Intercreditor Agreement as a Contractual Solution to Restructuring Leveraged Buyouts

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ABSTRACT

Leveraged buyout (LBO) transactions are corporate acquisitions financed with multiple layers of debt and equity and form a large subset of the leveraged finance markets. Intercreditor and debtor-creditor conflicts and conflicts within a larger debtor group arise in these transactions on many levels. The data suggests that a vast majority of distressed leveraged transactions are restructured without using statutory insolvency procedures and are governed by extensive contractual packages.

This thesis analyses how intercreditor agreements governed by English law (ICAs) and used in LBOs deal with the risk of the strategic creditor actions of distressed debtor groups, deal with the financial agency costs in multi-layered financing structures and create a controlled bargaining space for resolution of financial distress. The thesis addresses whether the ICA regime is theoretically and in practice able to deal with these concerns and to reduce the use of statutory insolvency law.

The thesis sets out some theoretical approaches and problems that are argued to restrict the use of privatised insolvency procedures. This analysis leads to four key propositions that are tested empirically to determine whether the contractual solutions can overcome these theoretical impediments to privatised solutions to distress. The empirical part consists of in-depth interviews with market participants and content analysis of Loan Market Association ICAs and market ICAs. The main themes addressed in the empirical section are creditor priorities, dealing with changes in the capital structure, creditor control *ex ante* and *ex post* distress and enforcement and distressed disposals clauses.

The thesis argues that contractual solutions for dealing with financial distress in corporate finance are both theoretically and practically feasible. ICAs are shown to deal with the most pressing risks for strategic actions by stakeholders and enable effective restructuring. Also, ICAs can operate without necessarily resorting to the statutory procedures. Therefore, the theoretical impediments to contractual solutions to financial distress are not pervasive in the financial markets and the theoretical literature on the parties' ability to design financial contracts and capital structures to avoid strategic creditor actions is correct at least in the case of LBOs. Secondly, it is argued that LBO ICAs enhance creditor coordination by using contractual and capital structures that enable the stakeholders to achieve a reliable bargaining framework dealing with corporate insolvency. Creditors can, therefore, optimise the restructuring and creditor recoveries on the debtor group level, achieving a 'Coasian bargain', and offer an option of single or multi-entry point enforcement for the controlling creditor group. The employed capital structures and the ICA restructuring provisions also enable the parties to alleviate in some cases the so-called 'debt overhang' problem.

The thesis shows that the stakeholders of an LBO arrangement seek to achieve an optimal game-theoretical scenario to deal with distress scenarios. This means reducing the variables of a non-cooperative game to a level that is apt to provide the parties with a predictable *ex post* negotiation framework for distress.

However, the analysis shows that the effectiveness of the ICA and its solutions to distress scenarios relies on strong contract law protection, efficient enforcement of security interests and robust regulation of the fiduciary obligations of the security agents.

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Main Abbreviations

ICA	Intercreditor agreement
LBO	Leveraged buyout transaction
LMA	Loan Market Association
LMA Leveraged Document	LMA Senior Multicurrency Term and Revolving Facilities Agreement for Leveraged Acquisition Finance Transactions (Senior/Mezzanine).
LMA S/M ICA	The Loan Market Association, The Loan Market Association's recommended form of Intercreditor Agreement for leveraged acquisition finance transactions (Senior and Mezzanine structure) (18 July 2017)
LMA SS/S ICA	The Loan Market Association's Intercreditor Agreement for leveraged acquisition finance transactions (Super Senior/Senior) (17 May 2018) (2018)
LMA SS/HY ICA	The Loan Market Association's Intercreditor Agreement for leveraged acquisition finance transactions (Super Senior revolving facility, senior secured notes and High Yield notes) (18 July 2017) (2017)
SFA	Senior facilities agreement, often based on the LMA Leveraged Document

Table of Cases

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Other Primary Sources

The Loan Market Association, *Senior Multicurrency Term and Revolving Facilities Agreement for Leveraged acquisition finance transactions (Senior/Mezzanine)* (2012) ('The LMA Leveraged Document')

——, *Intercreditor agreement for leveraged acquisition finance transactions (senior / mezzanine) (18 July 2017)* (2017)

——, *Intercreditor agreement for leveraged acquisition finance transactions (super senior revolving facility, senior secured notes and high yield notes) (18 July 2017)* (2017)

——, *Users Guide to Form of Intercreditor Agreement for Leveraged Acquisition Finance Transactions (Senior/Mezzanine) (12 January 2017)* (2017)

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——, *Super Senior Multicurrency Revolving Facility Agreement with HY notes for Leveraged Acquisition Finance Transactions (super senior revolving facility, senior secured notes and high yield notes) (2018) (dated 21 December 2018)* (2018)

——, *Users Guide to Form of Intercreditor Agreement for Leveraged Acquisition Finance Transactions (Super Senior Revolving Facility/Senior Secured Notes and High Yield Notes), May 2018* (2018)

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PART A - INTRODUCTION AND METHODOLOGY

1 Introduction

(a) Scope of financial contracting

Financial law is the realm of the contract, but it lives in the shadow of insolvency law. However, whether it requires the existence of mandatory corporate insolvency law if sophisticated parties can solve among themselves the debtor's financial problems is an open question. This question is material and pronounced in modern corporate finance.

First, the relationship between financial creditors and the debtor is always based on contracts assumed to be respected in insolvency. All significant corporate finance transactions are implemented through extensive and detailed financial contracts, often in highly specialised sub-categories that follow specific market conventions, risk-dynamics, parties and objectives. Secondly, although financial contracting in modern corporate finance is pervasive and complex, analysis of the terms of these contracts and the connections between different contractual solutions has been limited. This is unsurprising, given that some of the most essential financing agreements are confidential and veiled from public scrutiny and academic analysis, only to emerge occasionally should the parties have an unresolvable dispute. These materialise most often when the debtor is unable to meet its financial obligations.

This raises questions about how financial contracts deal on a more granular level with financial distress when there are several layers of indebtedness, creditor groups and other stakeholders. It is often assumed that these situations are in the realm of the

statutory insolvency procedures. This is because there are several theoretical and practical reasons favouring the statutory procedures. In light of these, why do these stakeholders then contract among themselves regarding measures to deal with financial distress and what does it mean for corporate insolvency law and theory? In efficient markets, firms should surely be able to finance their new positive net value projects. Failure to achieve this, even if the company were financially[1] or economically distressed,[2] is a market imperfection. Theoretically, in perfect markets, we would expect the participants to avoid mandatory insolvency altogether if a company has going concern value.[3] This thesis discusses when and how avoidance of statutory insolvency procedures is possible through intercreditor contracting and what it means for the structure of corporate insolvency law theory.

(b) Contracting with creditors in LBO transactions

Intercreditor contracting does not cover all categories of corporate finance, but it is present in several markets in varying forms. Especially in segments of European corporate finance markets such as in leveraged buyouts (LBOs), real-estate finance, securitisation and project

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1 I refer to financial distress in this thesis as a situation where a firm would have positive earnings if it would not have to service its debt. See: Alan Schwartz, 'A Normative Theory of Business Bankruptcy' (2005) 91 Virginia Law Review 1199, 1200. This does not necessarily imply economic distress; see n 2. In the context of this thesis, the term is relevant in many respects. Most importantly, it is rational in some cases to restructure financially distressed firms instead of liquidating or selling them.

2 According to Schwartz, an economically distressed firm cannot earn enough revenues so that it can cover its costs (not including financial costs), ibid. However, it is common in the economic literature to define an economically distressed firm as a firm where the liquidation value is larger than the going concern value. This does not imply that the firm would default or has defaulted in its obligations.

3 Anthony Joseph Casey, *The New Bargaining Theory of Corporate Bankruptcy and Chapter 11's Renegotiation Framework (March 16, 2019)* (Available at SSRN: https://ssrn.com/abstract=3353871 2019) 23-24.

finance, it has become common to use comprehensive contractual packages that deal with intercreditor issues between various classes of creditors and the debtors.[4] These types of pre-agreed contractual, or 'privatised', insolvency and enforcement procedures are especially encountered in LBOs because they represent transactions where all of the relevant stakeholders enter into the contractual package at approximately the same time, which makes negotiating such agreements easier.

Although such contracting appears to be prevalent in the European markets, it is not clear under insolvency law theory what are the incentives for the parties to enter into these arrangements, why some creditors obtain enough private benefits to enter into the transaction and in what manner the parties deal with various hold-out scenarios[5]. Luckily, LBO arrangements provide us with a data-rich example of such contracts, which can be subjected to empirical and theoretical analysis. For this reason, I will focus in this thesis on LBO intercreditor agreements (ICAs). However, the analysis suggests that they provide a solution to contracting about insolvency in the corporate finance markets also more generally.

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4 See of the description of types of financing used in private equity acquisitions that lead to the need to regulate the intercreditor relationship: Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (Hart Publishing 2015) 773-780.

5 The two main categories are: (i) all or some individual creditors seeking to enforce against the debtor, even though this would destroy going concern value; and (ii) an individual creditor holding the transaction hostage, not agreeing to a restructuring, liquidation or another optimal arrangement and seeking to extract additional value from others.

(c) LBOs and voluntary resolution of distress

1. The connection between LBOs and ICAs

LBOs are acquisitions of a company or a group of companies using significant amounts of different classes of indebtedness to meet the costs of the acquisition.[6] Such acquisitions are often carried out by private equity funds, which are invariably limited liability partnerships managed by a private equity group controlling the management company. The partnerships are financed on the fund level by institutions that participate in the partnership as limited partners, committing to long-term equity provision to the fund. In turn, the funds invest, for the purposes of their leveraged acquisitions, in acquisition groups financed both by the fund equity contributions and multi-tiered external financing facilities.[7] The capital structure of the acquisition groups is usually multi-tiered so that different categories of lenders and equity holders can be separated, the group can be sold more easily, and structural subordination of certain claimants can be achieved so as to benefit from group relief and interest deductions in taxation.[8]

One of the main features of such funds is to create value through effective alignment of shareholder and manager interests by use of managerial incentives,

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6 Steven N. Kaplan and Per Strömberg, 'Leveraged Buyouts and Private Equity' (2009) 23 Journal of Economic Perspectives 121. See for a more detailed description Part C, Section 2(a).

7 See generally: John Gilligan and Mike Wright, *Private Equity Demystified, An explanatory guide* (2nd edn, ICAEW Corporate Finance Faculty 2010).

8 Philip Wood, *International loans, bonds, guarantees, legal opinions* (2nd edn, Sweet & Maxwell 2007) 2-019.

monitoring and coordinated shareholder control.[9] However, the combination of such interest alignment with the tendency of the funds to optimise their portfolio companies' capital structures through high leverage may lead to increasing financial agency costs and problems with effective creditor coordination in distress scenarios.

Therefore, it is not surprising that, in addition to extensive loan facility agreements, bonds, notes and other financing facilities, most European LBOs are governed by an English law ICA that covers all of the financial creditors of the group, the debtor companies and the investors.[10] In practice, despite the prevalence of English law documentation, similar intercreditor agreements governed by other laws and used with multi-tiered financing arrangements are encountered in a number of developed jurisdictions.[11] This implies that jurisdiction-specific underlying institutional or legal norms may not be as critical as widely assumed for the utility of ICAs.

ICAs regulate such matters as the ranking of the financing facilities and security, permitted payments and their restrictions, turnover obligations, the effects of formal insolvency, standstill periods and the collective decision making of the creditors. They also regulate the restructuring of the debtors and release of the liabilities and guarantees on enforcement. Technically, they contain several solutions that are characteristic of statutory corporate insolvency law.

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9 See generally of LBO value creation mechanisms: Luc Renneboog and Cara Vansteenkiste, 'Leveraged Buyouts: A Survey of the Literature (March 9, 2017).' CentER Paper Discussion Series No 2017-015.

10 See Part C, Section 3(f) for the sample structures.

11 See concerning the US: Edward R. Morrison, 'Rules of Thumb for Intercreditor Agreements' [2015] U Ill L Rev 721; and concerning Germany: Leo Plank and Wolfram Prusko, 'Die Intercreditor Vereinbarung als Instrument der internationalen Restrukturierung' in Thomas C. Knecht, Ulrich Hommel and Holger Wohlenberg (eds), *Handbuch Unternehmensrestrukturierung* (2. Auflage edn, Springer Fachmedien Wiesbaden 2018).

2. Evidence on the scope and the use of ICAs

According to Fitch Ratings, in 2017 (Q2) English law governed around 80% of all primary European loan documentation, New York law about 15% and local law about 5%.[12] The prominence of English law documentation is evident in European transactions.

In the European leveraged finance markets, the structure of LBO financing facilities is commonly based either on the LMA Leveraged Document[13] or the LMA Super Senior HY Document,[14] which are always modified to suit a particular transaction and the planned capital structure of the debtors. The structure and terms governing the intercreditor relationships and specific actions of the debtors are based generally either on the LMA Senior and Mezzanine ICA,[15] the LMA Super Senior and Senior ICA[16], which are both used in connection with the LMA Leveraged Document, or the LMA Super Senior HY ICA, which is used in connection with the LMA Super Senior HY Document.[17]

These documents are often used as a basis for drafting case-specific financing documentation and they have considerable structural similarities to the model ICAs

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12 Fitch Ratings, 'European Leveraged Loan Chart Book -3Q/2016'.

13 The Loan Market Association, *Senior Multicurrency Term and Revolving Facilities Agreement for Leveraged Acquisition Finance Transactions (Senior/Mezzanine) (2012)*. (2012), 'The LMA Leveraged Document'.

14 The Loan Market Association, *Super Senior Multicurrency Revolving Facility Agreement with HY notes for Leveraged Acquisition Finance Transactions (super senior revolving facility, senior secured notes and high yield notes) (2018) (dated 21 December 2018)* (2018).

15 The Loan Market Association, *Intercreditor agreement for leveraged acquisition finance transactions (senior / mezzanine) (18 July 2017)* (2017).

16 The Loan Market Association, *Intercreditor agreement for leveraged acquisition finance transactions (super senior / senior) (17 May 2018)* (2018).

17 The Loan Market Association, *Intercreditor agreement for leveraged acquisition finance transactions (super senior revolving facility, senior secured notes and high yield notes) (18 July 2017)* (2017).

employed by market participants.[18] In practice, the facility agreements and ICAs used in the markets deviate from the LMA model documentation, but as we will see in the empirical part of the thesis, the basic structure, general contents and most essential provisions follow them in material respects.

The broad scope of the terms of the ICAs appears to correlate with the use of out-of-court restructurings in distressed LBOs. According to *Debtwire*, 68% of all European LBO restructurings recorded by Debtwire between 2008-2010 were out-of-court[19] restructurings (referred to here as 'contractual insolvency procedures' or 'privatised procedures'), 28% also involved some court participation (including pre-pack administration, with the intercreditor relationship often based on the underlying contract[20]) and only 4% were court-driven procedures.[21] Although it is difficult to extract the UK position from these figures, they give us some indication of the importance of the contractual and negotiated procedures.

Furthermore, according to the analysis I carried out based on data obtained from Debtwire concerning a period commencing 2004 and ending October 2018, among

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18 See Part C, Section 3(f) for the empirical discussion.

19 Because the dataset includes companies and restructurings from several jurisdictions, the definition is not precise. However, in the UK, out-of-court arrangements exclude liquidation, administration (also pre-packed arrangements). The report suggests also that schemes of arrangement are considered here as court-driven procedures. However, the report provides no certainty of the used methodology in relation to schemes, Attila Takacs, *Debtwire, European Restructuring Report, Restructuring and Recoveries in 2008-2010* (2011) 23, 26, 32, 33. Garrido refers to out-of-court debt restructuring (differing from the above definition) as 'composition and/or structure of assets and liabilities of debtors in financial difficulty, without resorting to full judicial intervention and with the objective of promoting efficiency, restoring growth and minimizing the costs associated with the debtor's financial difficulties', José María Garrido, *Out-of-court debt restructuring* (World Bank 2012) 1.

20 Takacs (n 19) 23.

21 ibid. Situations that involved only covenant amendments were not included in the restructuring figures.

236 large leveraged deal restructurings of European borrowers[22], 43 were liquidations, 80 were court-driven restructurings (eg administration and pre-pack administration) and 114 were out-of-court restructurings.[23] Although the exact categorisation of the data (per jurisdiction) was not available, the figures suggest that the impact of contractual solutions to intercreditor conflicts and distress scenarios is more comprehensive than warranted by the theoretical analysis.

Similarly, the research by Demirogly and James on specific US distress procedures concluded that restructurings and pre-packaged bankruptcies represented around 68% of the entire sample.[24] Although parties may use Chapter 11 restructuring to achieve these mechanisms in the US, which is a more restrictive jurisdiction for the use of ICAs,[25] private mechanisms are still used.[26] Despite the differences in the insolvency and restructuring markets and legislation in the US, these results suggest that even in more restrictive bankruptcy systems compared to the English law, resolution of at least a part of the corporate debtors' distress scenarios relies on private mechanisms.[27]

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22 Proprietary data set collected from Debtwire for the thesis on 1 October 2018. The dataset consisted of the entire Debtwire restructuring data concerning those years.

23 It could not be determined conclusively from the data definitions whether schemes of arrangement were included in this group. However, terminology corresponded to the terminology used in Takacs (n 19) and a separate review of the company announcements indicated clearly that restructurings defined as 'court-driven' restructurings included ones relying on a scheme of arrangement. Due to the uncertainty of the definitions, however, no reliable conclusions can be inferred from the sample.

24 Cem Demiroglu and Christopher James, 'Bank loans and troubled debt restructurings' 118 Journal of Financial Economics 192.

25 Although, intercreditor contracting used also in the US, especially to bind eg second lien creditors in Chapter 11 procedures, the US case law against bankruptcy waivers and assignments is still pervasive and restricts intercreditor contracting, Morrison (n 11).

26 See concerning 'restructuring support agreements' used in the US: Douglas G. Baird, 'Bankruptcy's Quiet Revolution' University of Chicago Law School, Working Paper No 755, 2016 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2767057> accessed 28 October 2019.

27 See footnote 11 for the reference to the US and German position.

The prevalence of ICAs and the fairly large relative proportion of out-of-court LBO restructurings challenges the view that the resolution of distress scenarios under mandatory corporate insolvency law constitutes the core of insolvency theory as well as the argument that contractual solutions to dealing with financial distress are rare, at least as regards specific types of corporate and capital structures.[28] As Franks, Sussman and Vig (2017) said, '[r]emarkably little is known about the actual operation of freedom of contracting regimes, partly because law reforms have pushed them close to extinction'.[29] Also, Warren and Westbrook (2005) have noted that 'thus far the debate over whether parties should be able to contract out of bankruptcy has been entirely theoretical'.[30] In addition to possible statutory restrictions to agreements on insolvency, contractual insolvency procedures are often said to fail due to high creditor coordination costs and the risk of strategic creditor actions.[31]

These statements may, however, down-play the fact that the more permissive legal systems such as English law exhibit commercially reliable and developed remedies and judicial enforcement of contract, trust and securities law and may create optimal conditions for such contracting. There also appears to be some theoretical recognition for the increased prominence of such contracting, due to, for example, increasing control of

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28 Julian Franks, Oren Sussman and Vikrant Vig, *The Privatization of Bankruptcy: Evidence from Financial Distress in the Shipping Industry* (ECGI - Finance Working Paper No 505/2017, 2017) 1.

29 ibid 1.

30 Elizabeth Warren and Jay Lawrence Westbrook, 'Contracting Out of Bankruptcy: An Empirical Intervention' (2005) 118 Harvard Law Review 1197, 1201.

31 See generally on coordination costs: Alan Schwartz, 'Bankruptcy Related Contracting and Bankruptcy Functions' in *Yale Law & Economics Research Paper No 553* (2017) <https://ssrn.com/abstract=2806027>

secured creditors and activist loan investors.[32] However, there is much doubt in the corporate insolvency law literature concerning dealing with distress scenarios by contracts *ex ante*.[33]

The clash between developments in corporate finance and some of the arguments set out in the corporate insolvency literature on theoretical and practical difficulties in dealing with contractual insolvency procedures is stark. The need of the parties to ensure an efficient commercial restructuring mechanism has favoured multi-party ICAs to ensure control and enforcement structures both during the life of the loan facilities and in situations of distress. This may have a connection to the fact that in the US private equity-backed firms, which account for more than 90% of the LBOs, move through distressed restructurings more quickly, are handled out-of-court and are less likely to liquidate than other distressed leveraged borrowers.[34] This appears to be the case even though the higher leverage ratios often encountered in LBOs should correlate with an earlier onset of financial distress.[35] Although the figures may not be similar is the UK due to different legal remedies and the structure of the market, the US figures give an indication of how private equity funds are likely to approach restructuring also outside the US.

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32 David A. Jr. Skeel and George Triantis, 'Bankruptcy's Uneasy Shift to a Contract Paradigm' Public Law and Legal Theory Research Paper Series Research Paper No #18-21 <https://ssrn.com/abstract=3217295> accessed 1 October 2018, 2-3.

33 ibid 4-5.

34 Edith S. Hotchkiss, Per Strömberg and David C. Smith, *Private Equity and the Resolution of Financial Distress (March 13, 2014)* (AFA 2012 Chicago Meetings Paper; ECGI - Finance Working Paper No 331/2012, 2014).

35 M.H. Miller, 'Leverage' (1991) 4 Journal of Applied Corporate Finance 6.

2 The objective and the research question

(a) The objective of the thesis

The objective of this thesis is to analyse how English law ICAs used in LBO transactions deal with the risk of so-called strategic creditor actions when debtors are distressed while at the same time enabling creditors to effect an *ex post* optimal liquidation or restructuring of the entire debtor group. This objective is connected to a more general question how such agreements enable sufficiently strong creditor coordination to achieve these goals. Answering these questions requires addressing also the so-called incomplete contracting problem[36] and the posited difficulties of overcoming creditor coordination problems in complex and multi-tiered financial arrangements. Addressing these concerns requires both theoretical and empirical analysis.

