Treatment of senior unsecured debt in European leveraged finance transactions: the need for an intercreditor agreement

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Introduction

Over the last few years, the European senior secured high yield notes (SSN) and senior secured covenant-lite term loan B (TLB) markets have seen rapid growth and development. A common feature of both SSNs and TLBs (together referred to in this note as "Senior Secured Debt") is that their terms typically permit the incurrence of, among other classes, senior unsecured debt by a Credit Group subject to either the satisfaction of a financial ratio, typically being a total leverage ratio or a fixed charge cover ratio, or through various permitted debt baskets.

Historically, European financings have not addressed the intercreditor relationships between Senior Secured Debt and senior unsecured debt, as the ability to incur senior unsecured debt in Europe has customarily been far more limited. However, as flexibility to incur senior unsecured debt increases, and European Credit Groups seek to use this flexibility, the lack of any agreed intercreditor position may impair the ability of senior secured lenders to realise recoveries from a European Credit Group in line with expectations.[1]

Term	Definition
Credit Group	A parent company and its subsidiaries, where the parent and/or certain of those subsidiaries borrow and/or guarantee indebtedness (but excluding unrestricted subsidiaries). (See diagram on page 2.)
European Credit Group	A Credit Group where the indebtedness is primarily incurred and/or guaranteed by European based entities.
US Credit Group	A Credit Group where indebtedness is primarily incurred and/or guaranteed by US based entities.
Senior debt	Debt that is not contractually subordinated to any other debt and is borrowed (and which may also be guaranteed by guarantees which themselves are not contractually subordinated) by members of the Credit Group.
Senior unsecured debt	Senior debt where neither the borrowings nor guarantees benefit from security over assets of the Credit Group.
Senior Secured Debt	Senior debt where the borrowings and/or guarantees benefit from security over assets of the Credit Group.

This note considers certain intercreditor issues for creditors of Senior Secured Debt (the "Senior Secured Creditors") and European Credit Groups which may arise where a European Credit Group incurs and/or guarantees Senior Secured Debt and retains, under the terms of the Senior Secured Debt, the flexibility to incur or guarantee in the future senior unsecured debt which will rank pari passu with the Senior Secured Debt but which will not itself be secured by European Credit Group assets ("additional senior unsecured debt").

Intercreditor agreements and additional Senior Secured Debt

European intercreditor agreements have developed over time to deal with many different classes of debt. Typically additional debt which is incurred and/or guaranteed by a European Credit Group which ranks pari passu with Senior Secured Debt and which is secured by Credit Group assets ("additional senior secured debt") has been required by the Senior Secured Creditors to be governed by an intercreditor agreement (the "ICA"), which would accommodate the future accession of the creditors of such additional senior secured debt (the "additional senior secured creditors") (or their creditor representative on their behalf)

1 Care must be taken when discussing unsecured Senior Notes in a European context. True senior unsecured Senior Notes are occasionally seen in cross-over European credits where all of the issuers' material debt is unsecured. However, more often European Senior Notes represent junior debt, ranking behind Senior Secured Debt. These Senior Notes are typically issued by an entity that is structurally subordinated from the Credit Group of the Senior Secured Debt and are subject to the terms of an intercreditor agreement with, among others, the creditors of Senior Secured Debt. While holders of these Senior Notes have a senior claim against the Senior Notes issuer, their claims against the Credit Group of the Senior Secured Debt will, under the intercreditor agreement, be subordinated to senior debt of such Credit Group in all respects.

without further consents being required from the Senior Secured Creditors. The ICA would typically regulate the rights of the creditors in relation to intercompany debt and shareholder/subordinated debt, any other subordinated or second lien debt, hedging debt, working capital and liquidity providers (if there are any), the additional senior secured creditors and the Senior Secured Creditors as against each other. This note does not seek to revisit those arrangements.

