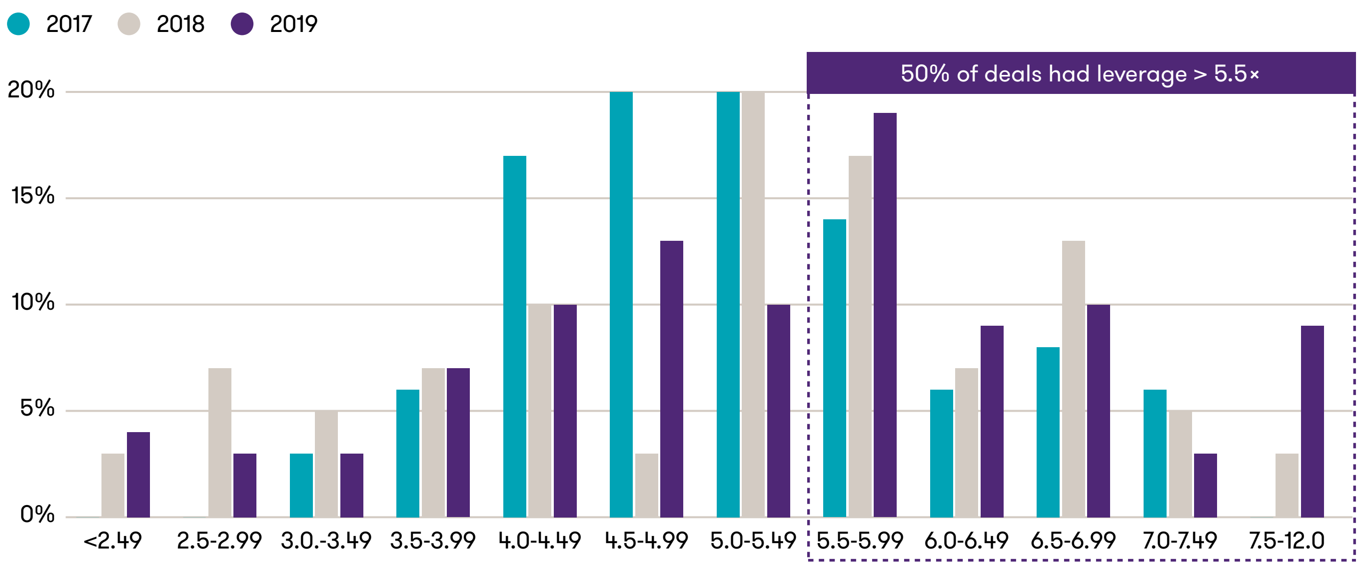
Before COVID-19, credit markets had an abundance of supply with borrower-friendly terms, underpinned by the dynamics of continued low interest rates.

Leverage expands

Leverage has trended higher over the last three years. The percentage of deals closing with leverage in excess of 5.5× has increased from 34% to 50%, representing a 47% rise.

On the face of it, higher leverage suggests a greater degree of risk. However, as always, the devil is in the detail – or specifically in the components of the leverage ratio (continued overleaf).

Display 3: Closing leverage



Source: Proskauer - Private Credit Insights Europe 2019

The key aspect here is not the 'debt' but rather the definition of EBITDA. The latter is not a term recognised in GAAP or IFRS but rather a defined term used in loan documents (for covenant testing and the various permitted baskets) and, of course, in M&A where it is often used for calculating earn-outs.

The LMA leverage precedent allows numerous add-backs and adjustments to EBITDA, the most important one of which here is for 'exceptional items'. UK GAAP does provide a definition of exceptional items but IFRS does not, therefore the LMA includes a definition of what this includes if IRFS is used. In essence, the definition of exceptional items becomes a live issue when the company is in distress, so the key issue is the extent to which these items are capped.