For the purposes of these objectives, the thesis contains a detailed discussion of the problems that are said in the literature to restrict the use of privatised insolvency procedures. This theoretical analysis enables us to examine empirically actual capital structures as well as ICAs, which contain solutions to dealing with distress scenarios, creditor coordination and enforcement on a debtor group-wide basis. The objective of this analysis is to answer whether the contractual solutions to corporate insolvency are, not only theoretically but also in practice, possible. This is needed because their theoretical feasibility is often said to be affected by several practical impediments that come up in corporate finance.

[36] See Part B, Section 3(d)2.

In addition, the thesis focuses on how the ICAs deal with the multi-party financial agency costs that arise in LBO financing structures and whether such costs incentivise the parties to enter into ICAs. Supplementing the analysis on strategic creditor actions with the analysis of the incentives of various stakeholders and agency costs in the LBO arrangement gives us a more comprehensive understanding of contracts for control. Such an approach also gives a more coherent framework for the empirical analysis of ICAs.

(b) Central themes underlying the research question

1. Strategic creditor actions

Before setting out the research question, it is important to elaborate the two main themes that were introduced in the previous section discussing the objectives of the thesis. They are the question of strategic creditor actions and the effects and incentives resulting from especially financial agency costs that arise in the context of multi-layered financing arrangements, such as LBOs. Both of these issues are discussed in detail in Part B of the thesis but setting out their main features is material for the research question.

The risk of strategic creditor actions is often seen as one of the main impediments to private contracting about insolvency. It is also presented as an argument for the existence of state-supplied corporate insolvency laws, because overcoming these strategic creditor actions is often difficult, whether generally or due to diverse, large creditor base and heterogeneous objectives of the creditors. In the thesis, I have divided these strategic creditor actions into two separate problems.

The first of these is the game theoretical prisoner's dilemma' problem in which

each stakeholder is incentivised to enforce against the debtor individually even though conventional enforcement would lead to a better overall result.[37] The second strategic action is the hold-up problem, in which a party is incentivised to withhold consent to a restructuring or enforcement arrangement even though overall enforcement would lead to a better overall result for all stakeholders. The hold-up risk may also materialise in a pure enforcement sale or liquidation because the controlling creditor group often has to reach a requisite level of support for the enforcement sale, which may not materialise if some creditors try to get additional private benefits from the arrangement eg by claiming full repayment, while other creditors write off of their claims.

We can divide these strategic actions into the 'vertical relationship', that is the interactions between different categories of creditors, and the 'horizontal relationship', or the interactions within a particular creditor syndicate or creditor category. This categorisation helps to understand the priority and control aspects of an LBO arrangement. The risk of strategic creditor actions in the horizontal relationship is dealt primarily with the terms of loan facility agreements and bond documents that rank creditors on an equal footing, ie *pari passu*, but often in different tranches.[38]

The risk of strategic creditor actions in the vertical relationship is dealt with by the terms of the ICA binding the debtor group, the financial creditors and the shareholders in their creditor status. The distributions relating to equity financing are not dealt with in the ICAs directly but are covered by the covenants used in the loan agreements and bond

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37 See for a succinct description eg Rachel McAdams, 'Beyond Prisoners' Dilemma: Coordination, Game Theory and Law' (2009) 82 Southern California Law Review 210, 214-16.

38 Distributions in a winding-up must be made to creditors in each category equally and *pro rata* to their claims. For statutory examples see: s107, Insolvency Act 1986 (voluntary winding up) and rule 14.12 of Insolvency (England and Wales) Rules 2016 (SI 2016/1024) (compulsory winding-up).

documentation, restrictions in corporate documentation and shareholder agreements as well as under company law.[39]

Overcoming these strategic actions in both the vertical and the horizontal relationship is material to any contractual mechanism designed to provide a solution to the distress scenario. The severity of these strategic actions is exacerbated as the number and heterogeneity of creditors grow, making creditor coordination more difficult.[40] These situations arise invariably in LBOs.

2. Agency costs

The second significant challenge to financial contracting is based on a stakeholder conflict, which is typical not only in LBO-type capital structures, but more generally. This is the risk of increased financial agency costs that results from the realignment of shareholder-management incentives in private-equity-held companies that use LBO capital structures. The most important of such costs result from the incentive for the owner-manager to engage, with limited equity exposure, in high-risk activities despite the low probability of their success, thus obtaining the full benefit with limited risk while the creditors bear the majority of the risk. The primary ways of dealing with the financial agency costs between the debtor and a particular creditor group are financial and general covenants and monitoring clauses in the financing documentation.

However, in multi-tiered financing structures the creditor groups need to control also other creditor groups. First, especially the senior creditor groups will need to

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39 Gilligan and Wright (n 7) 90-94.

40 D. G. Baird and R. K. Rasmussen, 'Antibankruptcy' (2010) 120 Yale Law Journal 648, 652.

control the terms included in the other financing contracts and the actions taken by the other creditors under these contracts. Secondly, the other creditor groups will face financial agency costs also if the other creditor groups are able to deal with the debtor group, or eg a private equity fund, obtaining private benefits not afforded to the other creditor groups.

Understanding the nature of these agency costs both between the debtor group and a particular creditor group as well as the costs arising due to the risk of other creditor groups receiving additional benefits from agreeing privately with some creditor groups means that the creditors, as a whole, are likely to have incentives to eliminate such costs by concluding a contract for control, such as an ICA. The theoretical Part B of the thesis sets out the incentive structures and the preconditions under which rational parties would be likely to enter into an ICA, as well as the clauses minimising the incentives of the creditors to take non-value maximising actions. Table 1 summarises how the financing agreements and ICAs deal with the risk of strategic creditor actions and the financial agency costs in a typical LBO arrangement.

Table 1. Contracts dealing with strategic actions and financial agency costs

	Risk of strategic actions	**Financial agency costs**
Horizontal relationship (within each creditor category)	Loan facility agreements and bond documentation; defusing of incentives of individual creditors to circumvent these	Loan facility agreements and bond documents: covenants and events of default; monitoring
Vertical relationship (between different creditor categories)	Intercreditor agreement, defusing the incentives among creditor groups; representation of the groups	Intercreditor agreement ensuring that breach of loan/bond covenants dealing with the costs is controlled throughout the capital structure

(c) The research question

This thesis seeks to answer the following research question and the two follow-up questions:

> 'Are the ICAs used in private equity LBOs able to defuse:
>
> (i) the hold-out creditor problem concerning distressed debtors, taking into consideration the increased financial agency costs characteristic of LBO structures; and
>
> (ii) the 'free-rider risk', ie the hold-up problem in financial distress while enabling a value-maximising solution for creditors?
>
> If so, why would the parties be incentivised to conclude such an agreement and do ICAs necessitate resorting to the state-supplied insolvency procedures and remedies to be effective?'

Although essential for creditor control purposes, I have excluded the contents of the financing agreements and security agreements from the scope of this thesis. The focus is on contracts governed by English law and on the intercreditor documentation used after the financial crisis of 2008. Because the thesis focuses on the *ability* of the ICAs to deal with, and overcome, the impediments set out in the research question, I have excluded from the scope of the thesis the actual restructuring transactions carried out in the markets. This is subject to further research.

3 The methodology of the empirical analysis

In addition to the theoretical discussion on the objectives of corporate insolvency law, strategic creditor actions and the financial agency costs, it is important to evaluate empirically whether ICAs are used in LBOs, what their contents are, and whether they

provide solutions to the strategic creditor actions. For this purpose, I have formulated the research questions into specific testable theoretical propositions. The theoretical Part B also lists observable implications which we would expect to see if those theoretical propositions were to hold. The empirical Part C consists of the content analysis of the LMA ICAs and a sample of English law governed ICAs, supported by in-depth interviews of market participants.

The empirical data consisted of 23 sample intercreditor agreements representing large, primarily cross-border, leveraged transactions between 2013 and 2018. The content analysis built on a detailed coding scheme for the ICAs and a 'grounded theory' analysis of the structure and terms of the ICAs. I grouped the results of the content analysis into three main categories: (i) capital structure and priorities, (ii) creditor control, and (iii) enforcement and distressed disposals. I built the analysis on the structure of three Loan Market Association ICAs, which are part of the generally accepted market conventions and contracts that are often used as a starting point in actual transactions.

I also conducted and transcribed 14 in-depth interviews with senior market participants carried out in 2018 and early 2019. The results of interviews were used to supplement the meaning and perceptions of the participants concerning the use and objectives of ICAs in leveraged transactions and to recognise possible inconsistencies in the content analysis. The objective of the interviews was to examine whether the participants consider that ICAs are in practice intended to overcome the problems identified in the theoretical Part B, whether they are broadly successful in achieving that aim and whether they enable the resolution of distress scenarios in a majority of cases without recourse to state-supplied procedures. The interviews were also intended to clarify

the most contested features of ICAs for LBO restructuring purposes. The detailed methodology is set out in Part C, Section 1(c).

4 Connections to existing research

(a) General strands of relevant literature

The thesis connects to two strands of academic literature. The first is that concerning the basis of corporate insolvency theory and the strategic actions of creditors, namely the game-theoretical problems faced by the creditors in distress scenarios, how to overcome these actions by better creditor coordination in distress scenarios and intercreditor conflicts.

The thesis also builds on the literature on agency costs, especially financial agency costs, and the measures and solutions dealing with the incentives of different stakeholders. This literature is material to understanding why the owners, managers and creditors would be incentivised to offer and accept a contract for control such as an ICA and incentivised to regulate their internal relationships to lower their coordination costs in corporate insolvency. This discussion links to the empirical private equity literature discussing the role and scope of the use of debt in LBO transactions.

(b) Strategic creditor actions and creditor coordination

There are prominent views presented in the corporate insolvency theory literature that contractual solutions to financial distress are rare (Warren and Westbrook, 2005;[41] Franks,

[41] Warren and Westbrook (n 30).

Sussman and Vig, 2017[42]) and suffer from often significant statutory restrictions[43] and from the risks of strategic creditor actions, which are defined in this thesis as the hold-out creditor risk, ie grab of the assets of the company, and the risk of opportunistic hold-up behaviour, ie opposing a solution to the distress by seeking personal additional benefits or by claiming full repayment, when the other creditors write off of their claims (Eidenmüller, 2006;[44] LoPucki, 1999;[45] Westbrook, 2004;[46] Jackson 1982[47]). Individual advantage-taking makes elimination of these actions by creditor coordination and *ex ante* insolvency agreements costly (Jackson 1982[48] and 1986[49]). Especially, control of the adverse effects caused by hold-out behaviour is typically presented as the main argument for the existence of mandatory insolvency law and an insurmountable impediment to contractual

42 Franks, Sussman and Vig (n 28).

43 The US position in relation to deviating from the statutory bankruptcy rules and eg bankruptcy waivers is complex. The main impediment results primarily from Section 316(b) of the Trust Indenture Act of 1939, which prohibits the bond-holders from changing any core term, such as principal, interest rate, or maturity of a bond by a binding vote; and more importantly the reluctance of the courts to enforce bankruptcy waivers or assignment of bankruptcy rights. The case law is complex and developing but evidences a clear contract to the more permissive English law regime. See a detailed account of the US case law: Morrison (n 11).

44 Horst Eidenmüller, 'Trading in times of crisis: formal insolvency proceedings, workouts and the incentives for shareholders/managers' (2006) 7 European Business Organization Law Review 239.

45 Lynn M. LoPucki, 'Bankruptcy Contracting Revised: A Reply to Alan Schwartz's New Model' (1999) 109 Yale LJ 380.

46 Jay Lawrence Westbrook, 'The Control of Wealth in Bankruptcy' (2004) 82 Texas Law Review 795.

47 Thomas H. Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 Yale LJ 857.

48 ibid.

49 Thomas H. Jackson, *The logic and limits of bankruptcy law* (Harvard University Press 1986).

arrangements (Block-Lieb, 2001;[50] Schwartz, 2005[51]).[52] Several academics have considered that the contractual procedures suffer from additional challenges, for example, the changing, heterogeneous, creditor base of the debtor and fragmentation of debt (Armour 2012,[53] Baird and Rasmussen 2010,[54] Schillig 2014,[55] Schwartz 2005[56]).

However, based on the Modigliani Miller[57] theorem, Haugen and Senbet (1978,[58] 1988[59]) propose that the costs of restructuring are limited to the lesser of formal bankruptcy costs and informal reorganisation costs carried out through the capital markets.[60] They argue (1978,[61] 1988[62]) that this may render the coordination costs associated with the restructuring insignificant in efficient markets. Knoll elaborates this by concluding that sophisticated financial contracts may achieve this through the use of the

50 Susan Block-Lieb, 'The Logic and Limits of Contract Bankruptcy' [2001] U Ill L Rev 560.

51 Schwartz, 'A Normative Theory of Business Bankruptcy' (n 1).

52 It should be noted that these studies focus on the general case where the company is likely to have trade or operational credit. Their focus is, therefore, much broader than in this thesis, which focuses on restructuring of financial claims.

53 John Armour, 'The Rise of the "Pre-Pack": Corporate Restructuring in the UK and Proposals for Reform' in Austin and Aoun (eds), *Restructuring Companies in Troubled Times: Director and Creditor Perspectives* (2012).

54 Baird and Rasmussen (n 40).

55 Michael Schillig, 'Corporate Insolvency Law in the Twenty-First Century: State Imposed or Market Based?' (2014) 14 Journal of Corporate Law Studies 1.

56 Schwartz, 'A Normative Theory of Business Bankruptcy'(n 1).

57 F Modigliani and M.H. Miller, 'The Cost of Capital Corporation Finance, and the Theory of Investment' [1958] American Economic Review 261.

58 RA Haugen and LA Senbet, 'The Insignificance of Bankruptcy Costs to the Theory of Optimal Capital Structure' (1978) 33 The Journal of Finance 383.

59 RA Haugen and LA Senbet, 'Bankruptcy and Agency Costs: Their Significance to the Theory of Optimal Capital Structure' (1988) 23 Journal of Financial and Quantitative Analysis 27.

60 Haugen and Senbet (n 58) 387.

61 ibid.

62 Haugen and Senbet (n 59).

capital markets and the reduction of information asymmetries.[63] Also, Armour and Deakin note that debtors may have 'incentives to offer a procedure that will maximise the net benefits of debt finance, solving any coordination problem'.[64] Gennaioli and Rossi have argued on similar lines.[65]

Schwartz[66] and Baird and Rasmussen[67] point out that formal procedures should not interfere if the parties can reach a contractual Coasian bargain.[68] Furthermore, Baird and Rasmussen[69] note that mandatory insolvency law is only required if the parties are unable to draft effective *ex ante* contracts for control of the debtor or if the costs for multi-party contracting are high (Warren and Westbrook, 2005;[70] LoPucki, 1999;[71] Block-Lieb, 2001[72] arguing the contrary). More recently, Schwartz has argued that there is seldom a creditor coordination problem and that debtors are capable of forming capital structures

63 See Michael S. Knoll, *The Modigliani-Miller Theorem at 60: The Long-Overlooked Legal Applications of Finance's Foundational Theorem (October 11, 2017).* (U of Penn, Inst for Law & Econ Research Paper No. 17-43. Available at SSRN: https://ssrn.com/abstract=3053953 2017).

64 John Armour and Simon Deakin, 'Norms in Private Bankruptcy: The 'London Approach' to the Resolution of Financial Distress' (2001) 1 Journal Corporate Law Studies 21.

65 Nicola Gennaioli and Stefano Rossi, 'Contractual Resolutions of Financial Distress' (2013) 26 The Review of Financial Studies 602.

66 Alan Schwartz, 'A Contract Theory Approach to Business Bankruptcy' (1998) 107 Yale LJ 1807.

67 Baird and Rasmussen (n 40).

68 Coasian bargain refers to an efficient allocation of economic resources or outcome when there are externalities present. If the transaction and negotiation costs are low-enough bargaining will result in a Pareto efficient outcome. Pareto efficiency generally means a scenario, where no other solution Pareto dominates it. Pareto dominance means that there is no outcome that one party is better off, and the others are not worse off. See generally eg: Ronald Coase, 'The Nature of the Firm' (1937) 4 Economica 386.

69 Douglas G. Baird and Robert K. Rasmussen, 'The End of Bankruptcy' 55 Stanford Law Review 751.

70 Warren and Westbrook (n 30).

71 LoPucki (n 45).

72 Block-Lieb (n 50).

that solve the coordination problem.[73]

However, Skeel notes that, irrespective of being able to reach a bargain, an optimal restructuring, liquidation or enforcement may still suffer from the 'debt overhang problem' under which an economically-viable but financially distressed debtor is liquidated prematurely.[74] Such a scenario occurs where new funding would ensure the continuance of the business and capturing the going concern value, but such funding will not be granted because the existing indebtedness would capture the gains.[75]

There is some proof that specific capital structures, access to efficient lending markets and sophisticated contracts may indeed work. Specific to LBOs, Hotchkiss, Smith and Strömberg[76] have shown that private-equity-backed firms move through distressed restructurings more quickly and are less likely to liquidate than other distressed leveraged borrowers, implying that these firms may be better able to use contractual means and secured credit to support going concern restructurings. Jenkins and Smith[77] and Gilson, Hotchkiss and Osborn[78] have shown that secured credit (which is pervasive in LBOs) does not negatively affect the outcomes. This appears to be the case even though LBOs are prone to use high levels of leverage that is connected to the credit market and general economic conditions. Such arrangements, therefore, differ from the general corporate finance market,

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73 Schwartz, 'Bankruptcy Related Contracting and Bankruptcy Functions (October 10, 2017)' (n 31).

74 Kenneth Ayotte and David A Jr Skeel, 'Bankruptcy Law as a Liquidity Provider' (2013) 80 U Chi L Rev 1557, 1573-74.

75 ibid 1570-72.

76 Hotchkiss, Strömberg and Smith (n 34). However, their research focuses on US companies.

77 Mark Jenkins and David C. Smith, 'Creditor Conflict and the Efficiency of Corporate Reorganization (May 29, 2014)' Available at SSRN: https://ssrncom/abstract=2444700

78 Stuart Gilson, Edith S. Hotchkiss and Matthew Osborn, 'Cashing out: The Rise of M&A in Bankruptcy (March 6, 2016)' Available at SSRN: https://ssrncom/abstract=2547168 accessed 28 October, 2019.

implying extensive capital optimisation and planning by private equity houses.

The literature on insolvency contracting has, therefore, focused heavily on the difficulties of creditor coordination especially at different times and among heterogenous creditor-base. On the other hand, the efficiency arguments favour such contracting and the feasibility of creditor coordination to overcome strategic creditor actions. There are gaps in the literature on when and how such creditor coordination is possible and how the specific negative incentives of the parties to deviate from optimal solutions can be eliminated in practice.

(c) Stakeholder incentives to contract

Questions involving the stakeholders' incentives to coordinate their actions both *ex ante* and *ex post* in order to avoid strategic creditor actions are connected to agency costs, especially in the literature dealing with financial agency costs. Building on the literature on the comparative benefits of closely held corporations (Jensen and Meckling, 1976;[79] Jensen, 1989[80]), some academics have argued that the most important value-creation mechanisms of private equity are alignment of shareholder interests with the interests of the management and wealth transfers among stakeholders (Renneboog and Vansteenkiste, 2017[81]). Although close interest alignment reduces managerial agency costs, the use of debt-related incentives means that there are pronounced risks arising out of the agency

79 Michael C. Jensen and William Meckling, H., 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' [1976] Journal of Financial Economics 305.

80 Michael C. Jensen, 'Eclipse of the Public Corporation' [1989] Harvard Business Review.

81 Renneboog and Vansteenkiste (n 9).

costs of debt (Armour and Frisby, 2001;[82] and Renneboog and Vansteenkiste, 2017[83]).

However, it has been argued that the use of leverage can operate as an external disciplining device (Armour and Frisby, 2001[84]), but its extensive use may result, for example, in higher default probability and other agency costs of debt (Armour and Frisby 2001[85]). These agency costs include the debtors misrepresenting the value or title to the assets, transferring assets outside the corporate entity or increasing the risk in the debtor's business (Armour, Hertig and Kanda 2017[86]). The risk is prevalent in private equity LBOs due to their high reliance on leverage (Axelson, et al., 2012[87]). The risk of financial agency costs suggests an imminent need for *ex ante* contracting, not only between a single creditor group and the debtor, but also to ensure that the debtor does not provide individual creditor groups undisclosed private benefits or advantages that worsen the relative position of the other creditors. The existing legal literature does not provide conclusive evidence whether such multi-party costs can be reduced contractually.

Ex ante contracting, on the other hand, promotes reliance on investments made by the parties and effectively allocates the risk and establishes incentives for the parties. In contrast, renegotiation of *ex ante* bargains *ex post* is likely to undermine the benefits of *ex ante* contracting (Skeel and Triantis 2018[88]). Despite the fact that a number of academics

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82 J. Armour and S. Frisby, 'Rethinking Receivership' (2001) 21 Oxford Journal of Legal Studies 73.

83 Renneboog and Vansteenkiste (n 9).

84 Armour and Frisby (n 82).

85 ibid.

86 Reinier H. Kraakman and others, *The anatomy of corporate law: a comparative and functional approach* (Third edn, Oxford University Press 2017).

87 Ulf Axelson, Per Strömberg and Michael S. Weisbach, 'Why Are Buyouts Levered? The Financial Structure of Private Equity Funds' (2009) LXIV Journal of Finance 1549.

88 Skeel and Triantis (n 32).

have argued that the incentives of *ex ante* contracting for financial distress exist, there is little empirical legal research concerning the existence or content of 'private' procedures especially in the leveraged markets in the UK. The emphasis of the research has been on the 'hybrid' procedures (Polo, 2012;[89] Franks and Sussman, 2005;[90] Frisby, 2007[91]), for example, the pre-pack administration.