Intercreditor agreements and additional senior unsecured debt

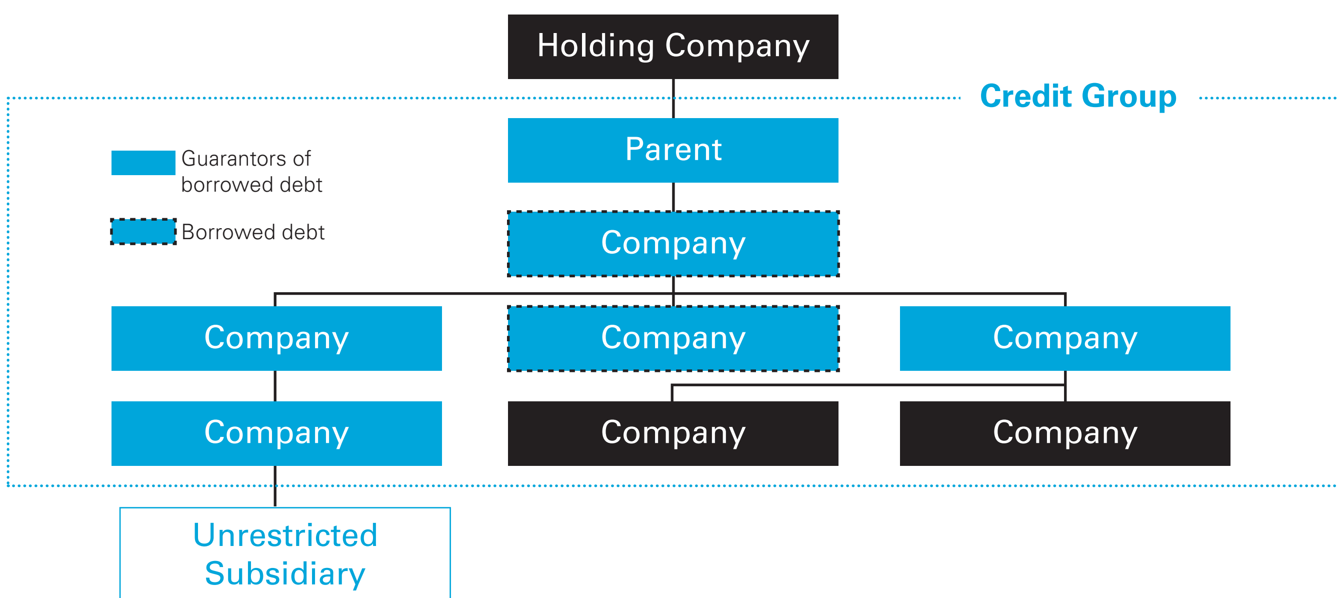
Documentation currently used in the European leveraged finance market has been derived from the US market, which has not historically required additional senior unsecured debt to be regulated by an ICA. As further discussed below, the reason why the US market has not required contractual intercreditor arrangements between Senior Secured Creditors and additional senior unsecured creditors is because a US Credit Group is generally able to provide a robust security package in favour of the Senior Secured Creditors. This security package is typically sufficient, without the need for extensive intercreditor agreements, to deliver expected outcomes. This is because Senior Secured Creditors in the US markets have come (for the purposes of protecting their secured priority, effecting restructurings and reorganisations and limiting actions that can be taken by various classes of secured and unsecured debt) to rely on a platform of settled US bankruptcy and finance law and, in particular, the framework of US Chapter 11 of the US Bankruptcy Code ("Chapter 11").

Guarantees, security and structural subordination—United States vs. Europe

For a US Credit Group, as a sweeping generalisation, guarantees can be granted by all entities in the US Credit Group and a perfected security interest can be achieved over most of their US assets; there are generally few or no legal or practical limits on the guarantee and security package granted by US based entities.

Compare this with a European Credit Group, where guarantee and security packages are generally much less comprehensive. In many European jurisdictions, taking security over certain assets is not commercially achievable due to prohibitive costs and/or practicalities. In addition, upstream and cross-stream guarantees given by European companies may also be of limited commercial value or simply prohibited due to local law corporate benefit and financial assistance restrictions (the inability of companies in certain European jurisdictions to guarantee and secure debt used to acquire their shares or their parent's shares is a classic example). The security package may equally be limited and bear the additional limitation that assets within the package may only include certain key or material assets—which could result in significant asset value of the European Credit Group remaining outside the security package to which the Senior Secured Creditors have recourse.