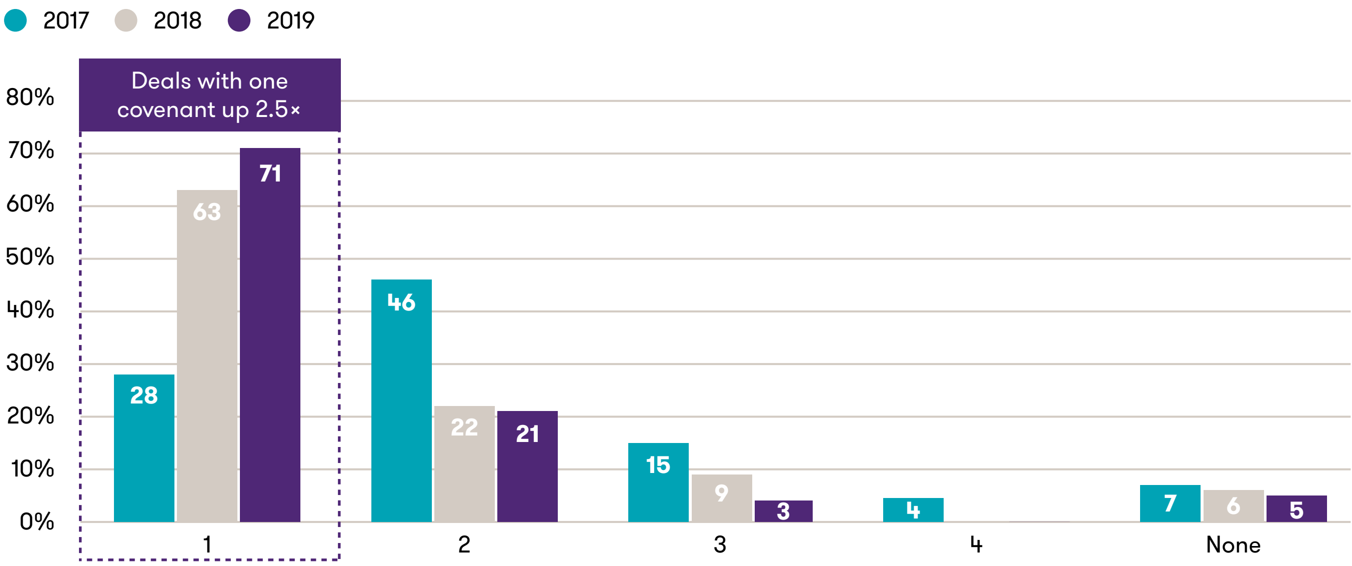
Data from Proskauer indicates that in 2019, exceptional items were uncapped in 69% of deals compared with 57% in the prior year. Against this background, the escalation in leverage coupled with the greater latitude given to borrowers over being able to add back exceptional items suggests further erosion in lender protection.

Financial covenants decline

Financial maintenance covenants have long been seen as the first line of defence for lenders so any erosion of their incidence should ring alarm bells for lenders. 'Cov-lite' transactions – i.e. with fewer protections for the lender – were first seen in European syndicate loans in around 2006 (Ceva Sante Animale may have been the pathfinder). In practice, cov-lite refers to the fact that the loan has fewer covenants than the standard three to four in the LMA leveraged precedent. Over the last three or four years, the cov-lite convention has migrated into mid-cap deals as well as the unitranche market, as data from Proksauer shows. In 2016 around two thirds of all deals had two or more covenants but in 2019 the picture had change dramatically with over 70% of all deals having only one covenant and a further 5% having no financial covenants at all.

> "There was a short period during national lock-down when key commercial terms tightened, benefitting lenders. That window has closed and borrowers now expect just as much flexibility as they did pre-Covid, for new deals in the right sectors."
>
> **Alexander Griffith, Partner,**
> **Private Credit Group, Proskauer**

Display 4: Financial covenant erosion – number of covenants per deal



Source: Proskauer - Private Credit Insights Europe 2019

Margins, floors and call protection

Unitranche lenders' returns are driven by a number of factors; the margin itself, the presence of a Libor/Euribor floor, the arrangement fees and also the call protection. The importance of this latter aspect is often unappreciated, but as debt funds are motivated by reinvestment risk, having adequate call protection is critical to their returns. This is particularly true given that margins have experienced a steady decline over the last few years.

Back in 2010, margins on the beginning of what would become unitranche were over 10%. These have declined over time and by 2017 the market standard was in the 7-8% range. Since then, margins have experienced further compression and by 2019 the nearly two thirds of deals fell in the 6-7% range.