Furthermore, there appear to be gaps in the literature concerning contractual mechanisms that enhance creditor coordination, retaining the benefits of *ex ante* contracting while benefitting from better information of the distress scenario *ex post*. Some prominent exceptions to this are Armour and Deakin (2001)[92] (restructuring of large corporates in the UK both theoretically and empirically under the 'London Approach') and Franks, Sussman and Vig 2017[93] (private resolution of distress in the shipping industry).

5 The main arguments and contribution to the literature

The thesis bridges the gap in the literature by analysing and showing both theoretically and empirically how one type of a contractual insolvency procedure, ICA-based LBO restructuring, deals with strategic creditor actions said to restrict the use of contractual insolvency procedures by enhancing creditor coordination. Secondly, the thesis adds to the literature by empirically examining how the parties can reduce financial agency costs and

89 A. Polo, *Secured Creditor Control in Bankruptcy: Costs and Conflict* (Saïd Business School, University of Oxford 2012).

90 Julian Franks and Oren Sussman, 'Financial innovations and corporate bankruptcy' (2005) 14 Journal of Financial Intermediation 283.

91 S. Frisby, *A preliminary analysis of pre-packaged administrations, Report to The Association of Business Recovery Professionals* (University of Nottingham 2007).

92 Armour and Deakin (n 64).

93 Franks, Sussman and Vig (n 28).

negative incentives of different stakeholders by means of a contract. Thirdly, it contributes to the literature by showing how and under what conditions different stakeholders are able to create a framework for optimal liquidation or restructuring decisions without necessarily resorting to the statutory procedures.

I argue in the thesis that ICAs enable the reduction of the incentives for strategic creditor actions that restrict optimal control and enforcement measures in the financial distress of the borrower. This is effective despite the heterogeneous, fragmented creditor-base often seen to restrict contracting about insolvency. The solution is based on my argument that a complete adherence by the entire creditor-base of the debtor to the contract is not necessary. Instead, for the ICA to be effective, exceeding a sufficient case-by-case negotiated threshold of adherence to the contract is sufficient to enable creditor coordination. The empirical Part C provides further evidence that the theoretical rationale and incentives that are said to support concluding contracts for control of the debtor are reflected both in the market practice and in the financial contracts. The empirical and theoretical analysis refutes, in the specific case of LBOs, the generally endorsed assumption that private insolvency procedures cannot overcome the hold-out creditor problem or achieve creditor coordination.[94] However, this argument is restricted in the thesis to purely financial restructurings that do not include general, eg trade or operative, creditors.

Secondly, I will show in the empirical Part C of the thesis that ICAs enable debtors to offer contingent control rights to all of the creditor groups of the debtor group

[94] It should be noted that this claim does not extend more generally into corporate distress scenarios. In such cases, companies may have a multitude of creditor types coordination of which may not necessarily be achieved by contract.

in a structured and uniform manner. This is likely to lower *ex post* creditor coordination costs and enable optimisation of enforcement and insolvency measures through lower financial agency costs arising from the shareholder-creditor conflict and from the conflict between the debtor (PE fund) and a specific creditor group against the other creditor groups. However, this solution has a connection to the controlling creditors having a comprehensive security interest in the debtor group's assets.

Thirdly, the current ICAs in particular enable borrowers to control and amend their capital structure within a flexible contractual control and enforcement regime applicable to existing and future financial creditors. This implies that an ICA operates as an extensive contractual distress resolution mechanism adjusting to the changing capital structure and financing requirements of debtors. The ability to adjust the capital structure within the ICA framework and to carry out a financial restructuring with a more sustainable capital structure also enables the parties to reduce the debt overhang problem, which is often seen as a theoretical impediment to restructuring an otherwise economically viable company that is financially distressed. The private equity fund is likely to have a keen interest to reduce the debt overhang risk, especially when the debtor group has enough going concern value for the private equity fund.

These specific arguments lead to a more general argument that has an impact on how to view both contractual and statutory solutions to financial distress. The empirical analysis of the ICA enforcement and distressed disposals procedures shows that they create a co-operative multi-party bargaining scenario covering the entire debtor group and offering the controlling creditors an option to enforce either at multiple levels of the debtor group or at a single point-of entry, eg by sale of holding company shares and releasing the

underlying group of all financial obligations. This means that the contractual solution is in fact an option for the controlling creditors to achieve an *ex post* optimal solution. The optionality here means that the controlling stakeholders are able to resort either to contractual or statutory solutions or their combination, depending on which arrangement is seen most feasible in the *ex post* scenario.

6 Structure of the thesis

Part B includes the theoretical part of the thesis. I first discuss the functions of corporate insolvency law and then specific theoretical reasons underlying the need to have statutory insolvency rules that are often said to justify the existence of the mandatory insolvency law and are seen as impediments to contracting about insolvency. I will then expand the discussion to how such impediments can be resolved contractually.

The focus is on the analysis of the strategic creditor actions and in what circumstances creditor coordination by contract can overcome these. This is framed by two questions: (i) is a purely contractual insolvency procedure possible or is a contractual procedure possible only as a part of mandatory insolvency law procedure; and if it is possible, (ii) can it overcome impediments to the use of such procedures. The latter section of Part B focuses on agency costs relevant to private-equity-leveraged transactions and the debtor's rationale for proposing to creditors contracts for control, ie how, under what conditions, and in what types of corporate and financial structures the parties would be incentivised to contract. It concludes by setting the key theoretical propositions that will be tested in the empirical part.

Part C contains the empirical analysis. I will first introduce certain fundamental

features of private equity LBOs and their capital structures and the assumed rationale of using ICAs and the assumptions underlying the LMA documentation. This part includes a detailed description of the methodology of the empirical research, the coding scheme and structure of both the ICA content analysis and the in-depth interviews. Its three main sections are supported by secondary literature and the English law principles relating to debt subordination, creditor oppression and some aspects of the law on security trustees. The themes of the empirical Part C are maintenance and control of the debtor capital structure, restrictions on hold-out creditor behaviour and facilitation of enforcement and distressed disposals.

The empirical findings are discussed and analysed in Part D, which also includes a discussion of and answers to the research questions and the key theoretical propositions set out in Part B. Part D concludes with a summary and scope for further research.

PART B - CORPORATE INSOLVENCY THEORY, CONTRACTUAL TECHNIQUES AND AGENCY COSTS

1 Introduction

(a) Background on financial distress and contracting

The first step in the analysis of contract-based corporate restructuring or insolvency procedures is understanding the parties' economic incentives when dealing with financial distress scenarios. In economically efficient markets, we would expect that the parties have incentives to contract about potential distress scenarios in advance. In an ideal situation, this could lead to a Pareto optimal outcome for the parties.[95] Assuming economic efficiency, financial distress would be self-correcting.

However, such contracting may prove impossible or very costly because, for example, the identity of the stakeholders in a company and the size and the nature of their claims change over time. Most of the parties are likely to have different incentives and commercial relationships with the debtor, or no prior relationship at all. Neither are all parties able to monitor the debtor nor contract in advance for priorities and control rights.

This increases the risk of strategic creditor actions when the financial state of the debtor deteriorates. In such a scenario, in addition to contracting difficulties *ex ante*, creditor coordination to overcome these actions *ex post* may be impossible. There will in

[95] Pareto optimality or efficiency means that there is no other alternative in the allocation of assets, rights or something else such that one party would be better off than another, and no party would be worse off, ie there is no room for Pareto improvement.

effect have to be additional incentives or obligations for the parties to coordinate their actions; for example to enable value maximising restructuring or a sale of the debtor and its assets.

Such strategic actions between the creditors and between the creditors and the debtor are directly affected by the company management and its shareholder relationships because the managers in effect act *economically* as the shareholders' agents when acting for the firm.[96] In this type of agency relationship, the parties' interests may not be aligned, creating room for managerial agency costs.[97] These costs arise because of the separation of ownership and management and because one party may benefit from the agency relationship or enjoy a majority of the profits while carrying only a fraction of the risk and costs. Related agency costs may arise between the company and its creditors in the form of financial agency costs, primarily because the manager-shareholders may have incentives to engage in high-risk projects where the creditor bears most of the risk of failure but whose potential benefit is capped to the interest and fees.[98] We shall return to these issues later.

Analysis of agency costs and their causes helps us to understand how and why a company or its creditors have incentives to reduce these costs through, for example, monitoring the company, bonding its shareholders and management and perhaps offering a contract for control to alleviate these risks in the form of an ICA. This is the debtor-creditor relationship understanding of which is material to understanding the nature of the creditors' relationships between themselves.

The two questions concerning, on the one hand, the control over strategic

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96 Jensen and Meckling (n 79) and Part B, Section 4(a).

97 See Part B, Section 4(a).

98 See Part B, Section 4(b).

creditor actions and, on the other hand, the creation of incentives for entering into contracts that reduce these, as well as the negative agency costs, are effectively connected. This connection is also apparent when we dissect how the corporate finance markets approach these risks and challenges contractually. To understand this, we must start from the basics of corporate insolvency theory because this reveals the questions that any contractual solution to corporate insolvency must address.

(b) Evaluating the basis and use of the contractual corporate insolvency procedures

There are four relevant aspects when evaluating the basis and use of the contractual corporate insolvency procedures, for example, the ICA procedure:

1) their theoretical plausibility (that is, the impediments to contracting and defusing the incentives for strategic creditor actions, ie hold-out and hold-up behaviour);

2) the incentives for entering into such contracts (managers', shareholders' and creditors' incentives) and how the procedures deal with the shareholder/manager agency costs and shareholder (or manager)/creditor agency costs;

3) their effectiveness in leading to higher returns to creditors generally, or achieving some better outcome, or taking less time, compared to the legislative solutions; and

4) how they actually regulate the resolution of financial distress and how market participants use them to this end.

I will limit the discussion in this part to the first two of these questions. The fourth question is evaluated in the empirical Part C of the thesis. The question of relative efficiencies between different restructuring systems is not directly addressed in the thesis, but I will

address the creditors' preferences and options concerning the choice of the restructuring procedure in a distressed LBO transaction, which enables the creditors to choose an *ex post* efficient solution.

In this part, I will examine the nature of the most pressing theoretical impediments to the use of contractual insolvency procedures, the risk of strategic creditor actions and the ways to overcome these by creditor coordination. These two issues are essential because, if the ICA procedure were able to deal with these impediments, the claim that contractual insolvency solutions fail due to high creditor coordination costs might not hold. This would also mean that certain types of contractual insolvency procedures are theoretically plausible and effective.

This part contributes to the thesis in three respects. First, it sets out the strategic creditor actions and agency costs that are peculiar to LBO-type financing structures, and how the debtor company and the creditors may deal with them rationally. Secondly, it will draw together the incentives and economic rationale for the shareholders, the debtor and the creditors to enter into an ICA, especially in a multi-tiered group financing structure. Thirdly, it will identify four key conditions, or propositions, under which ICAs can be argued to operate as a plausible contractual insolvency procedure and how they can defuse the risk for strategic creditor actions and the negative incentives caused by the agency costs. These four propositions are supplemented with the observable implications that we would expect to see in the empirical part of the thesis for these propositions to hold true in practice.

The rest of this part is structured as follows. Section 2 sets out the main objectives of mandatory corporate insolvency law. Section 3 discusses the relevant theoretical basis for the existence of mandatory insolvency law rules, the risk of strategic

creditor actions and the challenges this poses to contracting about insolvency. Section 4 addresses the agency costs question to the extent that it is relevant to the financing of LBOs. Section 5 draws together the question of strategic actions and the measures for dealing with agency costs and introduces a framework that incentivises the parties to agree on issues of control and resolution of financial distress.

2 Objectives of corporate insolvency law

(a) Between objectives and the challenges of financial distress

The arguments about the relationship between mandatory and contractual insolvency procedures are based on the objectives of corporate insolvency law. However, there is a fundamental distinction. The question of possible impediments to contracting about distress scenarios is not the same thing as the objectives of corporate insolvency law, but at least some of the objectives of corporate insolvency law should be consistent with resolving contracting difficulties in distress.

However, usually the objectives of corporate insolvency law are more far-reaching than just resolving eg the problem involving uncoordinated run-to-the-assets deteriorating the debtor's commercial or restructuring value. These objectives may include protection of jobs, non-acceding creditors, maximisation of creditor recoveries or protection of the environment.[99]

[99] See for a succinct description: Royston Miles Goode and Kristin van Zwieten, *Goode on principles of corporate insolvency law* (Fifth edition edn, Sweet & Maxwell, Thomson Reuters 2018) 2-14 – 2-29.

Even if it is fundamentally a question of the parties' abilities to overcome the most pressing issues, the question of the objectives of corporate insolvency law is important because if a private agreement is unable to deal with at least the most fundamental objective of corporate insolvency law, it is inconsistent to claim that a privatised procedure could replace or supplement the mandatory insolvency system. Therefore, we will first need to evaluate some underlying questions of corporate insolvency law. These will also inform us of the basic theoretical claims that have been argued to mandate having statutory insolvency rules.

(b) Proceduralist, traditionalist accounts and a rebuttal

We can understand insolvency law as a debt collection system in which efficiency is the only or main objective. This is sometimes called the proceduralist account of insolvency.[100] The 'maximisation of value' objective is in some cases equivalent to the objective of maintaining the going concern surplus,[101] instead of eg liquidating the assets of the firm. However, this holds only if the going concern value exceeds the liquidation value.[102] Baird and Rasmussen have even argued that corporate insolvency law should focus squarely on the going concern surplus, preserving the value a firm has above and beyond the liquidation value of its discrete assets.[103]

If the objective of corporate insolvency law were seen as the maximisation of

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100 Douglas G. Baird, 'Bankruptcy's Uncontested Axioms Essay' 108 Yale Law Journal 573, 575.

101 See for the discussion: Baird and Rasmussen (n 69) 754; Schwartz, 'A Normative Theory of Business Bankruptcy'(n 1).

102 For example, it is possible that a liquidation or a quick sale process maximises creditor recoveries instead of continuing the business of the firm after financial restructuring.

103 Baird and Rasmussen (n 69) 754.

distributions to the creditors following a pre-contractually agreed priority regime, it is logical to consider as paramount the efficiency of the system in relation to creditor recoveries.[104] It would be rational for the creditors to maintain the going concern value in distress scenarios and structure their contracts accordingly before extending credit to the company, because the expected distributions in a distress scenario affect the cost of credit and the creditors' investment decisions.[105] However, this may provide too narrow a view of corporate insolvency law.[106]

The second main account is that insolvency law should also serve other interests, such as those of employees, society and the environment.[107] Under the traditionalist accounts, these may be considered equally legitimate goals of the system.[108] This can entail both an explicit endorsement of such objectives and the avoidance of social costs incurred by corporate distress and the insolvency procedure. Block-Lieb has pointed out that the question of maximising distributions may, at least under neo-libertarian (akin to proceduralist) accounts, be misleading as they fail to take into account such social effects.[109] The traditionalist accounts are based on the view that, in addition to broader social objectives, only legislation is able to deal with the externalities – the effects on third

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104 For example, the primary 'tracking' method used by the World Bank in evaluating insolvency systems is the recovery rates of the creditors: http://www.doingbusiness.org/data/exploretopics/resolving-insolvency. However, this naturally begs the question of the nature of efficiency, eg whether transaction costs efficiency, Pareto Efficiency, Kaldor-Hicks Efficiency, or something else, see of general discussion: Schillig (n 55).

105 See as an example of such analysis: Schwartz, 'A Normative Theory of Business Bankruptcy' (n 1).

106 Westbrook (n 46) 828.

107 Kenneth Cork, *Insolvency law and practice: report of the Review Committee* (London HMSO 1982, 1982), s 198(i).

108 Baird, 'Bankruptcy's Uncontested Axioms Essay' (n 100) 576-7.

109 Block-Lieb (n 50).

parties – resulting from the distress scenario and the parties' actions and incentives.[110] Van Zwieten appears to support this type of a province for corporate insolvency theory eg because the claims of different classes of stakeholder such as the employees are inherently different depending on whether the company is solvent or insolvent. As she notes, for example, a priority rule 'would not make sense except in the context of bankruptcy', when the assets are insufficient to fulfil all claims.[111] She also points out that the protection of the wider interests of the society and other groups in that society are recognised explicitly under English law.[112]

The traditionalist view presents a challenge to the question whether and according to what standards a contractual regime can live up to the objectives of the mandatory insolvency law or whether a contractual regime merely circumvents material social objectives. Despite this, the traditional account does not present a fundamental problem for the analysis presented here because answering the underlying question about the theoretical feasibility of contractual insolvency solutions creates the basis for testing and evaluation of the feasibility of contractual solutions from the traditionalist perspective.

However, maximising creditor recoveries and the economic efficiency of the corporate insolvency system faces a more pressing challenge. Mokal has claimed that efficiency, that is creditor recovery maximisation, can 'never by itself constitute a substantive goal of the law'. He points out the role of efficiency should be reframed as

110 ibid. See for value loss in inefficient liquidations: Jenkins and Smith (n 77).

111 Goode and Zwieten (n 99) 2-17.

112 ibid 2-17.

being ‘quite indispensable as a procedural goal’ instead.[113]

Consequently, he notes that the objectives of corporate insolvency law should be divided into procedural and substantive goals.[114] Mokal structures his account based partially on a Dworkinian interpretivist jurisprudence[115] of law applied to corporate insolvency. This means that corporate insolvency law should be analysed as ‘internally coherent principles, which both fit and justify most current legal texts and practices’ and regulate matters that are peculiar to insolvency.[116] Mokal considers that the main substantive goal of insolvency law is enabling co-operation between stakeholders affected by issues ‘peculiar to insolvency’ as moral equals. Such a view means replacing utilitarian self-interest with a commitment to justify the common standards of morality publicly and in so doing he makes a forceful point on the fundamental rationale of corporate insolvency law. His argument suggests that a contractual solution may not live up to the substantive goal of corporate insolvency law at all.

He continues that from this initial position, the parties would be free to act in their self-interest and that rational participants would then endorse transaction cost efficiency. By that, he refers to ‘a method of implementing a set of substantial goals is efficient in this way when the consumed resources in the implementation are lower than what would be consumed by adopting any other feasible method of implementation’.[117]

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113 R. J. Mokal, *Corporate Insolvency Law: Theory and Application* ((online) edn, Oxford University Press 2010) 25.

114 ibid 25-26.

115 ibid 13-19; This refers to one of Ronald Dworkin’s best known models in legal philosophy, that the concept of law is ultimately an interpretative concept: Ronald Dworkin, *Law's empire* (Hart 1998).

116 Mokal (n 113) 1-2.

117 ibid 25-26.

Pure self-interested rational economic analysis of the parties' most feasible actions is likely to fail the demands of Mokal's model unless the morality is always equivalent to the utilitarian, rational preferences of the actors – an unlikely outcome.

However, even if Mokal's proposal was to create a material hurdle for the analysis of, for example, ICA-type contractual insolvency mechanisms, its impact on the findings of this thesis is similar to that deriving from the traditionalist accounts of corporate insolvency theory. Whether the contractual mechanisms fail the fundamental objectives and requirements of the traditionalist view or of Mokal's account is ultimately a second-order question, and one that can be addressed after determining whether they are theoretically possible. Despite Mokal's strong rebuttal of the underlying function of procedural corporate insolvency theory, the questions concerning value-preservation and maximisation of creditor recoveries are surely matters peculiar to insolvency and issues that corporate insolvency theory will necessarily have to address.

In effect, if a particular theorist endorsed a broader view on the objectives of corporate insolvency law, the issue of the theoretical plausibility of contractual insolvency procedures is still of importance because if it is established that such procedures are theoretically possible and widely applied in parts of corporate finance, they can be analysed and tested against the broader objectives of corporate insolvency theories. Such an assumption enables us to discuss at the policy level whether we should promote or restrict such procedures under statutory law. Therefore, the broader view of the functions of corporate insolvency law is not excluded when focusing on the narrower concept. Rather, the analysis of the narrower view is a necessary precondition for the social policy analysis of contractual solutions to insolvency and is also necessary to ensure they are feasible from

a broader social perspective.

Noting these opposing views in the fundamental objectives of corporate insolvency law, we should be able to assume that one of the primary objectives of corporate insolvency law and the basis on which contractual procedures can be analysed, can be the maximisation of distributions to creditors and avoidance of strategic creditor actions restricting this objective. This is important because, if we also assume that rational parties (noting Mokal's different understanding of the 'choice position') would also be likely to try to seek this objective in an efficient contracting environment, we can next evaluate what strategic actions and agency costs such a scenario entails for financially or economically distressed corporations.

3 Strategic creditor actions and creditor coordination

(a) Creditors' bargaining model and its implications

1. Thomas Jackson's model and its relevance

The challenge of the contractual procedures in dealing with corporate insolvency has a connection to the underlying theoretical problems that mandatory insolvency law intends to resolve in order to achieve the objectives discussed in the previous section. From a contractual point of view, Jackson has provided a succinct starting point for the necessary conditions of corporate insolvency law and the impediments to contractual solutions to dealing with distress.[118] However, Jackson's original account concerned theoretical

[118] Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain'(n 47).

justifications of mandatory insolvency law, not setting the grounds for contractual solutions to financial distress.[119]

According to Jackson, most issues of corporate insolvency concern distributive questions.[120] He describes a Creditors' Bargaining Model (CBM), according to which bankruptcy should be seen as 'a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an *ex ante* position', ie a hypothetical agreement.[121] Although Jackson's account was initially intended as a model against which we can measure the efficiency of the current system and to determine whether changes to it should be made,[122] the CBM has a strong appeal to the contractual insolvency procedures because it analyses the impediments of reaching such an agreement.

2. Some Criticism of the CBM

Mokal amongst others has strongly contested the creditors' hypothetical agreement as an assumption underlying corporate insolvency law theory. He argues that such a hypothetical agreement between creditors would in practice never arise. Jackson's theory would also have to exclude non-adjusting creditors and could not deal with the changing creditor base in justifying the need to constrain strategic creditor actions through the imposition of an

119 ibid, 859-60.

120 ibid, 857.