In addition, having originated from the United States (under the umbrella of the Chapter 11 framework), Senior Secured Debt terms in many recent European SSNs and TLBs typically do not contain any restriction



on where additional senior unsecured debt can be incurred in a European Credit Group (other than a limitation on the amount of debt that can be incurred or guaranteed by entities in the Credit Group that do not otherwise guarantee the Senior Secured Debt). This is a potentially significant issue when considered in tandem with the quality of the guarantee and collateral packages granted by a European Credit Group, as mentioned above.

If additional senior unsecured debt is incurred by (a) a member of the Credit Group that is not a guarantor of Senior Secured Debt or (b) a member of the Credit Group that has not granted full asset security to the Senior Secured Creditors or (c) a member of the Credit Group that has provided a guarantee to support the Senior Secured Debt which is of limited value, the Senior Secured Creditors may find themselves structurally subordinated and/or competing with additional senior unsecured creditors for recoveries from the assets of a Credit Group member over which the Senior Secured Creditors does not have security or other recourse. In general terms, where a group is wholly based in the United States, the scenario in (a) may be limited by certain debt incurrence/guarantee limitations included in the facilities agreement and neither scenarios (b) and (c) above are likely to apply. However, in many European jurisdictions the quality of guarantee and/or security granted by most companies in any given "target" group of companies will be limited by one or more of these factors.

Senior Secured Creditor expectations in the United States regarding senior unsecured debt

Through a Chapter 11 process, Senior Secured Creditors expect that an insolvency or restructuring of a US Credit Group will:

- Provide for Senior Secured Creditors to recover value from a US Credit Group in priority to the allocation of secured assets/recoveries to unsecured creditors
- Provide an automatic stay on the enforcement of security or guarantees for the duration of the process
- Provide for Senior Secured Creditors to benefit in any restructuring from the US bankruptcy court's ability to "cram down" secured and unsecured creditors' claims through a plan of reorganisation (which may include a 363 sale of the business as a going concern) because under the US Bankruptcy Code, a reorganisation plan may be confirmed even if one or more of the creditor classes votes to reject the plan, but only if, among other things, (a) at least one credit class votes to accept and (b) the plan treatment of rejecting creditors is "fair and equitable". Essentially, "fair and equitable" treatment requires payment in full of secured claims over time, return of collateral, or the equivalent

Contrast this position with the restructuring of a European Credit Group. There is no European equivalent to Chapter 11, with each European jurisdiction having its own insolvency regime and, unlike Chapter 11, as a generalisation, placing a European Credit Group into insolvency is value destructive. The European banking and capital markets have therefore compensated for this lack of a pan-European statutory regime by developing complex intercreditor agreements that contractually provide for many of the mechanics which arise under the US Bankruptcy Code.

How should similar protections for Senior Secured Creditors be implemented in Europe?

We set out in the table in the Annex a comparison as to how the US market has relied on Chapter 11 to achieve the expectations referred to above and where, to produce a similar outcome, the European market might deal with these matters in respect of a European Credit Group between Senior Secured Creditors (on the one hand) and additional senior unsecured creditors (on the other) contractually.

The European intercreditor provisions in the table in the Annex are all well known in the European mezzanine, subordinated notes and/or second lien markets. For borrowers and Senior Secured Creditors wishing to regulate additional senior unsecured debt, the question will be whether to employ all or only some of those techniques in intercreditor agreements. There are two very different considerations which influence this decision, and they often point to different outcomes. The first consideration is to achieve a position which is satisfactory from a Senior Secured Creditor perspective, broadly meaning that the documentation should contain sufficient protections such that Senior Secured Creditors can expect to be paid out in any enforcement scenario ahead of other creditors (and pari with additional senior secured creditors). The second consideration is to have a structure and documentation

which is familiar to loan investors in the market where the debt will be syndicated and which will also be marketable to future investors investing in other classes of debt in that market. Where the debt is to be syndicated in, or partly in, the United States, certain typical "European" protections may be undesirable in marketing debt to future senior unsecured creditors or even to potential Senior Secured Creditors who are unfamiliar with European structures. For example, including springing subordination may be unpalatable to potential additional senior unsecured creditors as such debt may be viewed by the market, and would need to be marketed, as senior subordinated debt with the resulting pricing increase associated with such debt, and this may also be undesirable from a Credit Group perspective. However, Senior Secured Creditors may be content to live without springing subordination if they are comfortable that a standstill period coupled with provisions allowing for the release and/or assignment of additional senior unsecured debt on an enforcement process will give sufficient control and time for them to execute any enforcement plan.