Margins on RCFs also experienced a decline over this period although not to the same extent as unitranche margins.

Floors have also experienced some attrition in the market. These have declined over the last three years so that by 2019 over 50% of deals had floors of zero compared to only 25% of deals in 2017. Moreover in 2017, over 70% of deals had floors of 50 bps or more with 25% of deals having floors of 1% compared to 9% in 2019.

Despite margins and floors being under pressure, two aspects have remained broadly unchanged over the last few years; arrangement fees (which have remained steady at around 3%) and call protection.

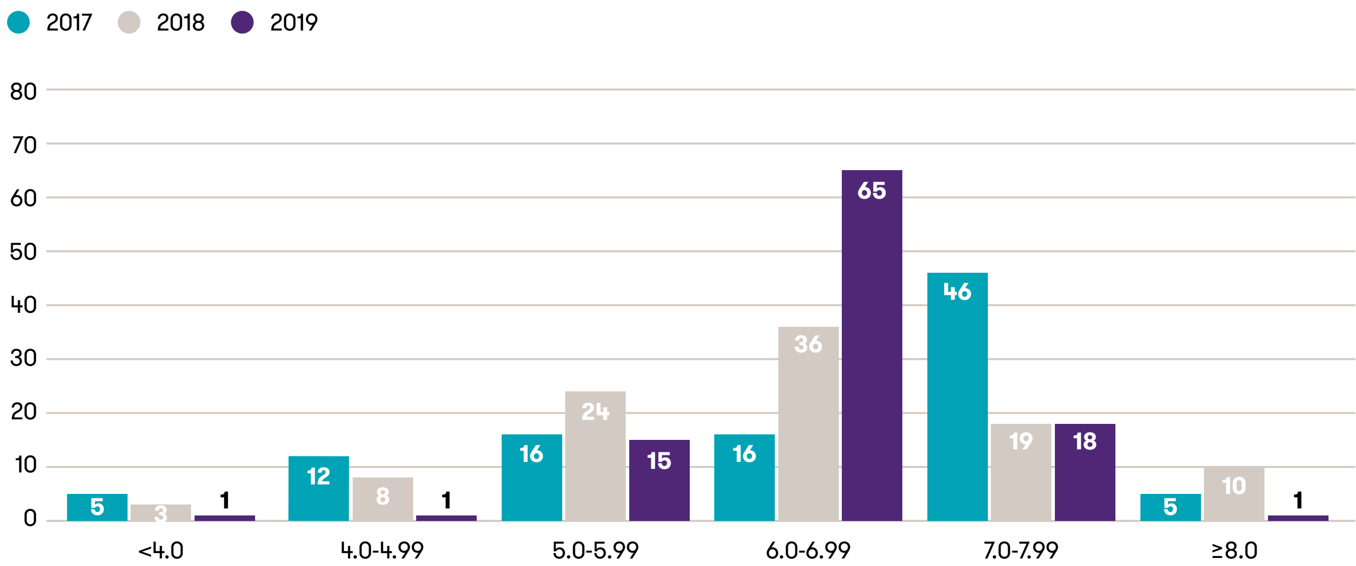
Many direct lending funds started out life as mezzanine funds, only migrating to unitranche when the mezzanine market waned. Mezzanine debt and (fixed rate) high yield bonds are both instruments which have historically had strong call protection, and this has continued into the unitranche market. According to data by Proskauer, over two thirds of deals had a make-whole for the first year with either 2% or, to a lesser extent, 1%, being the convention in year two. Few deals had call protection in the third year. The call premium is usually on the original amount of the loan.

In 2019 some 27% of deals included a PIK element in the margin reflecting the mezzanine heritage of many funds and their willingness to accrue some of the coupon which was roughly the same as the prior year.

Summary

It is worth noting that whilst there has been a market move towards borrower-friendly terms, this is on average, with the upper end of the market experiencing greater pressure (owing to the influence of the bond market which has also impacted large leverage loans) whilst the smaller end of the market and sponsor-less deals have not experienced as much pressure on lending terms.

Display 5: Interest rate margins on unitranche (%)



Source: Proskauer - Private Credit Insights Europe 2019

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