121 ibid 860. For a critical evaluation of CBM see: R. J. Mokal, 'The Authentic Consent Model: Contractarianism, Creditors' Bargain, and Corporate Liquidation' (2001) 21 Legal Studies 400.

122 Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain'(n 47).

automatic stay.[123] Mokal argues that the contractarianist ideal underlying most accounts[124] of corporate insolvency theory is flawed, as such an ideal assumes that rational parties could be assumed to be in a contracting position in which they would constrain individual enforcement actions.[125] In this, he refers to a line of Hobbesian thought and social contract where people are primarily self-interested and their rational assessment of the most feasible strategies for achieving maximisation of their self-interest will guide them to act 'morally' and subject themselves, for example, to government.[126] Contractualism, as endorsed by Mokal, is based on a Kantian line of thought and builds on rationality requiring respect for people and moral principles that can be justified to everyone.[127] The difference with Jackson is the nature of the contracting position, whether utilitarian or Kantian.

Casey has also played down the importance of the CBM from a different perspective, emphasising its role merely as a general commitment to efficiency. He considers the preservation of the stakeholders' pre-insolvency entitlements largely redundant from a theoretical perspective and considers that these should be diminished in role to that of ensuring that bankruptcy law should not have unintended negative consequences in 'other states of the world'.[128] Distributional questions are not a part of Casey's theory as he considers that when designing a system, we should only care about the rules increasing or decreasing the firm's value, not how the value is distributed,[129] in

123 R. J. Mokal, 'Contractarianism, Contractualism, and the Law of Corporate Insolvency' [2007] Sing J Legal Stud 51, 93.

124 Primarily that of accounts based on Thomas Jackson's original views discussed in this section.

125 Mokal, 'Contractarianism, Contractualism, and the Law of Corporate Insolvency'(n 123) 61-65.

126 ibid 81.

127 ibid 81-82.

128 Casey (n 3) 6-7.

129 ibid 11-12.

other words, the only changes that matter are those affecting possible inefficiencies.[130] He concludes that the mandatory contract or law is imposed and justified, not due to a hypothetical contract, but to facilitate an actual bargain which can only be achieved in the shadows of the mandatory law.[131] However, Casey's view presupposes the existence of mandatory bankruptcy law and its effect on stakeholders' behaviour. This view appears justified because bankruptcy laws are in fact encountered throughout legal systems.

Because the existence of corporate insolvency law is part of the laws of most jurisdictions, it is very hard to disprove Casey's view and his argument about the facilitation of an actual bargain appears persuasive. On a more profound level, his view is based on the difficulties of writing complete contracts governing corporate distress, which results in the need to have mandatory insolvency law. Despite this, we should expect insolvency law theory to also address whether there can be contractual solutions to insolvency if there is no insolvency law. For example, China does not have personal bankruptcy law, only relatively recent rules for corporate insolvency.[132]

Therefore, Casey's model would have to deal with a scenario where the incomplete contracting claim does not hinder solving financial distress. In such a case, dealing with the financial distress scenario through mandatory insolvency law may not be required, at least not to its full extent. We will return to the connections between statutory insolvency law and ICAs to evaluate the feasibility of Casey's view in Part D.[133]

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130 ibid 12.

131 ibid 5 and 17.

132 The Enterprise Bankruptcy Law of the People's Republic of China [2006]. This implies that there exist other social methods of dealing with bankruptcy questions.

133 Despite Mokal's criticism of the feasibility of Jackson's hypothetical choice position argument and the incomplete contracting problem, we can put them aside for now because it is the central

3. Creditors' objectives in the CBM's choice position

Despite Casey's criticism, the CBM still has clear analytical and descriptive value. In order to analyse Jackson's account further, we need to understand how the creditors would view the 'choice position' in CBM. Jackson points out that distributional questions usually entail three distinct topics from the creditors' perspective: reduction of strategic actions by the stakeholders, increasing the common pool of assets available to the creditors and administrative efficiencies.[134] From the LBO and ICA restructuring points of view, the problem of strategic actions is the most significant one.

The second topic of increasing the pool of available assets is connected to the question of avoiding strategic actions. The debtor's assets, if sold separately, may not be as valuable as when disposed of as a whole and this requires restraining creditors' individual actions and, therefore, there is an argument for preserving the 'going concern surplus', which is the embodiment of the 'creditor recovery maximisation objective' if a firm is only financially, as opposed to economically, distressed. The third topic of administrative efficiencies assumes that a collective procedure may be desirable to avoid enforcement and procedural costs. These two topics, which are discussed later in connection with the coordination costs of restructuring and maintenance of the going concern value, depend on the analysis of the strategic creditor actions.

Despite the differences between Jackson, Casey and Mokal on the fundamental features of corporate insolvency law, the question of costs or transaction costs that are

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tenet of this thesis to evaluate whether, if not only a hypothetical but also an actual, choice position exists. This enables us also to elaborate on Jackson's analysis of the difficulties in contracting about financial distress.

134 Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain'(n 47) 861.

inherent in a distress scenario bear some resemblance to each other. The first type of transaction costs described by Mokal are coordination costs, which result from parties' difficulties in foreseeing real world events, reacting to circumstances and responding to them and to information asymmetries.[135] Dealing with these would require either equal disclosure on both sides or mitigating the adverse effects if this cannot be achieved. The second type of cost described by Mokal is motivation costs, which means that different actors' interests may not be aligned if they have different incentives in a distress scenario.[136] In more general terms, the participants in Mokal's model face: (i) coordination costs made more pervasive to expected real-world outcomes, which is increased by information asymmetry; and (ii) dealing with different preferences of the participants, leading to possible 'individualistic' results in a distress scenario.

If we take a look at the impediments and difficulties faced by the participants in dealing with a distress scenario assuming a genuine 'choice position', we can see that the questions faced by the parties in Mokal's model are similar to what Jackson posits and that transaction cost analysis and the strategic creditor costs are sufficiently similar to be analysed together.

(b) The common pool problem

It is possible to divide the question of strategic actions into two sub-issues, the hold-out problem (the problem of the commons) and the hold-up behaviour problem, sometimes

135 Mokal, 'Contractarianism, Contractualism, and the Law of Corporate Insolvency'(n 123).

136 ibid.

referred to as the problem of the anti-commons.[137] The hold-out problem has two aspects, avoidance of a 'race to the court' by individual creditors and reduction of the variance of distributions actually received from the debtor.[138] The race to the court problem constitutes perhaps the most important justification for the existence of mandatory insolvency law. One way to describe this problem is through a game-theoretical prisoner's dilemma problem.[139] In this dilemma, two prisoners are interrogated for a crime they committed. If both confess, they get a reduced sentence (example outcome: 8 years both). If another confesses and the other does not, the confessing party gets acquitted (example: 0 years) whereas the other party gets a full sentence (example: 10 years). If both lie, their loss will be minimal (example: 1 year both). Evaluated together, the best alternative is for both to lie, because the total prison time is 2 years. However, if a party considers doing that, the best strategy is for the other to confess (ie outcomes: 10 years + 0 years). Lying is, therefore, not a feasible strategy. This means that the equilibrium strategy for both parties is to confess (outcome: 8 + 8 years), which is not clearly not an optimal outcome. The parties are, therefore, trapped into confessing, while understanding that the best alternative is to lie.

In corporate distress, this dilemma arises when each creditor has an incentive to seize the assets and enforce its claims even though it would be more efficient to carry

137 Schillig (n 55) 3.

138 ibid 862.

139 See for a general description of prisoner's dilemma as a simple form game: Robert Gibbons, *A primer in game theory* (Prentice Hall 1992) 2-4. A simple form game is usually presented visually as a grid or a table including various outcomes of the parties. Naturally, the strategies depend on the relative outcomes of the parties, so the logic only applies in the example if the order of the size of outcomes is similar to the one in the example.

out a coordinated restructuring that would provide a better overall result for all creditors.[140] In the absence of a rule or an obligation for mutual co-operation, the creditors facing the distressed company would have only one dominant game-theoretical strategy, which is to enforce individually.[141] This strategy applies both in an *ex ante* and an *ex post* distress scenario.

The race to the court may result in *ex ante* monitoring and implementation and *ex post* implementation and enforcement costs.[142] In addition to these costs, the loss of the going concern surplus resulting from a piecemeal liquidation of an economically viable firm may result in substantial losses.[143] These costs result from the misalignment of the creditors' objectives because the exercise of the enforcement rights of a single creditor leads to fully internalised benefits to that creditor, while the costs are externalised, in other words, borne by the creditors collectively.[144] In this scenario, the equilibrium of the parties' incentives would shift to 'everyone collects'.[145]

More generally, the issue is similar to the problem of commons or overuse of public goods.[146] Although the problem of the commons is more general and applies to any resource available generally that may be subject to overuse leading to depletion or non-

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140 Douglas G. Baird and Randal C. Picker, 'A Simple Noncooperative Bargaining Model of Corporate Reorganizations' 20 Journal of Legal Studies 311, 319.

141 Eidenmüller (n 44) 242.

142 Block-Lieb (n 50) 556.

143 Horst Eidenmüller, *Contracting for a European Insolvency Regime, January 2017* (Law Working Paper N° 341/2017, ECGI Working Paper Series in Law, 2017) 19.

144 Schillig (n 55) 5.

145 ibid 4. Under English law, manifestations of this right include the right of the creditor to sue the debtor for the owed sum, file for the commencement of collection and debt execution procedures and to seek commencement of the debtor's liquidation under Insolvency Act 1986 Part VI, s 124.

146 Even though there are differences in the formulation of these two problems, both are fundamentally based on the lack of individual incentives of the actors (here the creditors) to take into consideration the socially optimal solution.

optimal use of the asset, it also shows why the payoffs in the Nash equilibrium (what an individual rational creditor does, assuming the best rational strategy of the other creditors) can be worse than if the parties were able to negotiate a mutually optimal resource allocation.[147] The underlying difference is that the creditors may not properly take into account the effects of their actions on other creditors.

There are several ways to try to make the individually and socially optimal actions similar. If a solution is based on a contract, the first is to stop or delay the individual decision so that there is no 'run-to-the-assets'. In contracts, these are called standstill clauses, and in the statutory procedures, moratoria. The second step is either to allow one party or a collective, whose interests are aligned, to control enforcement. Both of these can be achieved by a law setting a rule or an authority coordinating the alignment of the interests. Imposing restrictions on hold-out creditor actions does not provide a solution to an optimal restructuring but instead deals with the first part of the strategic creditor actions risk, ie the 'run-to-the-assets' problem.[148] However, making individual actions optimal for all creditors requires external measures that are credible, enforceable and bind all or a sufficient number of the actors. I will next discuss this second step of the strategic creditor actions problem, ie the problem of overcoming the incentives of a creditor to try to obtain

147 Gibbons (n 139) 27-29. Gibbons takes the example of the individual and social decisions concerning farming goats on a limited piece of land. However, the underlying question that arises when a creditor decides how much to claim from a firm the assets of which do not suffice to the payment of its obligations, is a similar one. I am referring to socially and economically optimal here with the same objective. This may not naturally be the case if the objectives of corporate insolvency law are broader than that.

148 Solutions to the optimal restructuring involve understanding with a non-co-operative game discussed in Part B, Section 3(c).

private benefits by opposing an economically feasible agreement concerning the debtor, eg by claiming full repayment, when the other creditors write off of their claims.[149]

(c) The problem of hold-up creditors when restructuring is the optimal solution

The problem of the anti-commons, or the risk of an opportunistic hold-up behaviour, may arise if the resolution of the distress relies on collectivisation of creditor actions.[150] Schillig has pointed out that, whereas the problem of the commons results from 'too many private access rights to the assets', the problem of anti-commons arises due to excessive veto rights, characterised by 'underuse of a common resource'.[151] The anti-commons problem is a direct consequence of the stakeholders being bound by the moratorium. Schillig points out that, whereas the 'problem of the commons' resembles a prisoner's dilemma scenario, with one dominant strategy for all parties to enforce, the 'tragedy of the anti-commons' resembles a 'game of chicken' with multiple Nash equilibria[152] (good and bad) in which a party's best strategy depends on the strategies of the other participants.[153] In that case the question is finding a credible threat to ensure the parties choose the good outcome.

The theoretical difference between the problems of commons and anti-

149 See Armour and Deakin (n 64) 26.

150 Schillig (n 55) 7.

151 ibid.

152 Nash equilibrium is finding the best strategy taking into consideration the best strategies of other players. None of the players can make a gain by changing her own strategy.

153 Schillig (n 55) 8. The term refers to a game in which e.g. two cars drive directly towards each other. The can that swerves is called the chicken in the game. The one that continues straight, wins. If neither swerves, they collide causing maximum losses. If the other party gives in, it is the best strategy for the other to continue straight. The game may result in both incurring maximum losses.

commons in corporate finance is emphasised by the emergence of new types of debt instruments, the complexity of the property rights and the increasing heterogeneity of the creditor-base.[154] In a restructuring negotiation situation, this means that the creditors may have an incentive for hold-up behaviour by resorting to a veto and, thereby, making the most beneficial outcome for the creditor group less likely.[155] As with the hold-out creditor risk, this means we will need to make a distinction between scenarios in which the risk of the anti-commons is and is not relevant. Secondly, we need to distinguish priority and control aspects affecting the risk.[156]

If a particular creditor group is, under the contractual regime or by virtue of their security interests, prioritised over the other groups and able to decide on the deployment of the debtor's assets, it holds contingent control rights to those debtor's assets.[157] This is an aspect of vertical creditor control, that is among creditor groups. Secondly, if the controlling creditor group consists of several lenders, we need to specify horizontal creditor control, that is control within each creditor group. To the extent that the

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154 Baird and Rasmussen (n 40) 652.

155 Armour (n 53), 10-15 and Baird and Rasmussen (n 40) 678-87.

156 'English insolvency law addresses two central questions: priority and control', Goode and Zwieten (n 99) 2-02. This appears to be correct. However, the empirical analysis of the thesis adds the question of enforcement and disposal process to the group of central issues. Admittedly, these questions can be categorised as a part of the 'control' question. However, in the thesis, I refer to control as the ability to make or prohibit decisions or actions, not to the measures that a controlling group, the security agent or other parties or the authorities can take in practice. Technically, we can include here in the notion of 'control' also the rules governing enforcement, disposals and perhaps also valuation (a part of them). This may be warranted more generally. However, I have made the distinction in order not to lose the explicatory force of the enforcement and disposals discussion for the purposes of this thesis. This is because, the enforcement and disposals (and also valuation-related) questions in the thesis are not explicable through priority or control alone. They may have other objectives as well, such as avoidance of moral hazard, undervalue sales, and setting of a framework for auctions and controlled takeover by a new party. A separate treatment also makes it easier to evaluate the part of the research question of whether ICAs enable a value-maximising solution for creditors.

157 See, concerning the effects of comprehensive security interest on the control rights of bankruptcy creditors: Westbrook (n 46).

vertical creditor control is resolved, so that (either contractually or statutorily) only the controlling group decides on the matter, the controlling group would have to devise a mechanism to ensure that hold-up behaviour within that group does not restrict an otherwise feasible arrangement. Assuming we can agree on the group controlling the financing structure vertically, the question of control would be determined by the voting threshold rules of that creditor group. In liquidation,[158] administration,[159] under schemes of arrangement[160] and company voluntary arrangements,[161] such voting thresholds are provided by statute.

Even if individual actions of the members of this group were restricted, the hold-up risk is high if there is a disagreement as to the optimal liquidation or restructuring procedure and either (i) some opposing creditors hold a blocking minority; or (ii) the planned arrangement is, for example, a debt-to-equity swap that would require the consent of all participating creditors.[162] A straightforward liquidation sale does not raise similar

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158 Insolvency (England and Wales) Rules 2016 (SI 2016/1024) r 15.34 (1): ' A decision is made by creditors when a majority (in value) of those voting have voted in favour of the proposed decision, except where this rule provides otherwise'.

159 ibid r 15.34 (2): '…a decision is not made if those voting against it— (a) include more than half in value of the creditors to whom notice of the decision procedure was delivered; and (b) are not, to the best of the convener or chair's belief, persons connected with the company'.

160 Companies Act, Part 26, s 899(1): 'If a majority in number representing 75% in value of the creditors or class of creditors or members or class of members (as the case may be), present and voting either in person or by proxy at the meeting summoned under section 896, agree a compromise or arrangement, the court may, on an application under this section, sanction the compromise or arrangement'.

161 Insolvency (England and Wales) Rules 2016 (SI 2016/1024) s 2.36 (members: majority); and r 15.34 (3) and (4) (creditors): '…decisions in a proposed CVA is made when three-quarters or more (in value) of those responding vote in favour of it— (a) a decision approving a proposal or a modification; (b) a decision extending or further extending a moratorium; or (c) a decision bringing a moratorium to an end before the end of the period of any extension. (4) In a proposed CVA a decision is not made if more than half of the total value of the unconnected creditors vote against it'.

162 In leveraged loan syndicated loan practice, it would be atypical to see loan agreements obligating the banks or institutional investors to write off a part of their debt based on a majority or a

concerns of hold-up behaviour unless the creditor threshold for enforcement decisions is too high.[163]

Such a hold-up problem is closely linked to a non-cooperative game involving several participants and the subsequent difficulties in reaching an agreement. In a non-cooperative game, individual players compete with each other where only self-enforcing alliances (eg through credible threats) or competition between groups are possible due to the lack of external means to enforce cooperative behaviour.[164] In such a scenario, the parties aim to predict the other players' best possible strategies and, by doing that, achieve a Nash equilibrium.[165] One way of enforcing coordination externally is through mandatory insolvency law and the threat of using a legal right that is credible in the eyes of the parties or by resorting to contractual protections such as debt subordination.[166] The threats can also be managed by resorting to ancillary threats such as exclusion from future business or blocking the debtor group's access to working capital and liquidity. However, we focus here on the legal and contractual threats.

At the opposite end of the scale to such a credible threat, a non-credible threat represents a decision-point in a sequential game[167] that, if players act rationally, they will not carry out because it is not in their best interest. The others understand this and formulate

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supermajority decision. However, there is no legal restriction for making such an agreement. In fact, in some bond issues, such amendments can be carried out with a 90% majority.

163 See for the difficulties concerning debt for equity swaps and effecting them in restructuring context: Chris Howard and Bob Hedger, *Restructuring law and practice* (Second edition (revised). edn, LexisNexis 2014) 6-211- 6-221.

164 Schillig (n 55) 7-8.

165 See n 152. See generally on the definition in the relevant legal context: D. G. Baird, R. H. Gertner and R. C. Picker, *Game Theory and the Law* (Harvard University Press 1994) 21-23.

166 Schillig (n 55) 8.

167 This is a game in which the players take more than one decision and the decisions are made sequentially.

their game strategies to exclude such an alternative from their decision-making unless there are other reasons for adopting such a strategy.

The solution resulting from taking into consideration the other parties' strategies, preferences and credible threats may lead to a Nash equilibrium, but it does not mean that the solution would be a Pareto optimal in which there is no other alternative so that at least one party would be better off, and none would be worse off. In a number of equilibrium situations the outcome can, at least, be Pareto improved without making any other party worse off. This is the case, for example, when the going concern value exceeds the liquidation value, but the senior creditors' most cost-effective alternative is to liquidate the firm. In such cases, the Nash equilibrium, as in a prisoner's dilemma scenario, may lead to a very bad outcome. Instead, in a financial distress scenario, we should seek a Nash equilibrium that prohibits a run-to-the-assets and, as a consequence, try to ensure that the selected Nash equilibrium results in some way to Pareto improvement for the parties, ie to a better outcome for at least some, while not worsening the other parties' outcome.[168]

I have discussed in the following sections the questions concerning heterogeneity of the creditor-base, creditor coordination, and specific statutory ways of dealing with the above strategic creditor actions. These issues will be instructive of the usual difficulties and risks that will have to be taken into account also in the ICA analysis.

[168] In practice, seeking Pareto improvement would not be relevant if the amount of funds that can be distributed to the parties is fixed.

(d) Challenges to contracting around the strategic creditor actions

1. Heterogeneity of the creditors

There are two main methods of dealing with the problem of reaching a sufficient level of creditors adhering to a contractual arrangement. One should either ensure that all creditors adhere to the contract, in a similar manner to Alan Schwartz's bankruptcy contract model,[169] or that at least the primary creditors adhere and the effects on third parties are controlled, in a similar manner to Steven Schwarcz's bankruptcy waiver approach.[170]

Schwartz's model is based on the parties agreeing *ex ante* on an optimal insolvency procedure that would be operative *ex post* in the case of financial distress. The debtor is given in the model an optimal 'bribe' (as he calls it) to approve the contract by receiving a part of the going concern surplus.[171] However, despite the subsequent refinements proposed by Schwartz[172] and based primarily on the critique of the model by LoPucki,[173] the bankruptcy contract model still faces difficulties because of the changing creditor-base over the life of a company. This is because the last contracting round between the debtor and the senior controlling creditors effectively determines the 'most recent' insolvency contract.[174] Consequently, non-adjusting creditors and trade creditors, for example, are unlikely to have any knowledge of such a contract. It is also unlikely in

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169 Schwartz, 'A Contract Theory Approach to Business Bankruptcy'(n 66).

170 Steven L. Schwarcz, 'Rethinking Freedom of Contract: A Bankruptcy Paradigm' (1999) 77 Tex L Rev 515.

171 Schwartz, 'A Contract Theory Approach to Business Bankruptcy' (n 66)1827-28.

172 A. Schwartz, 'Bankruptcy Contracting Reviewed' (1999) [109] 109 Yale LJ 343.

173 LoPucki (n 45).

174 Schwartz, 'A Contract Theory Approach to Business Bankruptcy'(n 66) especially 1833-36.

practice that the debtor would be able or even be willing to replace the entire main creditor base simultaneously.