These competing considerations have given rise to different intercreditor arrangements in recent deals involving European Credit Groups. Treatment of additional senior unsecured debt varies from having such debt fully subordinated to having it completely unrestricted by intercreditor arrangements. A common middle ground seems to be to require a satisfactory intercreditor agreement to be agreed at the time of incurrence of unsecured debt above an agreed level, but this seems a poor result from a Credit Group perspective since it requires co-operation from the Senior Secured Creditors before future unsecured debt can be incurred.

The Credit Group's choices

Most of this note so far has been focused on how Senior Secured Creditors might manage their position in relation to additional senior unsecured debt and a European Credit Group. European Credit Groups will also have an interest in how this position is managed.

The mere fact of asking additional senior unsecured providers to sign into an intercreditor arrangement with the Senior Secured Creditors may inhibit the ability of a European Credit Group to execute quickly (or at all) additional senior unsecured financings in debt markets both in and outside the United States.

European Credit Groups might consider a basket (sized to accommodate a level of local working capital facilities or other ordinary course finance needs) so that only additional senior unsecured debt in excess of such basket threshold (either individually per related debt incurrence, in aggregate for the life of the deal or a combination of both) is required to be regulated by intercreditor arrangements with the Senior Secured Creditors. European Credit Groups are likely to see benefit from having agreed intercreditor arrangements between Senior Secured Creditors and creditors of additional senior unsecured debt. Firstly, access to capital from Senior Secured Creditors may become easier or cheaper if they have a clearly defined intercreditor position that allows them to differentiate their credit position from senior unsecured creditors. Secondly, if the European Credit Group becomes distressed, any restructuring process will likely be easier to control if all creditor classes are subject to agreed intercreditor arrangements.

CONCLUSION

There is no current practice that is applied consistently throughout the market in designing Senior Secured Debt transactions for European Credit Groups which permit the incurrence of additional senior unsecured debt. As noted above, various techniques (including those mentioned in the panel on page 5) have been employed as has the technique of not requiring the additional senior unsecured creditors to be regulated at all. Features that are getting most market acceptance in Europe, and that we would suggest applying to senior unsecured creditors above an agreed level of materiality are intercreditor arrangements which would ensure that:

- Additional senior unsecured creditors are stayed and payment blocked for a certain period of time after an acceleration event has occurred under the Senior Secured Debt to allow the Senior Secured Creditors to conclude an orderly enforcement
- Additional senior unsecured debt is subject to release provisions which will enable the Senior Secured Creditors to sell the European Credit Group as a going concern, subject to valuation protections for the additional senior unsecured creditors

However, as Senior Secured Creditors become more aware of the issues, they may continue to push for the full suite of protections they have historically come to expect in the context of protecting their Senior Secured Debt position against unsecured or junior debt. This could mean that, European Credit Groups are in practice unlikely to be able to raise unsecured debt which is priced as genuine senior unsecured debt.

In contrast to senior unsecured debt, second lien debt and senior subordinated notes are well understood in the European market. Given that debt incurrence tests will often not differentiate between second lien and unsecured debt, it may be that European Credit Groups are able to maximise debt incurrence flexibility by ensuring intercreditor arrangements allow second lien and senior subordinated financings to be added to their capital structure on pre-agreed terms without having to seek future Senior Secured Creditor consent, rather than by focusing on the ability to incur senior unsecured debt

Documenting Senior Secured Debt vs. additional senior unsecured debt intercreditor arrangements

There is no one right answer for how Senior Secured Debt vs. additional senior unsecured debt intercreditor matters in respect of European Credit Groups should be documented. Possible documentation options are:

Option one: Extend the terms of the ICA

The ICA would be drafted to accommodate additional senior unsecured debt and require additional senior unsecured creditors (or their creditor representatives) to accede to it prior to incurrence by the European Credit Group of the additional senior unsecured debt. This gives clarity and certainty from the outset of a transaction and allows the European Credit Group to incur additional senior unsecured debt without needing to involve Senior Secured Creditors to negotiate terms at the time.

