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Cortefiel – The Use of Schemes of Arrangement for 'Amend & Extends'

Introduction

The recent case of Cortefiel SA, a leading Spanish high street clothing retailer ("**Cortefiel**"), has demonstrated the possibility of amending and extending a company's obligations under its finance documents by way of an English law scheme of arrangement.

In this article we examine:

- the potential use of schemes as a tool for amend and extend proposals in light of the Cortefiel decision; and
- the implications for collateralised loan obligation ("**CLO**") vehicles and likely grounds for challenge.

Background

As is now widely known, the European leveraged buyout ("**LBO**") loan market faces a huge refinancing burden over the coming five years. The debt wall is looming, with an estimated €133 billion of unrated European LBO debt maturing by 2015. As traditional bank loan funding is likely to be scarce and many CLO funds are approaching the end of their investment periods, companies will be focussed on their ability to extend the maturity of their existing loans.

For those companies that are performing well, a forward start facility, which allows a borrower to enter into a new committed facility ahead of the maturity of its existing facility, is an attractive solution. If this is not possible, companies may look to use the 'amend and extend' technique, whereby the lenders agree (i) to extend the maturity of their loans; and (ii) to amend certain conditions and covenants, in exchange for a higher interest rate and/or additional fees. Based on standard LBO style facility agreements, such a proposal would require the consent of (i) all lenders under that facility, and (ii) a majority of all lenders.

The need for all lender consent under a given facility is a key concern for any company seeking to implement an amend and extend, particularly in complex LBO structures where there are likely to be both a greater number of lenders, often with different economic interests, and more layers of debt than in a standard non-leveraged loan. Further, although historically lenders have been willing to give their consent, there appears to be an increasing reluctance to do so where companies are performing less well, especially if the lenders anticipate that the company will struggle to meet its future interest payments.

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Schemes of Arrangement

A scheme of arrangement is a court sanctioned 'compromise' or 'arrangement' between a company and its creditors (or any class of them), made under Part 26 of the Companies Act 2006.

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. The technical test for composing the classes of creditors is that each class *"must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest"*. This is a broad test, but the focus should be on legal rights, not economic interests, and should consider both the rights which creditors have before the scheme and the rights which they would have if the scheme is approved. As such, creditors' rights do not need to be identical for them to be placed in the same class; they simply need to be sufficiently similar to make it possible for them *to consult together with a view to identifying their common interest.*

The key feature of a scheme of arrangement is that, upon sanction by the Court, it binds all dissident creditors as a matter of statute and, therefore, will override any voting thresholds in a company's finance documents (in particular, any super-majority or unanimous voting requirements). It is a very flexible tool and, since the start of the economic downturn, has typically been used to effect debt-for-equity swaps, debt reductions/extinguishments and/or the exchange of one debt instrument for another. However, as the recent case of Cortefiel demonstrates, the use of schemes is limited only by the imagination of the company.

Cortefiel

In 2007, Cortefiel refinanced its then existing facilities with an English law governed €1.4 billion senior-only facility (the "**2007 Facility**"). Cortefiel started experiencing financial difficulty and it became clear in early 2012 that, if it failed to refinance the 2007 Facility, it would breach its covenants in late 2012 and would be unable to repay the loan at maturity in 2014/2015. Accordingly, Cortefiel approached its existing lenders early in 2012 and proposed using the structural adjustment provisions contained in its senior loan documents to implement (i) an extension to its revolving credit facility and term facilities; and (ii) a reset of its financial covenants to a more achievable level, in exchange for increased margin and fees.

In order to use the structural adjustment provisions, majority lender consent and the individual consent of each lender affected by that adjustment was required. After approaching the lenders, Cortefiel had the support of the majority, but failed to achieve the required consent threshold. As a result, Cortefiel decided to implement its proposed amend and extend using schemes of arrangement on the basis that its senior facility was governed by English law.

Pursuant to the proposed schemes, the term loan A and revolving facility were to be extended by three years, covenants were to be reset with 17.5% headroom and there was to be a 200 bps margin uplift on the term loans A and B. Cortefiel argued that the senior lenders had, with one exception, substantially similar rights and constituted one class, particularly as those rights ranked pari passu and the lenders were bound by a loss sharing agreement. However, the lenders of one tranche of Cortefiel's senior debt would receive an additional €15 million prepayment under the scheme, which justified those lenders being placed in a separate class.

The court agreed with Cortefiel's class divisions and was satisfied that there was sufficient 'give and take' within the amend and extend proposal to constitute a fair compromise arrangement between it and its lenders. Importantly, the scheme of arrangement was not challenged in court by any of the scheme creditors and was sanctioned on 19 October 2012.

Any Risk of Challenge Going Forward?

The question arises as to whether the Cortefiel decision represents a panacea for 'amend and extends' as the refinancing wall approaches, or whether there are certain situations where schemes either will not work or could be challenged.

The ability to circumvent contractual consent requirements may be of particular concern to the investment managers of CLO structures. These investment managers must manage their portfolios of leveraged loans within the constraints of an investment management agreement, which strictly define what the investment manager is permitted to do with the portfolio (including any cash receipts). In some cases, the investment management agreement will restrict (or even prevent) the investment manager from reinvesting or committing additional cash and/or agreeing to extend the maturity of a loan if the CLO is at the end of its investment/reinvestment period. Many of the CLOs raised during the 'boom years' of the LBO loan market will be entering this phase of their lifecycle shortly (if they have not done so already). In many other cases the ability of a CLO to agree to amendments may be constrained by other circumstances or may simply be unclear.

If a company seeks to push through an amend and extend by means of a scheme and one or more of the CLOs is prevented from voting due to contractual restrictions, the question arises as to whether this could be challenged on either class or fairness grounds.

In terms of potential class issues, the argument would be that the CLO which is not able to vote on the scheme proposal does not have the same rights as other creditors as, by definition, it does not have the ability to vote and 'have a say' on the outcome of the scheme. However, Cortefiel suggests that the bar for challenging on class issue grounds will be set high. The first class in that case comprised the vast majority of lenders, including CLO funds, on the basis that the rights of the senior lenders were, with one exception (being those lenders that received the additional €15 million prepayment), substantially similar. Further, and importantly, the Court has traditionally shown a reluctance to allow individual creditors 'holdout' value to the detriment of the general creditor body unless absolutely necessary.

A second possible ground of challenge would be unfairness. A scheme will be fair if the arrangement is such that an intelligent and honest lender, a member of the class concerned and acting in respect of its interests, might reasonably approve. Taking the example used above, if a CLO is unable to vote due to its constitutional documents, is there a general fairness issue? This becomes an objective question as to (i) the extent to which a company, and then in turn the Court, is required to consider the circumstances of individual creditors, and (ii) whether it is fair if a company knows that a particular creditor cannot vote on the scheme proposal but proceeds with a scheme regardless. This goes back to the 'holdout' point raised above. In Cortefiel, there were no challenges on these grounds. This is unfortunate, as guidance from the Court would have undoubtedly been helpful.

Conclusion

It remains to be seen whether Cortefiel represents a solution for all 'amend and extends', particularly in situations where there are CLOs and potential class and/or fairness issues. In Cortefiel, the court placed considerable emphasis when sanctioning the scheme on both the risks facing the business and the loss of value that might result if the schemes were not approved. In the meantime, the fact that Cortefiel successfully promoted the 'amend and extend' is likely to result in companies threatening to launch schemes of arrangement as a 'stick' to encourage the dissenting minority to enter into a consensual deal.