Schwarcz's model provides a more limited account of dealing with creditor heterogeneity. It is based on a contractual arrangement in which some of the creditors opt out of the insolvency procedure and agree on their relationship with the debtor privately.[175] According to Schwarcz, the private nature of the arrangement means that the feasibility of the arrangement depends on the level of potential adverse consequences on the non-acceding creditors.[176] The difficulties with both models result from their assumption that a contractual procedure must either address all creditors or that the parties of a private insolvency arrangement would necessarily pay attention to the rights of non-acceding creditors. Therefore, the question of material adverse effect on third parties would appear to be more relevant in the context of discussing the function of corporate insolvency law more generally and whether there other social factors that mandatory insolvency law should address.

Neither one of Schwarcz's assumptions may be necessary if the private arrangement covers a sufficiently large proportion of the creditors or leaves the non-acceding creditors intentionally unaffected by the arrangement. The question of material adverse effects morphs into a question of whether such a private arrangement is socially acceptable. Whether the market ICAs then exhibit the characteristics of Schwarcz's model will be addressed later, but first we need to elaborate on what creditor heterogeneity means to the question of creditor coordination.

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175 Schwarcz (n 170).

176 ibid 556.

2. The difficulties of creditor coordination

Why no coordination takes place

Despite the problems of the commons and anti-commons, rational creditors that are mindful of the transaction costs relating to the distress scenario would surely pay attention to the possibility of resolving the distress scenario contractually as set out by the CBM. This leads to the question of impediments to such contracting.

Jackson notes that although the CBM would logically lead to an *ex ante* agreement between the creditors, such negotiation does not really take place.[177] First of all, the parties may encounter practical restrictions in concluding an agreement. Ayotte and Skeel have pointed out that the main reasons for the failure of contracting to avoid financial distress are debt overhang, asymmetric information and illiquid capital markets.[178] Although overcoming these would be more likely in efficient markets, the strategic creditor actions still emerge.

Jackson argues that one of the reasons for the parties not reaching a solution is that 'individualistic advantage-taking' may result in the consensual deal becoming too costly and the parties being forced to rely on the formal procedures.[179] This type of advantage-taking and the challenges of an *ex ante* agreement become more pressing as the number of creditors grows and when the creditor-base becomes more heterogeneous. The *ex ante* arrangement may not work because the creditors of the company extend credit or

177 Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (n 47) 866.

178 Ayotte and Skeel (n 74) in which they discuss each of these extensively.

179 Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (n 47) 862.

enter into agreements with the debtor at different times.[180] For example, Warren and Westbrook and Block-Lieb have independently pointed out that the holders of small claims and non-acceding creditors may never realistically participate in the bargain or even have knowledge of it.[181]

Because of this, Jackson recognises that the impediments for *ex ante* agreements are pervasive and the objectives of the CBM should thus be realised through mandatory procedures while minimising the incentives for deviating from the CBM.[182] As a consequence, the formal insolvency procedure translates in Jackson's model as a failure of contracting and as a coordination problem plagued by high costs caused by the strategic actions of the participants. Such a problem also arises in *ex post* distress scenarios where the 'free-rider' problem results in some of the creditors agreeing to such a deal, but the non-acceding parties being incentivised to pursue full recovery of their claims independently.[183]

Along similar lines, Eidenmüller has argued that it is likely that a 'significant portion, if not the majority, of corporate reorganisations within formal insolvency proceedings (regardless of jurisdiction) started as workouts – and failed'.[184] He notes that the likely reason for this is the 'free-rider' problem, especially when the number of parties holding out is high.[185] This implies that the fragmented capital structures lead to creditor

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180 LoPucki (n 45) 365-373.

181 Warren and Westbrook (n 30) 1239-40; Block-Lieb (n 50) 533-4. Notably, their concerns relate not only to financial creditors but also to trade creditors and other operative creditors.

182 Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (n 47) 867-8.

183 ibid 865.

184 Eidenmüller (n 44) 255. He notes that this problem may be overcome by legally or contractually imposed duties but arguing that transaction costs make *ad hoc* co-operation impossible.

185 ibid.

coordination problems and a lower likelihood of success for contractual workouts.[186] Generally, the existence of multiple creditors is likely to raise information costs.[187]

Mandatory insolvency procedures aim to deal with such problems and, according to Armour and Frisby, also assist the renegotiation mechanisms carried out in the shadow of insolvency procedures by modifying the structure of the game towards a game of cooperation instead of a prisoner's dilemma problem.[188] This suggests that an *ex ante* agreement dealing with the hold-out problem should most likely have a similar objective of overcoming the individual advantage taking of the parties. However, even if the parties are able to come to the negotiation table, there arises a question whether such a contract is at all possible because it cannot cover any eventuality relating to distress.

Incomplete contracting problem

According to Casey, the real problem with *ex ante* private contracting is the incomplete contract problem (namely one that cannot be resolved by facilitating private bargains) and corporate insolvency law is necessary to deal with corporate financial distress.[189] Casey's 'new bargaining theory' deals with minimising the value lost because of the incomplete contracting problem faced by the parties in financial distress.[190] He notes that the bargaining space provided by the bankruptcy law imposes procedural and substantive constraints on the parties while minimising the abilities and incentives of the parties to

186 K. Ayotte and E.R. Morrison, 'Creditor Control and Conflict in Chapter 11' (2009) 1 Journal of Legal Analysis 511, 523; concerning the effects of these findings: Armour (n 51) 13-14.

187 Armour and Frisby (n 82) 84-85.

188 ibid 85.

189 Casey (n 3) 18.

190 ibid 20.

engage in hold-up behaviour deviating from the value-maximising course of action.[191] Therefore, the resolving the incomplete contracting is, according to Casey, the proper role of the corporate bankruptcy law.[192] First, he points out that if it were costless to negotiate, the parties would always bargain for an efficient solution.[193] This failure does not arise due to the difficulties in convening the bargainers, but rather in 'writing enforceable *ex ante* rules in the face of the uncertainty'.[194] He builds this claim on the inability of the parties to deal with every eventuality encountered in financial distress and because their knowledge of the case-specific details of the scenario are *ex post* incomplete. Therefore, corporate bankruptcy is not contractible.[195] For example, Casey sees US Chapter 11 as a bargaining system that cannot be effected contractually.[196] As we will see, although Casey's view appears to be correct, the empirical data shows that ICAs provide solutions to a number of important questions regulated by mandatory insolvency law.

Whether *ex ante* contracting fails due to the incomplete contracting claim or due to high creditor coordination costs is also relevant. The problem is particularly pronounced if the debtor's overall financial structure consists of different priorities of creditors and several creditors on each priority level. This means that the risk of strategic creditor actions would first have to be resolved horizontally within each creditor croup and then vertically between the creditor groups of different priorities collectively by requisite majorities (or unanimity) within each group. To the extent that the parties would be able to coordinate

191 ibid 35.

192 ibid 22-32.

193 ibid 1.

194 ibid 2.

195 ibid 4.

196 ibid 25-28.

their action to a sufficient degree to make a private arrangement, such an arrangement needs to contain provisions defusing the private incentives of the parties to enforce individually.

(e) Some procedures for overcoming strategic actions in practice

1. Privatisation and collectivisation

In order to find solutions to the strategic creditor actions problem, we need to dissect different issues and incentives that create or affect the problem. According to Jackson, the common pool, or the hold-out, risk can be reduced by imposing a moratorium on creditor actions, which justifies imposing a mandatory insolvency law system and a collective distribution procedure on the parties.[197] Schillig points out that the solution provided by Jackson results in 'delinking the individual rights from the right of access to the common pool' and that this leads either to consolidation of such rights to creditors to a single entity (privatisation) or to a group that can act as an entity (collectivisation).[198] He considers English law administration as an example of collectivisation and a situation where a secured creditor is entitled to appoint a receiver as an example of privatisation.[199]

These aspects of corporate insolvency law have been endorsed by many authorities, especially in the US. For example, Ayotte, Casey and Skeel see the role of insolvency law as resolving the coordination problem between multiple creditors and the

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197 Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain'(n 47) 863; Schillig (n 55).

198 Schillig (n 55) 6.

199 ibid.

statutory law aims to strike a balance between the rights held by various creditors while limiting the 'run-to-the-assets' problem.[200] Addressing some of the statutory mechanisms assists us in understanding how contractual procedures might achieve similar outcomes.

2. Some statutory solutions to strategic creditor actions

Armour and Deakin have discussed how a self-enforcing system can defuse the incentives for hold-out and hold-up behaviour in a non-cooperative bargaining scenario using the so-called London Approach[201] restructuring regime as an example. Although their approach used a slightly more nuanced model of evolutionary game theory, their findings are of relevance here. They find that the London Approach evidences several norms:[202]

> 'including *self-enforcing* conventions which co-ordinate on equilibria, "mutual aid" games in which co-operation is enforced by the threat of exclusion from future business, and internalised norms concerning "fair" distributions in debt restructurings.'

The analysis of Armour and Deakin is one instance of making otherwise non-credible threats credible for the stakeholders in a particular transaction and through signalling effect on a wider corporate finance market. However, although the London Approach was (and to a certain degree still is) an effective mechanism for reducing the

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200 Kenneth Ayotte, Anthony J. Casey and David A. Skeel, Jr., 'Bankruptcy on the Side' Northwestern University Law Review 255, 257. I have referred to this question both with the term ´run-to-the assets´ and ´run-to-the-bank'.

201 The London Approach is a set of procedures and conventions developed in the financial markets but can be briefly described as a procedure being 'designed to ensure that decisions about whether to call in receivers on the one hand or to organise a "workout", or company support operation on the other, are orderly and well-founded. Its purpose is primarily to help the financial community preserve value'. Bank of England, 'The London Approach' [1993] Bank of England Quarterly Bulletin 110, quoting Pen Kent, Bank of England's Director for Finance and Industry.

202 Armour and Deakin (n 64) 22.

incentives to deviate from the regime, in practice it requires a relatively coherent group of actors, often with similar types of credit policy and objectives for holding particular loans or bonds.[203] As Armour and Deakin already observed in 2001, shifts in the creditor base and globalisation of financial services posed challenges to the London Approach,[204] which situation subsequently materialised in the financial markets.

In addition to systems such as the London Approach, the concerns about overcoming the risk of strategic actions can also be resolved by using either *enhanced procedures* in which the contractual solutions are supported by norms or principles for workouts and *hybrid procedures* in which the courts or administrative procedures support the contractual arrangements.[205] The enhanced procedures may, for example, provide formal or semi-formal 'regulatory protocols', such the INSOL principles,[206] binding (not necessarily under law) the financial creditors to act in a precise manner in any future restructuring procedures.[207] Such enhanced and hybrid procedures often come to existence to resolve some specific problems concerning the formal procedures and the out-of-court arrangements, such as above-discussed strategic creditor actions and, for example, because of the need to effect the termination of onerous or executory contracts.[208]

The risk of strategic actions may direct the stakeholders specifically towards

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203 See on the 'London Approach' and corporate restructuring: ibid. See also Sarah Paterson, 'Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards' (2014) 14 Journal of Corporate Law Studies 333 concerning the reasons why arrangements using the 'London Approach' have become more difficult.

204 Armour and Deakin (n 64) 51.

205 Garrido (n 19) 1.

206 INSOL International, *Statement of Principles for a Global Approach to Multi-Creditor Workouts II (May 2017)* (2017).

207 Garrido (n 19) 39.

208 ibid 1.

statutory or hybrid procedures. For example, Armour has argued that one of the reasons for the development of the 'pre-packed' insolvency in the UK was indeed fragmentation of corporate debt.[209] He has pointed out, that before the current fragmentation of the corporate finance markets, firms in the UK tended in the past to rely on a single dominant bank or a small group of lenders, which made the creditor coordination costs low, but such debt financing structures have been eroding through the 1990s and 2000s.[210] He notes that, as one of the consequences, the rate of formal rescue procedures evidenced an apparent increase during the second half of the 2000s, supporting the claim that the creditors have coordination difficulties, reducing the likelihood of out-of-court bargaining.[211]

Generally, the statutory procedures can and are designed to deal with the risk of strategic creditor actions. As we will see in the empirical Part C, the stakeholders consider that especially the English law scheme of arrangement, although not an insolvency procedure, can be used to avoid possible unanimity requirements in the debt documents.[212] This is useful, especially, if the existing creditors wish to restructure the debtor group through a debt-to-equity swap where a large enough creditor opposes the arrangement because the decision thresholds within each voting 'class' are the majority in number and 75% of the value of the claims.[213] Schemes are often 'twinned' with an administrative

209 Armour (n 53) 15.

210 ibid 10.

211 ibid 15.

212 According to the Companies Act s 895(1) 'A scheme of arrangement involves a compromise or arrangement between a company and its creditors, or any class of them, or between the company and its members, or any class of them'.

213 ibid s 899(1). However, it should be noted that the construction of classes is a material factor in understanding the creditor control aspect of schemes of arrangement.

procedure, especially a so-called pre-pack administration[214] to benefit from a moratorium and to enable the administrator to dispose of the debtor's assets.[215]

In effect, all of the English insolvency statutory procedures, ie administration,[216] administrative receivership,[217] voluntary and compulsory liquidation[218] and company voluntary arrangements[219] each deal specifically with the creditor coordination problem, albeit with different solutions. The primary methods for liquidation and administration are the moratoria on creditor actions and collective voting procedures. For administrative receivership, the primary method relates to the requirement that the persons nominating the administrative receiver have the whole or substantially the whole of a company's property as a security for their claims, which in practice prohibits other creditors from interfering with the enforcement.[220] However, also the statutory procedures, perhaps except for administrative receivership, which concentrates control in one single creditor, may have difficulties in providing comprehensive solutions for the strategic creditor actions risk. This is because although the hold-out risk is often dealt with by the moratorium rules, the creditors will still need to vote on the most feasible procedure and the procedure faces the risk of hold-up behaviour, ie a large enough creditor seeking private benefits and withholding its support as a result.

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214 See for general discussion: Goode and Zwieten (n 99) 11-40–11-44.

215 See for the use and benefits of pre-pack administration: ibid 11-38.

216 Insolvency Act 1986 Part II.

217 See for the main provisions ibid ss 44-49.

218 ibid Part IV.

219 ibid Part I.

220 ibid s 29(2). It should be noted that the current scope for the use of administrative receivership is heavily qualified to limited types of financial arrangements, see ibid ss 72A-72GA.

Although the statutory procedures provide a framework for the stakeholders, they do not provide a case-specific solution. They instead fix the parties rights and voting thresholds for these procedures. Secondly, the statutory procedures may have difficulties in dealing with debtor groups. Also, the bargaining scenario may not necessarily lead to maximisation of value for the stakeholders. The private solutions to financial distress face the same problem.

Therefore, a contractual solution to financial distress would have to be able to defuse the incentives of the creditors arising from the common pool problem. Also, a contractual solution should be able to provide a mechanism for the creditors to agree on the most feasible restructuring procedure, despite the presence of different types of financing instruments and creditor categories as well as a heterogeneous and changing creditor-base. However, logically, in line with the statutory procedures, we should only require that contractual solutions provide a framework for contracting that deals with these impediments, not a specific solution. Requiring a specific a solution may be too strict a constraint.

(f) Summary

We can summarise the impediments that affect contracting about strategic creditor actions as follows. Each of these factors will be addressed in the empirical Part C.

Table 2. Factors affecting strategic creditor actions

Incomplete contracting claim
General difficulties in creditor coordination
Number of creditors
Different types of creditors

Different types of financial instruments
Dealing with debtor groups
Asymmetric information and limited knowledge of the *ex post* circumstances affecting the debtor
Prisoner's dilemma and lack of incentives to withhold enforcement actions
Lack of credible threats to deal with the non-co-operative game scenario (to achieve optimal restructuring

However, before discussing how the LMA ICAs and market ICAs deal with the risk of strategic creditor actions, we will need to address the second aspect of the stakeholder conflict, ie the managerial and financial agency costs, which affect the incentives of the debtor's owners and managers to contracting with its creditors. This is a question that logically precedes the intercreditor conflict. The underlying question for resolving such conflicts in private equity managed LBO transactions concerns the ways of reducing the financial agency costs resulting from a close interest alignment between the managers and the private equity fund.

4 Agency costs and defusing incentives

(a) Managerial agency costs

1. General aspects of agency relationships

A firm's capital structure is linked to various agency costs that are bound to arise in connection with any business activity that involves the separation of ownership and

management or control of an asset, ie between a principal and an agent.[221] One of the underlying causes of agency costs is the corporate law-based ability to partition particular assets into distinct legal entities,[222] usually within corporate groups. These issues are pronounced in LBOs, which invariably include a private equity fund as a shareholder, a specialist management team whose interests need to be aligned with the funds and multi-tiered equity and debt capital structure that requires coordination both between the creditor constituency and the shareholder-managers.

Such agency costs are relevant for the corporate insolvency analysis in this thesis, first, because they give us an insight into the incentives of private equity funds have to deal with concerning managerial agency costs and what such incentive alignment means to the creditors. The second reason, and resulting from the first point, why agency costs are essential for analysing ICAs and loan facility agreements is because they help us understand why a private equity fund may be prone to accept the creditors' requirement to use an ICA. In addition, a private equity fund may also have its own economic incentives to suggest its own ICA to the creditors, eg to enable the use refinancing, and additional financing options within the same contractual framework. Analysis of these incentives also helps us understand how creditors can reduce financial agency costs connected to the risk of private equity funds contracting privately with some creditors for undisclosed benefits.

Naturally, corporate law provides different strategies for dealing with agency costs. Armour, Hansmann and Kraakman divide these legal strategies into regulatory

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221 Jensen and Meckling (n 79) 308-10.

222 Armour, Hertig and Kanda, in Kraakman and others (n 86) Part 5, 109 and in relation to bankruptcy: D. G. Baird, Anthony J. Casey and R. C. Picker, 'The Bankruptcy Partition (January 5, 2018)' <Available at SSRN: https://ssrn.com/abstract=3110210> accessed 30 October 2019.

strategies and governance strategies. According to them, the regulatory strategies include the substantive terms that directly restrict the agent's activities and regulate the content of the actual principal-agent relationship. Governance strategies 'seek to facilitate the principal's control over their agent's behaviour'.[223] Private equity funds can deal with these concerns contractually because they can influence the agency costs by requiring the management of the acquired portfolio company to co-invest equity into the company alongside the fund. It is, in fact, quite common that the management of a private equity fund held portfolio company often holds a portion of the equity of one of the holding companies in the acquisition group structure.[224] Also, the management is invariably aligned with the fund interests by a shareholder agreement.[225] These considerations should be borne in mind when we approach the question of how the agency costs affect the parties' incentives to enter into ICAs.

The nature of agency costs between the managers and shareholders deviates from the agency problems between the owner-shareholder and creditors and also from that among the creditors. As an example, the risk of a private equity fund giving private benefits to some creditors to enhance its own position is a part of financial agency costs faced by the other creditors. These are multi-party agency costs that arise between the company and various classes of creditors, which have different incentives due to their different priorities, funding capabilities, affiliation with the debtor and other commercial matters.

Whereas the agency conflicts between the shareholders and the managers

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223 Armour, Hertig and Kanda in Kraakman and others (n 86) Part 2, Section 2.2.

224 Wood has noted that the level of the management equity is commonly at the level of about 10 percent of the relevant holding company shares. Wood (n 8) 2-023.

225 See for the level of institutional and management equity in private equity LBOs: Gilligan and Wright (n 7) 3.3.5.

affect the control of the firm throughout its life, the conflicts between the shareholder-managers and the creditors emerge when negotiating debt arrangements and during the life of the indebtedness. Therefore, control features of this relationship are in their nature 'contingent', ie the ownership or claim of the creditors to the assets is triggered by a breach of a covenant, which entitles the creditors to enforce against the debtor. Notwithstanding this, the parties will need to deal with the conflict issue before the actual trigger events take place. Analysing these agency costs and the incentives of the debtor and the creditors has a profound impact on contracts for corporate control such as ICAs.

2. Managerial agency costs

Jensen and Meckling have defined an agency relationship as 'a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent'. They note that if the agent is a utility-maximising actor, it is likely that she will not always act in the best interests of her client because, for example, the agent may get personal non-pecuniary benefits from her position.[226] The principal is likely to benefit from limiting deviations from her interest by setting up incentive structures for the agent, by incurring monitoring costs that restrict non-feasible decisions of the agent and by compensating the agent for taking actions in the interests of the principal.[227]

The divergence of the agent's decisions from the decisions maximizing the principal's welfare (in other words, the agency costs) is the sum of the principal's

226 Jensen and Meckling (n 79) 312.

227 ibid 308.

monitoring expenditures, the bonding expenditures by the agent and the 'residual loss'.[228] The last one of these, ie the monetary reduction in the welfare of the principal, cannot be directly eliminated from the relationship. The agency costs stem in essence from the separation of ownership and control of the firm.[229] It is important to note here that, although the 'ownership' referred in this case also applies to creditors, their ownership is contingent, triggered by an insolvency event or events of default entitling the creditors to accelerate and enforce their claims.

In the case of a limited liability company, from the perspective of its capital structure, the agency relationship is primarily that of the firm's managers and its shareholders. As Jensen and Meckling point out, in a manager-owned company, the utility of the manager is based not only on the financial returns derived from the company but also on 'various non-pecuniary benefits' associated with the position.[230] However, the manager also bears 100% of the costs of the non-pecuniary benefits derived from the company. A sale of a portion of the equity changes the incentives of the shareholders because, after such a sale, the manager-shareholder only bears the cost of the non-pecuniary benefits partially, corresponding to the ownership she has in the company after the sale.[231]

However, in efficient capital markets, the other shareholders are able to anticipate these wealth effects and the agency costs will be reflected directly in the price of the firm's securities. Therefore, a manager selling the shares is likely to bear the effects of the agency costs and, consequently be incentivised to reduce them by granting increased

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228 ibid.

229 ibid 327-28.

230 ibid 312.