Option two: Pre-agreed short-form intercreditor agreement

A short-form intercreditor agreement setting out intercreditor terms would be included as schedule to the intercreditor agreement. Providers of any future unsecured debt would be required to enter into the short-form intercreditor agreement on a standalone basis. This provides certainty for both the European Credit Group and the Senior Secured Creditors and an easier route to execution by senior unsecured creditors who would also not need to consider a full secured debt ICA. The short-form intercreditor agreement would need to be executed by the Senior Secured Creditors' creditor representative, the applicable members of the European Credit Group and other interested parties (e.g., hedging banks).

Option three: Term sheet of key intercreditor principles

A term sheet setting out the key intercreditor terms could be scheduled to the ICA. Providers of any additional senior unsecured debt would be required to enter into intercreditor arrangements with the Senior Secured Creditors (and other interested parties) on the terms set out in the schedule. Gives additional senior unsecured creditors an opportunity to negotiate the terms but would effectively mean further negotiation with the Senior Secured Creditors (and other interested parties) before the debt is incurred.

Option four: Secured creditor approval of future intercreditor terms

Requirement in Senior Secured Debt terms that, if permitted, additional senior unsecured debt may be incurred subject to the creditors thereof entering a customary intercreditor agreement or arrangements reasonably acceptable to the Senior Secured Creditors. This gives the most flexibility to future additional senior unsecured debt providers to negotiate terms but the timeline for incurring additional senior unsecured debt may be protracted as intercreditor arrangements need to be negotiated with the Senior Secured Creditors.

ANNEX

We set out in the table below a comparison as to how the US market has relied on Chapter 11 to achieve the expectations referred to in the section "Senior Secured Creditor expectations in the United States regarding senior unsecured debt" and how, to produce a similar outcome, the European market might deal with these matters in respect of a European Credit Group in an ICA:

Possible intercreditor contractual protections	US Chapter 11
Standstill Period or Stay	
Include a specified period of time under which an additional senior unsecured creditor is prevented from taking any action in relation to its claims (including acceleration of direct debt and guarantee claims) to: □ Avoid triggering the commencement of an insolvency process in relation to members of the European Credit Group on which it has a claim □ Give the Senior Secured Creditors an exclusive period of time during which to assess their rights and, if the Senior Secured Creditors determine that they will enforce their rights and options, to so enforce without interference from the additional senior unsecured creditor	The Chapter 11 automatic stay prevents creditors from taking any action in relation to its claims against an entity that has filed for Chapter 11 protection (or any other entity that has filed for Chapter 11 protection) without court approval during the pendency of the Chapter 11 case.
Springing Subordination	
Contractually subordinate the additional senior unsecured debt to the Senior Secured Debt upon the occurrence of certain events, such as insolvency of the relevant European Credit Group member or the Senior Secured Creditors taking enforcement action.	Chapter 11 achieves an equivalent outcome through the operation of the provisions described below regarding Waterfall.
Payment blockage	
Place a restriction on payments by the European Credit Group to additional senior unsecured creditors on the occurrence of certain trigger events (such as major events of default) under the Senior Secured Debt. Similar to a standstill period, the purpose of a payment blockage is to give Senior Secured Creditors time to assess their rights and take action without value leakage from the European Credit Group.	The Chapter 11 automatic stay prevents payments from being made to creditors without court approval. Typically, certain ordinary course operating payments will continue to be permitted in order to operate the business, various fees and expenses associated with the Chapter 11 process will be permitted and, to the extent oversecured on the date of filing, scheduled interest payments of the Senior Secured Debt will be permitted.
Control of enforcement process	
Include a prohibition on the additional senior unsecured creditors taking enforcement action to allow a period of time for the Senior Secured Creditors to take their own enforcement action. That enforcement action may include a holding company share sale/the sale of the business as a going concern.	The Chapter 11 automatic stay prevents a creditor taking any action in relation to its claims against an entity that has filed for Chapter 11 protection without court approval. This stay gives the company time to present its plan of reorganisation, which, if one creditor class votes to accept it, the court will approve if, among other things, the court determines that the treatment of rejecting creditors is "fair and equitable". A court approved plan of reorganisation will "cram down" all non-consenting creditors who will become bound by it. Note, whilst in a typical US deal, second lien creditors will agree in an intercreditor agreement not to agree a reorganisation plan with the Credit Group which the Senior Secured Creditors do not accept, a United States deal would not have the same protection for the Senior Secured Creditors as regards the creditors of additional senior unsecured debt which are not subject to an intercreditor arrangement. However, in US deals, it is generally considered that protection for the Senior Secured Creditors against a debtor company presenting to the court an unsecured creditor class approved reorganisation plan with which the Senior Secured Creditors disagree, is the requirement that the plan must be, "fair and equitable". Essentially, "fair and equitable" treatment requires payment in full of secured claims over time, return of collateral, or the equivalent.

Possible intercreditor contractual protections	US Chapter 11
Turnover	
Place an obligation on additional senior unsecured creditors who receive a benefit (for example, a cash payment or the exercise of a contractual right of set-off) during enforcement to hold on trust and turnover any such receipts to Senior Secured Creditors.	The Chapter 11 automatic stay prevents payments from being made to creditors and creditors otherwise receiving any benefit from an entity the subject of a Chapter 11 process without court approval. Such amounts will be subject to disgorgement or preference claims.
Waterfall	
Add a requirement that all recoveries by additional senior unsecured creditors post enforcement are turned over to the security agent to be distributed first to the Senior Secured Creditors and thereafter to additional senior unsecured creditors.	The Senior Secured Creditors will be distributed the value attributed to the assets in which the Senior Secured Creditors had been granted a secured and perfected first lien securing the Senior Secured Debt. Any amount of Senior Secured Debt remaining after such distribution will form part of a deficiency claim of the Senior Secured Creditors, which would share in the value of all remaining assets on a dollar for dollar basis with all other unsecured creditors (such as additional senior unsecured creditors) and other secured creditors with deficiency claims.
Release and/or assignment of debt and guarantee claims	
Include release/assignment provisions permitting the security agent on the instructions of the requisite Senior Secured Creditors to release/assign claims of additional senior unsecured creditors against the borrower and each guarantor member of the European Credit Group that guarantees such additional senior unsecured debt. However, release of borrower debt (unlike uncalled guarantees) could lead to a tax charge for the relevant European Credit Group member which could depress the value of the European Credit Group. An important tool in a European Credit Group restructuring, the release provisions enable the European Credit Group to be sold as a going concern as a result of an enforcement process by the Senior Secured Creditors free from any senior unsecured claims which would otherwise impact on the value of the European Credit Group. These provisions are usually accompanied by valuation mechanics to afford a certain level of protection to the released creditors.	The bankruptcy court has the ability to extinguish secured and unsecured creditor's claims through a plan of reorganisation (which may include a 363 sale of the business as a going concern). A reorganisation plan may be confirmed if at least one credit class votes to accept it and the plan treatment of rejecting creditors is "fair and equitable". Essentially, "fair and equitable" treatment requires payment in full of secured claims over time, return of collateral, or the equivalent.
Restrictions on additional senior unsecured debt Borrowers and Guarantors	
Prohibit additional senior unsecured debt being borrowed in a structurally senior position to the Senior Secured Debt. Assuming the debt is borrowed above the share pledge that would represent the single point of enforcement in any enforcement disposal (for example, in the Credit Group diagram on page 2, at the Parent level) then a sale of the Credit Group as a going concern (when coupled with the release of guarantee claims) could be achieved avoiding the tax charge referred to in Release and/or assignment of debt and guarantee claims above. Restrictions could be included in either the facilities agreement or the intercreditor agreement.	Not dealt with in Chapter 11, but in US financing documents, restrictions are traditionally placed on members of the Credit Group from incurring or guaranteeing additional senior unsecured debt if such member is not otherwise an obligor of the Senior Secured Debt.

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