231 ibid.

monitoring and bonding rights to the shareholders.[232] However, even though the rise in the value due to increased monitoring and bonding rights is reflected in the shareholder-manager's wealth, the increase is less than before because they are no longer able to enjoy some of the non-pecuniary benefits foregone due to increased monitoring or bonding.[233] Therefore, the manager is incentivised to increase the monitoring and bonding rights up to the level where the marginal benefits achieved are less than the marginal costs.[234] In theory, these should yield an efficient outcome for the parties, but it is unlikely that the monitoring and bonding costs could be zero, so separation of the ownership and control result in total gross agency costs. [235] Despite the impossibility of eliminating all agency costs, alignment of the managers' and shareholders' incentives, as wells as monitoring and bonding the managers, is feasible for value-maximisation purposes of the firm. In summary, the most important solutions for the manager-shareholder agency costs are:

(i) the level of concentration of ownership in the firms;

(ii) efficient monitoring and bonding of the management; and

(iii) aligning the incentives of the managers with those of shareholders through material share ownership.

3. Value-creation in private equity LBOs

Not surprisingly, Jensen subsequently set out in *Eclipse of a public corporation*[236] the advantages of a closely-held corporation, for example, one held by a private equity fund,

232 ibid especially 313-19.

233 ibid 324.

234 ibid 326 and 329.

235 ibid 327.

236 Jensen (n 80).

in comparison to a widely-held public corporation. He noted that in LBO associations, as he called them:[237]

> (i) the incentives of the managers are built around a strong connection between pay and performance;
>
> (ii) direct monitoring is pronounced because they are more centralised than publicly held companies;
>
> (iii) material leveraging of the company is feasible, because it allows efficient use of equity, while retaining the disciplining effect of debt financing; and
>
> (iv) there are well-defined obligations in relation to the creditors and clear distribution rules to 'residual claimants', such as their limited partners, and cash distribution restrictions effected contractually by debt covenants.

Consistent with these categorisations, private equity sponsors may have an incentive to restrict the use of the firm's free cash flow for any purposes other than funding positive net present value investments.[238] The use of debt may help in achieving this goal. According to Armour and Frisby, debt can alleviate managerial agency costs by imposing discipline on the managers due to periodic interest and capital repayments.[239] However, the use of debt results in a downside-risk for managers as a result of a payment default or a covenant breach that would lead to loss of control or of assets.[240] According to Armour and Frisby, these reasons are likely to give the managers additional incentives to maximise

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237 ibid 69-70.

238 Michael C. Jensen, 'Agency costs of free cash flow, corporate finance and takeovers' [76] American Economic Review 323. See generally on the research: Renneboog and Vansteenkiste (n 9).

239 Armour and Frisby (n 82) 74.

240 ibid 74-76.

expected returns by accepting and complying with loan covenants.[241] The authors argue that the disciplining effects can also operate *ex post* because the monitoring rights attached to financial indebtedness may enable the creditors to form a better view of the proper measure to be taken in a distress scenario.[242]

In addition to these objectives, the managers may have incentives to use the resources of the firm for 'empire building',[243] which is likely to run against the interests of the shareholders who have an interest to control the optimal use of the firm's free cash flow. Therefore, the shareholders will have an incentive to align the interests of the managers with their own economic interests. Such an alignment of the interests of the shareholders and the managers is an example how private equity creates value.[244]

Consequently, as Renneboog and Vansteenkiste note, the interest alignment hypothesis set out by Jensen and Meckling that the marginal cost on non-pecuniary benefits will decrease when a manager sells a proportion of the firm's residual claims to outsiders leads to re-aligning the interests of the managers of the portfolio companies with the interests of the private equity funds through the use of equity ownership and similar benefits.[245] Although, this may be beneficial for the owners, it may create additional concerns for the creditors.

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241 ibid 80.

242 ibid 80-81.

243 Renneboog and Vansteenkiste (n 9) 31.

244 Renneboog and Vansteenkiste have identified certain other value-creation mechanisms for LBOs, which are: stakeholder wealth transfers, tax benefits, transaction cost savings, takeover defence strategies and corporate undervaluation; ibid 5-13. They review the literature by evaluating these in different LBO phases, ie intent of a buyout, impact of the buyout on various stakeholders, process of restructuring after the buyout and duration of retaining private status for public-to-private transactions.

245 ibid 5-6.

(b) Financial agency costs and private equity

1. High leverage and the agency costs

The benefits of concentrated share ownership and the resulting alignment of interests between managers and shareholders implies that an owner-manager would benefit from acquiring the entire share capital of the firm and financing the acquisition, for example, with debt. This eliminates the manager-shareholder conflict. The owner-manager may also accept the agency costs resulting from the incurrence of debt as long as the marginal increase in wealth from the additional investment opportunities exceed the marginal agency costs of the debt. The use of debt may also be preferable to a sale of equity if the agency costs of the debt are less than the loss of wealth and utility resulting from the equity sale.[246]

The risk of high agency costs is pronounced in private equity LBOs, in which use of high leverage is pervasive and where indebtedness correlates strongly with the economy-wide credit conditions.[247] Therefore, we would expect private equity funds to be mindful of lowering the perceived agency costs of debt in their contractual arrangements, which is likely to have an impact in turn upon the use of LBO ICAs.

Some of the reasons for restricting excessive use of debt appear to be the adverse incentive effects of highly leveraged firms, costs relating to creditor monitoring, bankruptcy and restructuring, and costs of enforcement of claims. The likelihood of such adverse incentives rises with higher leverage capital structures. In such firms, not only is a

246 Jensen and Meckling (n 79) 333-37.

247 Wouter De Maeseneirea and Samantha Brinkhuis, 'What drives leverage in leveraged buyouts? An analysis of European leveraged buyouts' capital structure' (2012 Suppl) 52 Accounting and Finance 155.

lower level of equity unable to effectively cushion the financial deterioration of a firm but the costs of entering into bankruptcy, the process and the possible loss in value resulting, for example, from a delayed enforcement and loss of going concern value affect the creditors' pricing of their loans and bonds.

Armour and Frisby have noted that the use of debt-related incentives can lead to material agency costs of debt.[248] Perhaps the most obvious negative aspects of high leverage are the owner-manager's (with limited equity exposure) incentives to engage in high-risk activities despite the potentially low probability of their success. Armour, Hertig and Kanda have argued that creditors face agency problems both before and after entering into financing arrangements.[249] First, they note that creditors face the risk of the debtor misrepresenting the value of, or title to, the assets *ex ante*. Secondly, they face the risk of the debtor transferring its assets outside the corporate entity (asset dilution), increasing the riskiness of its business (asset substitution) and subsequently increasing the borrowing of the group (debt dilution).[250] They continue that the risk of simultaneous occurrence of these events is pronounced in so-called controlled transactions (event risk), such as LBOs.[251]

Renneboog and Vansteenkiste similarly emphasise 'wealth transfers from bondholders' as a source of conflict in the shareholder-creditor relationship and continue that such transfers can occur by means of increasing the riskiness of the firm's projects, dividends and other distributions and the issuance of new or additional debt that has either

248 Armour and Frisby (n 82) 80-82.

249 Armour, Hertig and Kanda in Kraakman and others (n 86) 127-128.

250 ibid 111-12.

251 ibid 112.

the same or better seniority than the existing indebtedness.[252] However, it is not evident that the strong interest alignment between the private equity funds and the portfolio company managers always leads to financial agency costs, especially between the managers and the creditors. For example, Paterson has argued that private equity fund transactions may lead to incentives among management to support the creditors' restructuring plans instead of aligning with the fund.[253] This may be the case even if there is residual value in the company.

2. Multi-party transactions and financial agency costs

When we consider the more complex structures of modern financial transactions such as LBOs, there arises a question of what the agency costs of debt mean between different stakeholder categories, not just between the debtor and the group of general creditors. If a particular group has effective control over the disposal and use of the debtor's assets, it can resort to strategies akin to the described debtor's actions, also together with the private equity fund. For example, Paterson has given a nuanced view of the financial agency costs that arise not only between the debtor and the creditors, but also within the sub-groups; for example between the senior and junior creditors.[254] Dealing with this question means eg determining the mechanisms that the junior creditors have for ensuring that the senior creditors do not resort to similar measures against the other creditor groups together with

252 Renneboog and Vansteenkiste (n 9) 8.

253 Sarah Paterson, 'The Paradox of Alignment: Agency Problems and Debt Restructuring' 17 European Business Organization Law Review 497, 511. This is a difficult question because it involves leading with the agency costs problem on multiple levels, and which cannot be answered thoroughly in this thesis. However, I will discuss some ICA solutions dealing with this problem in the empirical Part C.

254 ibid.

the fund.[255] Therefore, it is feasible to extend the evaluation of financial agency costs somewhat to cover group scenarios and the fact that there may be several creditor groups with different priorities and control rights triggered at different times.

The follow-up question is why a creditor could not control such behaviour in advance. We must remember that in our scenario, private equity sponsors are likely to be post-LBO in a position of concentrated ownership of the target company, ie have adequate incentives and resources to monitor the management and indeed have a comparative advantage in monitoring over other types of stakeholders.[256] This means that management incentive alignment has morphed into a financial agency problem that the creditor groups of different priorities will have to resolve. This also leads to the need to examine the incentives of the debtor and the creditor groups to monitor the managers, the debtor group and possibly the other creditor groups as well.[257]

3. Summary of financial agency costs

We can summarise that:

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255 Armour, Hertig and Kanda in Kraakman and others (n 86).

256 Ernst Maug, 'Large shareholders as monitors: is there a trade-off between liquidity and control?'; and generally Renneboog and Vansteenkiste (n 9) 7-8.

257 Sufi Amir, 'Information Asymmetry and Financing Arrangements: Evidence from Syndicated Loans' [American Finance Association, Wiley] 62 The Journal of Finance 629; Frank H. Easterbrook and Daniel R. Fischel, 'Voting in Corporate Law' 26 The Journal of Law & Economics 395; Armour (n 51) on UK-specific statutory measures dealing with, among other things, dispersed and heterogeneous creditors. We should also take into consideration that the incentives between the general partner and the limited partners of the fund are likely to differ as well. Also, the incentives of the other stakeholders may differ depending on the capital structure of the portfolio investments and whether the debt financing of the fund is arranged on a general level or individually for each LBO transaction. However, these conflicts of interests are omitted here because the internal incentives of the funds are not the subject of this research.

1) the use of debt may serve to reduce managerial agency costs due to the disciplining function of debt through a fiscal restraint upon the use of corporate assets.[258]

2) the manager-shareholders can take on additional investment opportunities, capturing the benefits of the lower agency costs of debt if they can offer:

    a) monitoring rights to the creditors covering the debtor group,

    b) bonding commitments covering the debtor group and the shareholders, and

    c) control rights in enforcement and insolvency scenarios covering the debtor group;

3) the creditors may be better incentivised to spend resources on monitoring the debtor if they can internalise enough private benefits from the monitoring. This depends on their ability to control subordinated creditor groups and the debtor group; and

4) different creditor categories are likely to have different incentives for spending resources and also different concerns of non-optimal actions by other creditors groups. However, the creditor group in control should have an incentive to spend resources for control and to prohibit non-optimal creditor actions.

I will next discuss how these issues come up specifically in private equity structures.

[258] Axelson, Strömberg and Weisbach argue that the efficiency, resulting in lowering the agency conflicts between the GP and the LPs, may be increased by the use of deal-by-deal debt financing arrangements, Axelson, Strömberg and Weisbach (n 87).

5 Private equity and the incentives for contracting

(a) The space for contracting

Private equity literature contains numerous arguments supporting a space for contracting about strategic creditor actions and agency costs in private equity-led leveraged transactions and groups. Most of this literature concerns the role of debt in LBOs, how private equity deals with debt markets and how it approaches the risk of distress. Brunner and Eades[259] and Wright et al.[260] find that excessive corporate leverage correlates strongly with failure rates when the macro-economic conditions become unfavourable.

However Andrade and Kaplan's findings on financially distressed, highly-leveraged transactions show that the net effect of financial distress and high leverage is to increase value slightly, claiming that, for example, the highly leveraged transactions that took place in the late 1980s were value-creating.[261] They point out that financial distress destroys about 10-20 percent of the enterprise value and that for firms not facing an adverse economic shock, the costs appear to be negligible.[262]

Despite the preference for high leverage, private equity-backed firms appear, adjusting for the leverage, to be no more likely to default on their obligations than comparable, non-private equity -backed firms. As Hotchkiss, Strömberg and Smith note,

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259 Robert Bruner and Kenneth Eades, 'The Crash of the Revco Leveraged Buyout: The Hypothesis of Inadequate Capital' (Albany, N.Y.) 21 Financial Management 35.

260 Mike Wright and others, 'An analysis of management buy-out failure' (London) 17 Managerial and Decision Economics 57.

261 Gregor Andrade and Steven N. Kaplan, 'How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed' (Boston, USA and Oxford, UK) 53 Journal of Finance 1443 and 1487.

262 ibid 1445.

they restructure more often through out-of-court procedures, which are carried out more quickly, and they are also more likely to survive as an independent going concern post-restructuring.[263]

Wright, Wilson, Robbie and Ennew also conclude that managerial incentive plans and properly-timed corporate restructuring are apt to reduce the probability of buyouts and buyins of unquoted companies failing.[264] Similarly, Wilson and Wright find that leverage is not a strong predictor of failure and that buyouts backed by private equity firms are no more susceptible to failure than others.[265] These factors may have several causes, but they are also connected to the ability of the private equity funds to inject further funds into the firm.

One alternative for a quicker, more efficient restructuring process may be connected to the incentive structures and enforcement structures used in LBO financing arrangements. These often enable a going concern group-wide restructuring effected privately or with the assistance of the court. However, there is no unequivocal evidence that such capital and contractual structures would lead to quicker and better enforcement. Despite this, it appears that the leverage of a debtor group can be increased and the cost of credit controlled by offering contracts for control regulating strategic creditor actions and the high risk of financial agency costs associated with LBOs.

We may thus conclude that LBO transactions are likely to be highly leveraged and that the financial agency costs may be pronounced due to strong shareholder-manager

263 Hotchkiss, Strömberg and Smith (n 34) 29-30.

264 Wright and others (n 260) 68.

265 Nick Wilson and Mike Wright, 'Private Equity, Buy-outs and Insolvency Risk' 40 Journal of Business Finance & Accounting 949.

interest alignment. Therefore, *ex ante* contracting is likely to result in economic benefits to the private equity sponsors. There is also evidence that private equity is able to deal with these concerns well, and we can argue that private equity funds either resort to such *ex ante* contracting concerning financial distress or, if this cannot be empirically shown, there is some other mechanism for dealing with these issues. For this purpose, we will need to elaborate why the private equity funds would be incentivised to offer ICAs to their creditors.

(b) The rationale for contracting about insolvency

Some academics have argued that, at least in certain scenarios, informal workouts may result in lower direct and indirect insolvency costs compared to formal procedures.[266] However, this view may not hold. The reason is that distressed transactions that end up in a voluntary arrangement will be those which most likely have lower costs in a voluntary arrangement compared to the statutory procedures. On the other hand, the cases ending up in statutory procedures are likely to have lower costs in that procedure. This bias makes any actual comparisons difficult.

Therefore we should assume a more cautious starting position, as presented by Armour and Deakin, that assumes that financial creditors would first opt for debt renegotiation or some other type of a contractual restructuring if the bargaining transaction

[266] R. Franks and W.N. Torous, 'A Comparison of Financial Recontracting in Distressed Exchanges and Chapter 11 Reorganisations' (1994) 35 Journal of Financial Economics 349; S.C. Gilson, K. John and L.H. Lang, 'Troubled Debt Restructurings: An Empirical Study of Private Reorganisation of Firms in Default' (1990) 27 Journal of Financial Economics, 315.

costs are likely to be less than the expected costs of insolvency.[267] Armour and Deakin also consider that well-coordinated creditors are likely to resort to formal insolvency procedures in the case of viable firms only in extreme circumstances, preferring to use the insolvency procedure as a threat to effect a voluntary restructuring.[268]

However, the choice of procedure also depends on the parties' access to the competitive capital markets and the availability of distress financing. Building on the Modigliani-Miller arbitrage theorem[269] concerning the irrelevance of the firm's capital structure on its value, Haugen and Senbet conclude that the costs of restructuring are limited to the lesser of formal bankruptcy costs and the transaction costs of an informal reorganisation through the capital markets.[270] Sophisticated financial contracts may achieve this through better use of the capital markets and the reduction of information asymmetries,[271] especially by using detailed intercreditor co-operation provisions. The increased efficiency may reduce the coordination costs associated with the restructuring to a level that does not prohibit reaching a contractual solution to financial distress.[272]

However, the 'free-rider' problem still affects the creditor coordination costs and the efficiency of corporate restructurings.[273] Haugen and Senbet argue that in well-functioning capital markets, the inclusion of contractual terms dealing with the risks of

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267 Armour and Deakin (n 64) 25.

268 ibid 12.

269 Modigliani and Miller (n 57).

270 Haugen and Senbet (n 58) 387.

271 Knoll (n 63).

272 However, Block-Lieb believes that insolvency rules should minimise the loss to society from the financial distress and that they should be seen as distinct from the costs of implementing and enforcing insolvency rules, Block-Lieb (n 50).

273 Haugen and Senbet (n 59) 29.

strategic creditor action should be costless and that such terms should be able to 'prevent free riders from impeding informal reorganisation of the capital structure'.[274] Along similar lines, Armour and Deakin have argued that the debtor company is likely to have 'appropriate incentives to offer a procedure that will maximise the net benefits of debt finance, solving any coordination problem'.[275] Such an incentive can be based, for example on better expected recoveries by the creditors in an optimal restructuring procedure, which is also likely to lower the cost of credit for the debtor.[276] If this is correct, we can expect that these objectives are also embedded in financial contracts.

(c) The incentives for retaining *ex ante* benefits

The incentives for the creditors to deal with the financial agency costs are clear. Manager-shareholders understand this, making them more likely to agree on measures to deal with these costs *ex ante*. The reason for agreeing to this is that it is the owner-manager that not only bears the financial agency costs of debt, but also captures the benefits of lowering them.[277] The allocation of these agency costs also holds if the capital markets are efficient, being capable of anticipating and pricing them into the price of the securities. Consequently, an owner-manager may have an incentive to offer the creditors bonding[278]

274 ibid 30.

275 Armour and Deakin (n 64) 26.

276 Schwartz, 'A Normative Theory of Business Bankruptcy'(n 1) 1203-05.

277 Jensen and Meckling (n 79) 51. I have omitted the tax effects of debt in this discussion.

278 Jensen and Meckling consider costs incurred to audit the firm an instance of bonding costs; ibid 338-39.

and monitoring options and a way of controlling and minimising the bankruptcy, restructuring and enforcement costs of debt.[279]

Therefore, lowering the agency costs of debt by approving covenant restrictions and default provisions on such actions and monitoring rights for the creditors in the financing documentation would appear to lower the cost of capital for the firm.[280] Armour et al. conclude that some of the legal measures to reduce the high agency costs of debt include: taking security in the debtor, requiring creditor consent for asset transfers, prevention of debt dilution, entity shielding and structural subordination.[281] These measures are both statutory and contractual and are directly linked both to the creditors' priority position and the debtor's need to be able to deal with the financial agency costs.

From an economic point of view, Skeel and Triantis have argued that *ex ante* contracting promotes reliance on investments made by the parties, allocates risk effectively and establishes incentives.[282] Concerning the US position, they conclude that permitting renegotiation of concluded bargains might encourage rent-seeking by 'late-arriving' parties; for example, distress investors that purchase claims at sub-par value.[283] They continue that such benefits may be undermined if an *ex ante* contract is renegotiated after the occurrence of a distress scenario.[284] Even though they conclude that *ex ante* contracting suffers from incomplete information about the possible subsequent distress scenario making it less effective, it may be that the *ex post* benefits can be retained if the parties are

279 Armour et al. in Kraakman and others (n 86) Part 5, 112.

280 Jensen and Meckling (n 79) 45-6; Armour and Frisby (n 82) 80.

281 Armour and Frisby (n 82) 80-81.

282 Skeel and Triantis (n 32) 5-6.

283 ibid 19.

284 ibid 6.

able to commit to a mechanism and pre-determined negotiating positions on capital structure and priorities beforehand, while enabling the case-specific resolution of distress to be determined by an *ex post* contract.[285] Therefore, there is a connection between the legal and the contractual measures that reduce financial agency costs and seek to retain the benefits of *ex ante* contracting. This is clear, but the mechanisms to achieve this are not. For this purpose, we need to look at some techniques as to how the statutory procedures achieve similar objectives.

(d) The benefits in contracting with a fragmented creditor-base

1. The ability to coordinate as a starting point

Allocation of risk and establishing the right incentives for the parties in a multi-party financial contracting scenario means in practice that there needs to be a clear creditor priority structure, that the acceding creditors must be able to monitor the debtor group systematically and that the contract needs to include provisions regulating the use of control rights (ie rights to decide on the deployment of the assets[286]) in the debtor on an event of default and a distress scenario.[287] Otherwise, the creditors may not be able to internalise enough private benefits to forego the possibility of individual enforcement which they may prefer. Logically, in high-leverage transactions, due to higher financial agency costs, the benefits that creditors obtain from monitoring the debtors are likely to be higher as well.

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285 On the efficiency arguments between committing to *ex post* bankruptcy agreements and renegotiating *ex post,* ibid 15-17.

286 See for a definition: Baird and Rasmussen (n 69) 779.

287 On creditor control: Schwartz, 'Bankruptcy Related Contracting and Bankruptcy Functions (October 10, 2017)' (n 31) 42-53.

The same applies to the benefits obtained from monitoring possible actions the debtors carry out together with the other creditors.

The question about the incentives of the creditors to monitor the debtor is not an easy one because, in a fragmented capital structure, the costs of monitoring by a particular creditor may outweigh the benefits if the other creditors are also able to benefit from such monitoring. However, this may not be the most instructive position when looking at actual financing structures because it assumes existence of a vast dispersed, non-professional creditor base. For example, Schwartz argues that the standard corporate insolvency model assumes fragmentation of debt and that an individual creditor is assumed to hold only a small portion of the debt, which gives it few private benefits from coordinating value-preserving liquidation or restructuring alternatives.[288] Nevertheless, in modern corporate finance, capital structures usually consist of a small number of creditors capable of negotiating monitoring covenants.[289] Schwartz argues that the standard model assumes incorrectly that:

> 'in a no bankruptcy system world, creditors would not monitor debtors (monitoring would be a public good); lending agreements would not contain covenants (because no creditor would have the incentive to create or enforce them); debt would never be renegotiated; and every insolvent firm would be dismembered'.[290]

Schwartz points out that there seldom exists a coordination problem in contemporary corporate capital structures, which have small groups of senior creditors incentivised to decide and implement the most viable resolution of the distress.[291] In fact,

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288 ibid 1.

289 ibid 28-37.

290 ibid 27.

291 ibid 1-2.

creditors do monitor debtors, covenants are pervasive in financial contracts, indebtedness is in practice often renegotiated and, if firms are efficient, their business is often continued.[292] He notes the existence of bankruptcy as a legal default influencing these measures, but 'it cannot completely account for them'.[293] It appears that the central feature underlying Schwartz's claims is that there most commonly exists in practice a single creditor or a concentrated group of creditors able to internalise enough private benefits to carry out these measures.[294]

We should, first, bear in mind that Schwartz's position much like the majority of the US literature assumes that it is the debtor firm that decides on the procedure under the mandatory legislation. In the US, the starting point is the debtor's 120-day priority period to propose a Chapter 11 procedure.[295] This is not a universal position and it is often actually the creditors that decide on the procedure. Such a right is based usually either on the right to file for bankruptcy after a default or on the fact that the creditor holds a comprehensive security interest. If the debtor has a right to seek bankruptcy protection, this is a second-stage matter.

However, if there exist jurisdiction-specific restrictions on bankruptcy contracts, they can be inefficient even in more permissive (or creditor-oriented) insolvency regimes, when they 'prevent creditors from bribing debtors to choose the *ex post* efficient

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292 ibid 27.

293 ibid 27.

294 ibid 27-28. Much like the majority of the US theoretical papers, Schwartz focuses on the risks of the debtor firm and its incentives for choosing an efficient insolvency mechanism, ibid 18 and 23.

295 US Bankruptcy Code, Chapter 11, s 1121(c)(2).

bankruptcy chapter'.[296] Assuming Schwartz is correct in claiming that, bankruptcy contracting should not be restricted on efficiency grounds, unless it narrows the alternatives of the stakeholders. Efficiency means in this case that the controlling creditors have a possibility to choose the most effective mechanism, even when they use an *ex ante* contract.

In addition to the efficiency argument, Schwartz is correct in claiming that the bankruptcy models do not, perhaps, endogenize the debtor's capital structures that we encounter in practice. However, this argument does not have strength in all scenarios and Schwartz recognises this.[297] It is as likely that the capital structure of a company is highly fragmented. However, the key is understanding Schwartz's point that the actual capital structures appear to enable sophisticated creditors to control a distress scenario. This means that the corporate insolvency law should perhaps start from explaining how this is possible.

One example of achieving creditor coordination through a concentrated capital structure is found in English law administrative receivership. Armour and Frisby point out that administrative receivership, which was widely used until the early 2000s, was able to generate savings for all parties because the controlling creditor was able to gather substantial information about the debtor continuously and make a more reasoned decision as to whether to continue the debtor's business in default or alternatively liquidate the company.[298] They consider administrative receivership a clear example of allocation of control, which may also lead to more efficient enforcement or restructuring decisions.[299]

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296 Schwartz, 'Bankruptcy Related Contracting and Bankruptcy Functions (October 10, 2017)' (n 31) 23.

297 ibid 28.

298 Armour and Frisby (n 82) 73, see also 87-91 and 96.

299 ibid 74. They have also noted that such control rights are apt to 'toughen the disciplinary effects of debt finance "*ex ante*"' 74-75. The scope of administrative receivership was reduced

Furthermore, it can be seen as 'an opt-in' mechanism to a private insolvency procedure because it enables the controlling creditor to appoint an administrative receiver.[300] Fragmentation is not an issue with administrative receivership because the controlling creditor can direct the procedure as a result of holding a comprehensive security interest.

Administrative receivership, despite being much more limited nowadays, is a good example supporting the argument that firms can create capital structures and comprehensive contracts that result in concentration making creditor control possible. Technically, there are no restrictions to extending this type of mechanism contractually to cover all of the group's financial creditors (even though they would not be covered by security) and the entire debtor group. The question which makes the contract effective, whether through security interests,[301] creditor restrictions or reliance on the statutory insolvency procedures, is an important one. The issue becomes even more relevant when we extend the need to extend creditor coordination to a larger debtor group.

2. The need to control the enterprise

The reason why creditors may wish to rely on contracts to control insolvency scenarios becomes clear when we consider the debtor group as an economic enterprise inside which capital and resources can be moved around according to the wishes of the controlling

considerably in 2002, which in practice signals that on a societal level such a procedure brought about also negative effects, which overcame the efficiency arguments.

300 ibid 74-75.

301 Westbrook has pointed out, although as a part of the deficiency underlying contractual procedures, that they fail to explain the control mechanisms required to be workable, Westbrook (n 46) 799. He considers that contractual theories cannot be legitimate or efficient unless they rely on a dominant secured lender(s) whose interest covers substantially all of the debtor's assets, ibid 799. Some corporate finance structures such as LBOs and project finance arrangements rely on comprehensive security interests, which supports Westbrook's view.

owners.[302] In multi-layered financing transactions security of material group assets may be held by several creditor groups.

Furthermore, a restructuring may require the release of financial obligations and security on different levels of the group and binding the subordinated creditors and debtors to the decision of the controlling creditor group. Therefore, because of the number of parties and claims involved, the effectiveness of the restructuring of the debtor group depends not only on a comprehensive security interest but also on the effectiveness of such contractual clauses between all stakeholders.

Mandatory insolvency procedures may have difficulty in dealing with distressed economic enterprises consisting of many separate legal entities. The matter is well-recognised in reforming the mandatory systems. For example, in the UK, the Cork Report emphasised in 1982 that society may not have an interest in the rescue of an individual company, but rather the preservation of the commercial enterprise.[303] From the economic perspective, the same objective can be framed by asking whether it is economically beneficial to retain the assets in a single entity or structure the firm[304] in such a way that the assets are located in an entity in which the relative costs of carrying the activity are the lowest.[305] In addition to optimal resource and risk allocation, it is also likely that, private equity funds will wish to carry out asset-partitioning into several entities to enhance their leverage over that of the creditors when building and managing the group capital structure. For commercial lenders, this means that they need to extend their ability

302 Douglas G. Baird and Anthony J. Casey, 'No Exit: Withdrawal Rights and the Law of Corporate Reorganizations' 113 Columbia Law Review 1, 4-5.

303 Cork (n 107).

304 Coase (n 68) 393.

305 Baird and Rasmussen (n 69) 754.

to control a borrower and coordinate their actions in relation to a broader economic enterprise instead.[306]

For the creditors to be able to capture the group going concern value with larger enterprises, they need to ensure that the senior creditor group maintains control to decide on the deployment of the debtor's assets, enabling an *ex post* decision on the procedure. This can leads to maximisation of the going concern surplus of the entire debtor group. Such control rights often restrict the possible asset-partitioning incentives of the debtor group and eg control the optimal moment when the creditor's contingent control rights are triggered. Preservation of the debtor group's value may warrant that this moment is pre-negotiated, so as to depend on the specific situation of the debtor group rather than on a statutorily pre-determined insolvency trigger event.

Therefore, we would expect the contract offered by the debtor group to its creditors to enable group-wide enforcement and to include payment restrictions, group-wide asset disposals and releases of claims and security on a group-wide basis.

(e) The moral hazard with using creditor control

In addition to the need to deal with the wider creditor base and the debtor group to capture the benefits of *ex ante* contracting, another problem that arises is controlling the creditor group's decision-making when the value of the assets that the group can realise either falls short of or exceeds the claims against that group. The effect of asset valuation on the

306 Coase (n 68). Baird and Rasmussen have pointed out that, despite the boundary between transactions within and outside the firm, the economic idea of a firm from the perspective of corporate restructurings has been mostly unexplored, ibid (n 69) 753 and 758.

creditor incentives is an essential aspect of creditor control that also affects the contents of contracts for control.

In general, granting secured credit to a creditor enables it to control the collateral and to be paid in priority upon enforcement. Armour and Frisby note that this may also create efficiencies because it may increase expected post-enforcement returns making it a less costly strategy.[307] The same argument can be extended to other contractual protections that enable the controlling creditor to exercise its discretion in enforcement. However, Armour and Frisby note that priority and control are not necessarily related.[308] As they point out, '[w]here the debenture-holder is 'undersecured'—i.e. its security does not cover the debt outstanding—then it will indeed be the residual claimant and this inefficiency will not be manifest'.[309] This also means that there may be inefficiencies if the creditor is oversecured, which may distort the decision-making of the secured senior creditor.

Ayotte and Morrison have shown empirically in a set of US Chapter 11 transactions that the restructuring decision of the senior creditors may be skewed eg if the collateral value is close to the amount of their claims. If so, they are not incentivised to carry out an optimal restructuring, even if the asset values exceed the secured loan value. This would lead to a value loss in the enforcement suffered by the lower-ranking creditors.[310] Along the same lines, Schwartz has pointed out that the creditor's incentive to monitor and carry out optimal enforcement requires that the creditor's claim be impaired[311]

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307 Armour and Frisby (n 82) 88.

308 ibid 89.

309 ibid 90-91.

310 Ayotte and Morrison (n 186).

311 Schwartz, 'Bankruptcy Related Contracting and Bankruptcy Functions (October 10, 2017)' (n 31) 30.

because, if the creditor is over-collateralised, it may not have incentives to choose the most value-preserving enforcement or insolvency structure.

Absent statutory, contractual or reputational obligations, an over-collateralised creditor would have an incentive to liquidate even firms where the going concern value would exceed the liquidation value. Therefore, the debtor would have an incentive to ensure the collateral value of the firm held by the senior secured creditors is less than the total value of the claims or that there are claims not subordinated to the senior secured creditors or that are outside the contractual insolvency regime. Such a scenario would incentivise the senior secured creditors to seek an optimal enforcement alternative in all scenarios.[312]

The moral hazard risk means that we would expect to see private equity funds to negotiate capital structures that enable granting of more limited security interests to the main creditor group or capital structures that give them an option of incurring additional indebtedness that is not covered by the ICA. The existence of such clauses supports Schwartz's argument on the optimal capital structures we would expect to see in a free-contracting environment. Outside pressure caused by non-ICA funding and leverage may enhance the likelihood of the secured creditors choosing an *ex post* optimal enforcement and insolvency method.[313] On the one hand, under-collateralisation or non-ICA funding option will enhance the private equity fund's negotiation leverage in a restructuring scenario and simultaneously increase the likelihood of an optimal enforcement by the

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312 Schwartz argues that firms that are more likely to face financial distress are more likely to choose capital structures facilitating renegotiation and the use of private restructuring measures ibid 4.

313 ibid 33-34.

senior creditors. On the other hand, we would expect the senior creditors to be mindful of the incentives of the private equity funds and insist as broad as possible a security package and that ICA covers most of the financial indebtedness of the debtor group.

Balancing such incentives is likely to depend on case-specific circumstances. However, these are important points for the purpose of the empirical analysis of the multi-party agency costs analysed in Part C.

6 Theoretical outline and key propositions

(a) Summary of incentives and restrictions

The analysis set out in this Part B sets the theoretical framework for the empirical analysis in the next part. These issues can be summarised as follows.

The strategic creditor actions were divided into two scenarios, each plagued by its own game-theoretical problem. The first is the hold-out creditor scenario resulting from the 'prisoner's dilemma' and the consequent creditor incentives to enforce even though a coordinated procedure might lead to a better solution. The second is the hold-up creditor scenario in which the relevant creditor-base would have difficulties in agreeing to an optimal outcome because the non-consenting creditors could try to obtain additional benefits from the other creditors in exchange for their consent to the arrangement.

Creditor coordination to overcome the strategic creditor actions becomes harder due to fragmented creditor base; the nature and the objectives of different creditors; multiple financial instruments; and the changing creditor base of the debtor group. The heterogeneity and broad scope of different creditors, and especially the control rights

between different creditor groups, warrants that we analyse creditor control and reduction of the strategic creditor actions and the financial agency costs first within each creditor group (horizontal aspect) and then between different creditor groups (vertical aspect). Analysing if and how these strategic creditor actions are defused contractually is key to resolving creditor coordination problems in our scenario.

Overcoming these obstacles by a contract has generally been seen as insurmountable, making creditor coordination very difficult. This has meant that the theoretical literature has regarded statutory solutions to financial distress as a necessary and near-universal method. However, these views are based partially on the incomplete contract problem, which may not be a feasible assumption when we look at practical negotiation situation in corporate finance.

I also set out the rationale and incentives for the private equity fund and its management to offer covenants, monitoring rights and more general contractual protections to help the creditors solve their coordination problem. These incentives are emphasised because of the generally debt-heavy capital structure of private equity portfolio companies and because of the management's need to partition the assets and contractual obligations within the group in an optimal manner. Therefore, the ability of the creditors to monitor and control such a wider corporate group using an ICA would be rational. When recognising that such contracts may lower transaction costs and the cost of credit, the parties are likely to conclude that giving an option to the creditors to restructure the debtor either contractually or through statutory means (if this proves *ex post* more feasible) is economically rational. The incentives for offering such a contract covering the entire debtor group and protecting the creditors against asset-partitioning and other financial agency

costs on a group-wide level operates similarly.

Importantly, it is possible to retain the *ex ante* benefits by adhering to a contract for control, but that the purpose of such contract is to create optimal bargaining conditions for the stakeholders so that they can achieve the best possible solution for the distress and create more value for the parties within a contracting framework where the variables affecting the non-co-operative game are reduced to an acceptable level. Such a solution can help overcome the incomplete contracting problem and achieve the benefits of *ex ante* contracting while benefitting the better case-specific knowledge of an *ex post* situation.

It can also be argued that private equity funds would be rational in trying to negotiate flexible capital structures enabling additional debt to be incurred whether covered by contracts for control or not, but in any case subject to a pre-agreed priority structure. This enhances their leverage in a potential distress scenario. Noting that the creditors have a strong incentive to require the use of contracts for control to deal with the strategic creditor actions on a debtor group level, the argument that we ought to see such contracts used widely in the markets is persuasive. This assumes that the parties can devise a regime to bind a sufficient number of financial creditors of the debtor group to the contractual package. Under such a regime where creditor coordination is possible, the senior or controlling creditors may be able to internalise enough private benefits to monitor the debtor, evaluate its financial situation and to take necessary measures to liquidate or restructure the debtor. Based on economic arguments, we would also expect the creditors to require extension of the control and coordination rights to the whole debtor group.

To evaluate the above arguments, we will need to structure the analysis set out in this part as propositions that will be tested in the empirical analysis of the market ICAs.

This also means that we need to set out the observable implications that we would expect to find in the ICAs if these propositions were to hold.

(b) The key propositions evaluated

The research question and the sub-questions are addressed in the empirical Part C of this thesis by evaluating whether the ICAs and the market participants' views are consistent with the below theoretical propositions. These propositions are based on the analysis of strategic creditor actions, the agency costs analysis and the measures for defusing incentives for such actions and costs by contractual means and especially in closely-held private equity-owned LBO structures. The key propositions are:

A. The ICAs are drafted and designed so that they set out the priority and capital structures of the creditors and, through standstill, enforcement and release provisions, can defuse the incentives of hold-out creditor actions in distress scenarios.

B. The terms of the ICAs can overcome the hold-up creditor risk by facilitating creditor coordination and enable the use of a value-maximising enterprise-wide solutions for the creditors in restructuring or enforcement scenarios.

C. The terms of the ICAs enable the parties to carry out restructuring without necessarily having to resort to the statutory procedures.

For proposition A to hold, we would expect to find in the ICAs: (i) comprehensive regulation of debt priorities, amendments to the capital structure and new facilities; and (ii) payment and enforcement restrictions and standstill periods dealing with hold-out creditors, creating a moratorium for all value-destroying creditor actions, majority control provisions regulating these scenarios and protective clauses ensuring the defusing of negative incentives of the debtor and the creditors to deviate from these rules. For

proposition B to hold, we would expect the ICA terms to include provisions facilitating debtor group-wide restructuring and enforcement that enables an optimal enforcement choice by the controlling creditor group that also binds other creditor classes and is supported by protective clauses against 'free-rider' behaviour.

For proposition C to hold, we would expect to see that the market participants consider the use of statutory procedures to be non-mandatory for carrying out an LBO restructuring. Alternatively, we would expect to see that the controlling creditors or other stakeholders with sufficient bargaining leverage are able to choose the most feasible procedure and 'point of enforcement' for the liquidation or restructuring contractually. This means that logically opting for a statutory procedure is not necessary, but can be used, subject to the evaluation of the controlling group, if it provides the best solution for the distress. If the propositions hold, we can argue that ICAs are capable of providing a solution to the strategic creditor actions and a partial solution to the 'incomplete contracting problem'. This will also mean that there is a solution to the creditor coordination problem in multi-tiered financing with changing capital structure and creditor-base and a mechanism for achieving an optimal restructuring or liquidation outcome from the enterprise perspective.

PART C - EMPIRICAL ANALYSIS OF THE TERMS AND USE OF INTERCREDITOR AGREEMENTS

1 Introduction

(a) Background and theoretical basis

ICAs are used extensively in LBOs and other leveraged finance transactions. However, there is little theoretical or empirical evidence as to whether and, if so, how such agreements regulate strategic creditor actions by enhancing creditor coordination in financial distress scenarios or how they affect financial agency costs in LBO structures discussed in Part B. These questions also have a close connection to the question of whether contractual insolvency mechanisms enable value-maximising solutions for creditors in a distress scenario and whether the parties will, in any case, have to resort to the statutory mechanisms.

To address these questions, ICAs will have to overcome the theoretical challenges restricting the use of comprehensive contracts for control of debtor companies and privatised insolvency procedures discussed in Part B. Answering these questions also requires analysis of the contents of the actual ICAs and the market participants' perceptions of their use and status in the corporate finance markets.

This chapter describes the results of the content analysis of the sample ICAs, the structure and terms of the Loan Market Association's model ICAs (LMA ICAs) and the results of in-depth interviews concluded with senior market participants. The objective of the chapter is to describe whether and, if so, how English law ICAs used in LBO

transactions facilitate creditor coordination and eliminate strategic creditor actions in relation to distressed debtors while enabling a value-maximising solution for creditors and dealing with financial agency costs prevalent in LBO structures.

I have grouped the results into three main topics: terms regulating (i) capital structure and priorities, (ii) creditor control and decision-making and (iii) security enforcement and restructuring processes. These main themes are connected to the theoretical problems and the key propositions set out at the end of the previous Part B as shown in Table 3.

Table 3. Key propositions, main themes and theoretical questions

Key Proposition	Main Theme	Theoretical questions
A. The ICAs are drafted and designed so that they set out the priority and capital structures of the creditors and, through standstill provisions, can defuse the incentives of hold-out creditor actions in distress scenarios.	capital structure and priorities (Section 3) creditor control and decision making (Section 4)	incomplete contracting problem universal insolvency procedure (heterogeneity and flexibility) problem of commons
B: The terms of the ICAs overcome the hold-up creditor risk by facilitating creditor coordination and enable the use of a value-maximising enterprise-wide solution for the creditors in restructuring or enforcement scenarios.	security enforcement and restructuring processes (Section 5)	problem of anti-commons debt overhang problem optimal enforcement framework
C: The terms of the ICAs enable the parties to carry out restructuring without necessarily having to resort to the statutory procedures.	security enforcement and restructuring processes (Section 5)	incomplete contracting problem failure of creditor coordination

The empirical analysis will show that all of the key propositions are regulated in the LMA and the sample ICAs in an empirically consistent manner. This applies to controlling the LBO capital structures and their amendments in all material scenarios. The analysis shows that the ICAs, as used currently, create an extensive, but not a

comprehensive, contractual insolvency regime accommodating most capital needs and changes of the debtor groups.[314] Material default events also consistently result in payment and enforcement restrictions and moratoria restricting hold-out behaviour.

The analysis will, furthermore, show that the enforcement and distressed disposals clauses of the ICAs regulate in detail the rights of the controlling creditor majorities to carry out any type of enforcement or restructuring procedure concerning the entire debtor group deemed optimal in any particular scenario. As we will see, the sample ICAs also include provisions defusing the remaining negative agency costs and incentives to either restrict or prolong the enforcement or restructuring procedure, thereby considerably reducing the need to resort to statutory insolvency procedures. The results also evidence the legal institutions and preconditions that are material for the effectiveness of contractual insolvency procedures.

(b) Structure of the part

I will first discuss the methodological choices underpinning the empirical research and set out the coding methodology used for the content analysis and the structure of the interviews. Section 2 includes a description of certain aspects of private equity capital structures and the reasons for using ICAs. Section 3 includes a discussion about LBO and ICA capital structures and their amendments in the LMA ICAs and sample ICAs. It also covers ICA clauses protecting the contractual priority structure.

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314 For how long-lived ICAs are designed: Anne Cathrine Ingerslev, 'Designing long-lived leveraged intercreditor agreements -- how to survive refinancings and additional debt incurrence' [2017] JIBFL 691.

Section 4 sets out the LMA ICA and sample ICA creditor control provisions, focusing on the payment and enforcement restrictions and provisions protecting against value-destroying creditor actions. In Section 5, I describe the results of the enforcement and distressed disposal rules regulating group-wide enforcement and restructuring, and provisions that defuse any remaining negative incentives to affect the desired procedure. Section 6 summarises the results.

I have used many terms throughout this Part C and also in Part D, which are listed in Appendix 3. For readability, the definitions are in lower case. The definitions do not necessarily conform to the LMA or sample ICA definitions because they vary depending on the party in charge of the drafting process and on market structures that often define similar actions, creditors and indebtedness with different terms.

(c) Methodological choices

1. Selection of the research subjects and the documents

The empirical data gathered in the research consists of three LMA ICAs and 23 sample ICAs that represent large leveraged transactions carried out between 2013 and 2018 and recorded and transcribed in-depth interviews with 14 senior market participants. I have set out the basis of the data sampling and collection methods as well as the coding of the empirical data below.

2. In-depth interviews

The selection of interviewees followed a stratified sampling method, with the objective being for the sample to include representatives of international law firms, banks and private equity funds. The interviewees were selected based on industry rankings of large international companies active in the leveraged finance markets. It was intended to interview senior managers in these organisations. The interviews took place between May 2018 and January 2019. The focus was on acquiring data-rich in-depth observations from the participants. The categorisation of the interviewees is set out in Table 4.

Table 4. Categorisation of the interviewees

No	Date	Profession	Location	Expertise	Transcript
1.	9 May 2018	Attorney	London	1.d.ii	Yes
2.	10 May 2018	Attorney	London	1.d.ii	Yes
3.	10 May 2018	Attorney	London	1.d.ii	Yes
4.	16 May 2018	Hedge Fund professional	London	1.b.ii	Yes
5.	16 May 2018	Attorney	London	1.d.ii	Yes
6	1 August 2018	Attorney	London	1.d.ii	Yes
7.	5 September 2018	Attorney	London	2.d.ii	Yes
8.	5 September 2018	Attorney	London	2.d.ii	Yes
9.	15 October 2018	Banker	Helsinki	1.a.ii	Yes
10.	15 October 2018	Banker	Helsinki	1.a.i	Yes
11.	15 January 2019	Private Equity Manager	London	1.c.ii	Yes
12.	17 January 2019	Private Equity Manager	London	1.c.ii	Yes
13.	19 January 2019	Private Equity Manager	Oxford	1.c.ii	Yes
14.	22 January 2019	Investment Bank / Bank Manager	London	1.a.ii	Yes

Expertise codes:
Size of the interviewees' firms: 1 International; 2. Large Domestic
Type of expertise: a. banking; b. hedge fund; c. private equity; d. law firm
Length of expertise: i. 5 to 10 years; ii. more than 10 years

Stratified sampling was adopted to ensure that the views were not biased due to the nature of the institutions' business, ie their usual role in a leveraged transaction. The sampling was not intended to be statistically representative because, rather than intending to produce generalisable results or trying to capture the phenomenon accurately, the objective was to reveal the meaning and perceptions of the participants on the use and

objectives of ICAs in leveraged transactions. The interviews were semi-structured with a set of questions for the participants (see Appendix 1) and lasted between 50 and 90 minutes. Rather than constrain the interviews tightly to that particular set of questions, the questions were intended to guide the interviewee to the topic and themes.

The validity of the in-depth interviews was reduced by the decision to concentrate on data-rich interviews and a highly qualified interviewee sample.[315] Such concerns should be minimised, however, due to the above specific objectives of the interviews. However, the sample size may affect reliability of the interviews and focusing on a larger group of restructuring lawyers or bankers might have resulted in different findings and emphasis.[316] As with validity, however, I considered such concerns to be minimal in practice also because the sample was comparatively of reasonable size.

3. Content analysis of the ICA sample

The content analysis was based on the LMA ICAs and a sample of market ICAs concluded in connection with LBOs or leveraged refinancing arrangements based on LBOs. The initial coding adopted in the content analysis was based on the LMA ICAs. The LMA documentation was made available by the LMA following a written agreement concerning their use for research purposes only. Although the content analysis focused on the actual transaction documentation, extensive description of the solutions adopted in the LMA documentation was necessary because:

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315 Validity is the extent to which the research method captures the phenomenon accurately. Lisa Webley, 'Qualitative Approaches to Empirical Legal Research' in Peter Cane and Herbert M. Kritzer (eds), *The Oxford handbook of empirical legal research* (Oxford University Press 2010) 935.

316 ibid. Reliability refers to the reproducibility of the results by other researchers.

(i) the LMA leveraged documents represent, based on the literature and the interviews, broad market consensus concerning the general structure of ICAs and the general solutions to intercreditor problems recognised in the markets over the last decade; and

(ii) the general structure of the LMA documents conforms materially to the actual ICAs and, for demonstration purposes, discussing the LMA solutions prior to the ICA sample enables a more systematised approach to the ICA sample.

The 23 sample ICAs were each between 100 and 300 pages long. Since most of the sections were potential material for analysis, all were reviewed in their entirety. Only ICAs governed by English law were included in the sample, and those concluded before 2011 were excluded to allow a focus on the latest market cycle. ICAs are confidential documents and cannot generally be obtained publicly. Half of the ICAs were obtained from institutional investors with their consent to release the documentation for the purposes of this research. The remaining documents were obtained through the US Securities and Exchange Commission's disclosure system based on the mandatory disclosure obligations arising from certain transactions having a US aspect or public disclosure of the target groups online.

Since the ICA sample was very data-rich and each of the sample documents included substantial and extensive regulation of creditor priorities, control and enforcement, the time required for the detailed analysis of an individual transaction was approximately three weeks. This limited the maximum number of ICAs to the 23 transactions included in this chapter. I used the Debtwire[317] and S&P Intelligence data sites

[317] Access was granted by Debtwire on three occasions during 2018.

to determine the basis of the financing dynamics and status of the debtor group.[318] I have set out in Table 5 the categorisation of the sample ICAs.

The ICAs represented a stratified sample of the capital structures commonly represented in the markets. The validity of the content analysis was enhanced due to the reasonably good sample size, considering the extensive scope of the individual ICAs. The sample did not warrant a longitudinal analysis of the variation in ICA terms, since this would have required a larger sample. This means that the sample is only likely to be reflective of a part of the leveraged finance ICAs during the period 2011-2018. The process of gathering and analysing the material was completed over a period of one year, which meant that the sample could not be increased within the time available. Any concerns about the reliability of the analysis, however, should be limited due to the reasonably good sample size. That said, the sample is unlikely to capture systematic variations in contract terms of the ICAs within individual ICA groups (ie capital structures) or developments in the market standard.

Table 5. Categorisation of sample ICAs

No	Year	ICA category*	Law/Jurisdiction	No	Year	ICA category	Law/Jurisdiction
1.	2015	1	English law	**13.**	2014	3	English law
2.	2015	1	English law	**14.**	2016	3	English law
3.	2014	1	English law	**15.**	2015	4	English law
4.	2015	1	English law	**16.**	2016	4	English law
5.	2017	1	English law	**17.**	2015	4	English law
6.	2017	1	English law	**18.**	2017	5	English law
7.	2017	2	English law	**19.**	2017	5	English law
8.	2017	2	English law	**20.**	2017	5	English law
9.	2014	2	English law	**21.**	2017	5	English law

[318] Access to the databases was granted for research purposes.

10.	2010	3	English law	**22.**	2018	5	English law
11.	2017	3	English law	**23.**	2017	5	English law
12.	2016	3	English law				
* = See for the categorisation of sample ICAs (LBO capital structures) Section 3(f).							

4. Data analysis

The method used to analyse the data was a combination of the grounded theory method[319] and classical content analysis. Together, these enabled thematic coding of the materials. The intention was to find from the data concepts and consistencies that could be compared to the key propositions set out at the end of Part B. Compared to classical content analysis which aims to count the frequency with which the various themes and codes appear in the materials,[320] I adopted a somewhat modified method focusing also on the variances within the themes and the connections between different themes and sub-categories; that is, the context and connectedness of the clauses were emphasised in my approach.

The method of analysis, therefore, had connections to the grounded theory method, attempting to collect and analyse data to generate a theory from the sources using a comparative method. This approach also required revisiting the understanding of the phenomena to confirm the validity of the pre-existing descriptions and the initial themes. Therefore, the contract categories were refined during the process of content analysis.[321]

The initial coding was based on the main categories of creditor priorities, creditor control and enforcement which were identified as the main categories in Part B.

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319 Webley (n 315) 943-45.

320 ibid 941-42.

321 ibid 943-45.

The thematic coding of the LMA ICAs identified the following refined themes:

(i) the capital and priority structure, refinancing and additional financing facilities and amendments to the facilities;

(ii) payment and enforcement restrictions both *ex ante* and *ex post* financial distress, including no-action and standstill clauses;

(iii) security agent and instructing group enforcement control, and enforcement of security; and

(iv) distressed disposals, the release of claims and security and protective clauses.

In the third stage of the analysis of the ICA sample, each of the three main categories was divided into several sub-groups of clauses regulating either capital structure, creditor control or enforcement and distress scenarios. Although the specific contents of most of the clauses within the LMA ICAs and the sample ICAs frequently deviated, the *types* of sub-categories were observed in all contracts. The solutions to specific issues were not necessarily found in similarly titled clauses, however, so the solutions were collated from various parts of the contracts. The sub-categories were further divided into clauses dealing with each of the creditor groups.

The consistency of the content analysis was enhanced by the fact that there were no material differences between the themes or categories of clauses regulated by the documents. The detailed coding scheme is set out in the below Table 6. The detailed coding framework is included in Appendix 2.

Table 6. Coding scheme

Capital Structure and Priorities	Creditor Control	Enforcement
Capital structure	Agent control	Enforcement of transaction security
Transaction security	Party enforcing	Enforcement instructions
Anti-layering	Majorities	Manner of enforcement
Priorities	Restrictions on payments	Voting
Amendments	Senior	Granting waivers
Senior liabilities	Junior	Duties owed to whom
Junior liabilities	Other financial	Distressed disposals
Other financial liabilities	Parent/vendor/investor	Definition
Parent/vendor/investor liabilities	Intra-group	Scope
Intra-group liabilities	Restrictions on enforcement	Release of claims and security
Refinancing facilities	Senior	Fair value requirement
Incremental facilities	Junior	Non-cash consideration
Redistribution	Other financial	Structural adjustments
Turnover	Parent/vendor/investor	
Equalisation	Intra-group	Effect of insolvency event
-	-	Application of proceeds
-	-	Filing of claims
-	-	Further assurance
Theoretical questions		
Incomplete contracting problem Universal insolvency procedure (heterogeneity and flexibility)	Problem of the commons	Problem of the anti-commons Debt overhang problem Optimal enforcement framework

2 Private equity capital structures and the ICA

(a) Private equity and leveraged transactions

To understand why ICAs are structured in a particular manner, we need first to address some aspects of leveraged financing transactions. As outlined earlier on in the thesis LBOs are corporate acquisitions in which a buyer acquires a listed or unlisted company or group with consideration financed through a large proportion of external debt, which usually exceeds the average indebtedness of comparable companies.[322] Such transactions are often structured as a multi-layered financing arrangement consisting of loan and bond facilities, individual loans and equity and debt investment by the investors.[323] LBOs are also invariably carried out by private equity sponsors that are fund structures investing in companies, usually in unlisted companies, unless taken private as a result of the LBO.[324] They are a subset of the broader category of leveraged financing transactions.

Private equity funds are investment structures governed by a fund manager or a general partner managing a private equity fund, which is entirely, or almost entirely, funded by limited partners that are commonly institutional investors.[325] Private equity funds have a pre-defined, often extendable, investment period and subsequent holding period, after which the fund is dismantled. Such funds are, therefore, likely to prefer capital

322 Kaplan and Strömberg (n 6) 124-25.

323 See David Billington in Andrew Shutter, *A practitioner's guide to syndicated lending* (Andrew Shutter ed, Sweet & Maxwell: Thomson Reuters 2010) 86.

324 On LBO categorisation: Renneboog and Vansteenkiste (n 9) 2-4.

325 Kaplan and Strömberg (n 6) 123-24.

structures with maturities within the duration of their fund structures.[326]

LBO financing structures usually employ several holding and operating companies. The main reasons for this are the need to set out the structural priorities of various stakeholders with respect to equity, debt and management, and structuring the acquisition group efficiently for financing and tax purposes.[327] This may also be fuelled by jurisdiction-specific restrictions on enforcement of, for example, share security.[328] A multi-tiered holding-company structure may also enable better asset and debt partitioning for the fund and the ability for the secured creditors to enforce their security on an optimal level of the debtor group.[329]

(b) The main reasons for using ICAs

The fact that LBO capital structures are likely to have several categories of creditors means that the issue of the heterogeneous debtor-creditor relationships and the intercreditor relationships become pronounced. Whereas the loan and bond facilities include contractual clauses dealing with the debtor-creditor relationship and the relationship between the creditors of an individual loan facility, intercreditor agreements provide a way of dealing with both of these concerns between different creditor groups and in relation to the entire

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326 On the basics of fund structures: Axelson, Strömberg and Weisbach 1550-51 (n 87); on investment periods: Christopher Brown and Roman Kraeussl, 'Risk and Return Characteristics of Listed Private Equity' in Douglas Cumming (ed), *The Oxford Handbook of Private Equity* (Oxford University Press 2012) 550-51.

327 On wealth-generation, Renneboog and Vansteenkiste (n 9) 4-13; Philip Wood, *Project finance, securitisations, subordinated debt* (2nd edn, Sweet & Maxwell 2007) 10-009.

328 For example, it is typical to introduce a Luxembourg holding company structure holding shares in a French company because whereas French law may impede enforcement of share security in distressed scenarios, Luxembourg law does not.

329 On asset partitioning in a corporate group: Baird, Casey and Picker (n 222).

debtor group. The need to regulate the intercreditor relationship and entire debtor group were also emphasised in the interviews.

Most of the interviewees noted that intercreditor agreements are invariably the standard procedure used in LBO transactions. It was also pointed out that the parties would always,[330] or almost always, expect the use of such agreements and that situations, where the participants considered that no ICA would be needed, were marginal.[331] One of the interviewees was not able to recall a time when an ICA was not used.[332]

The underlying view of the interviewees was that English law is well established in the area of financial agreements and that the banks always prefer to have an ICA.[333] It was also pointed out, however, that the ICA does not necessarily work as it should, or could, in every in-court or local bankruptcy process,[334] or if so-called 'security-lite' structures, in which the security is limited to the debtor group's material assets, become more prevalent.[335]

The interviewees considered that the primary reason for using ICAs was to regulate the rights of different creditors throughout the life-cycle of the company and, in particular, to set out the enforcement regime if the debtors become distressed, facilitating out-of-court restructuring across multiple jurisdictions.[336] It was emphasised that the primary purpose is that the secured lenders can control the process so that their debt comes

330 Interviews 2 and 14.

331 Interviews 5 and 6.

332 Interview 13.

333 Interviews 4, 6 and 13.

334 Interview 6.

335 Interview 6.

336 Interviews 1, 2, 4 and 5.

out ahead of the other debts. Specifically, the ICA provides them with a formal basis through which to undertake restructuring to write off the equity and cram down the junior debt, stop the payments on the junior debt and associated leakage of cash, prohibit value-destroying actions and, where a statutory process has been initiated, make sure any recoveries are paid in accordance with the pre-determined priorities.[337]

Private equity representatives had a slightly different emphasis, however, noting that the ICA gives different stakeholders their leverage and negotiating power around the table and is a fundamentally important document.[338] The private equity funds' focus was more on SFA covenants and possible controls on debt transfers.[339] Some respondents argued that the ICA is mainly a mechanical document for the sponsors, but a number emphasised that the additional and refinancing clauses are particularly material to the sponsors and should reflect any changes in the capital structure allowed by the debt documents.[340] In addition, some interviewees considered creating efficiency in the capital markets and enabling syndication of the loan as some of the more fundamental reasons for having an ICA.[341]

(c) LMA ICAs and their assumptions

These market perceptions are also reflected in the LMA ICAs, although they also respond to the leveraged market's need to have a template ICA for use in connection with the LMA

337 Interview 8, 9 and 14.

338 Interviews 1 and 11.

339 Interview 12.

340 Interviews 6, 7, 8 and 11.

341 Interviews 3, 7 and 8.

Leveraged Document[342] in acquisition finance transactions.[343] There are currently three LMA ICA templates: the LMA S/M ICA and the LMA SS/S ICA (both used with the LMA Leveraged Document – a loan document in concerning the latter was not published at the time of the analysis) and the LMA SS/HY ICA (used with the LMA Super Senior HY Document). The content analysis builds on these three documents, which, as we will see, conform materially to the market ICAs and provide general solutions to the key propositions set out in Part B, Section 6(b).

The LMA ICAs are intended to be used in transactions involving a large number of creditors that provide financing to the same debtor group in a leveraged acquisition transaction. The user guides also state their objective as being ranking indebtedness and the creditors' entitlements to enforcement and other proceeds by contractually restricting creditor enforcement actions and rights to receive payments and to effect distressed disposals.[344]

The LMA S/M ICA has been revised a number of times,[345] reflecting the developments in the leveraged finance market and extensive consultation with the market participants. Although the LMA ICAs themselves have considerable practical standing in the markets, they cannot be used as exact models since they need to be adapted to a particular transaction depending on the specifics of the transaction and the commercial deal

342 The LMA Leveraged Document (n 13).

343 The Loan Market Association, *Users Guide to Form of Intercreditor Agreement for Leveraged Acquisition Finance Transactions (Senior/Mezzanine) (12 January 2017)* (2017) 2.

344 ibid 2.

345 In 2009, 2012, 2016 and 2017.

terms.[346] The documents assume (with some differences) that:[347]

(i) the debt documentation is based on the LMA Leveraged Document, LMA Mezzanine Facility Agreement or the Super Senior HY Document;

(ii) the transaction structure corresponds to the user guides of the relevant debt documentation – recognising that structural changes lead to changes in the ICA;

(iii) the ICA is governed by English law;

(iv) the hedging liabilities follow the LMA's recommended form of hedging letter for leveraged acquisition finance transactions (senior/mezzanine); and

(v) the security agent is (or is related to) a member of one of the lending syndicates, or to debt facility agents.

The documents each assume a different underlying capital structure, which explains a number of the differences between the LMA and ICAs. Because the LMA documents are structured on specific capital structures and priorities, however, I will first discuss some of these questions before analysing the actual capital structures and the contract clauses. To the extent that the solutions of the sample ICAs conform to those of the LMA ICAs, they are not repeated in the sample ICA analysis.

3 Capital structure and priorities

The creditor categorisations of LMA ICAs and the sample ICAs are built on the exclusion

346 Loan Market Association, *Users Guide to Form of Intercreditor Agreement for Leveraged Acquisition Finance Transactions (Senior/Mezzanine) (12 January 2017)* (n 343). A number of the lawyers interviewed that firms active in the LBO markets use their own ICA templates for various capital structures.

347 ibid 4-5.

of non-financial creditors from its scope and a priority or subordination regime applied to acceding creditors. I will examine each of these in turn below.

(a) Creditor heterogeneity

None of the LMA ICAs or sample ICAs covered all of the indebtedness or creditors of the debtor group, but only financial creditors to the extent they have acceded to the agreement. This exclusion means that some of the arguments presented in Part B concerning the difficulties in achieving an optimal restructuring of the debtor due to the multiplicity and heterogeneity of the creditors and the creditors extending credit to the debtor at different times are not as pronounced.[348]

The LMA ICAs deal with the questions of heterogeneity,[349] multiplicity and contracting at different times in three ways. First, they do not apply to non-adjusting or trade creditors or to parties not having acceded to the ICA.[350] Also, ICAs appear to be, at least *ex ante*, neutral towards such parties under the contract.[351] As two interviewees put it, however, the use of extensive security rights in an LBO is likely to constrain the hold-out claims of certain non-acceding creditors such as landlords.[352] The ICA, therefore, sets out

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348 The question of whether accession of all creditors, as opposed to just the financial creditors, will be required to make the contract effective in practice is an important one but is not addressed here.

349 The LMA Leveraged Document deals with creditor heterogeneity by restricting loan transfers to parties that are more likely to pursue their unique agendas, such as a distress funds. One interviewee (interview 12) expressed, however, that such restrictions may restrict loan syndication and that, naturally, there are no transfer restrictions in bonds.

350 Such creditors had not acceded to any of the sample ICAs.

351 The analysis of such effects is outside the scope of this thesis and would require empirical analysis of the effects of leveraged transaction restructuring on non-financial parties.

352 Interviews 7 and 8.

an intentional two-tier categorisation of the creditors into sophisticated financial creditors and other creditors.[353]

Secondly, changes in the debtor's financing requirements are dealt with by including working capital and ancillary facilities as a part of the senior liabilities. The private equity fund also often negotiates exceptions to the financing structure, for example, broader definitions of 'permitted financing' and 'permitted security' in the loan facility agreements. Thirdly, the LMA Leveraged Document enables the incurring of additional and incremental facilities and senior refinancing facilities, making these facilities subject to the same regulation as the original, replaced, or existing loan facilities. This may be feasible, for example, if the credit markets become more favourable or if the group's financing needs were to change.[354] According to the market practice, accession of certain unsecured facilities to the ICA is optional,[355] but, if the creditors wish to be secured by the transaction security or guarantees, accession will be required. However, some of the interviewees pointed out that a distress scenario is often about cash-flow and the ability to get additional liquidity by getting a third party to lend to the group outside of the ICA is a powerful option for the person holding it.[356] If the amount of such additional indebtedness is large enough and the parent retains the financing outside the ICA, however, this may constitute a hold-out problem in liquidation or restructuring.[357]

ICAs are therefore theoretically capable of operating as an extensive long-term

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353 See for the more general position: Sarah Paterson, 'Rethinking Corporate Bankruptcy Theory in the Twenty-First Century' (2016) 36 Oxford Journal of Legal Studies (GB) 697, 723.

354 LMA S/M ICA 20.

355 Interviews 1 and 14.

356 Interview 14.

357 Interview 14.

contractual insolvency mechanism allowing material amendments to the capital structure within the contractual framework. This flexibility was emphasised especially by the interviewees affiliated with private equity funds. According to one interviewee, the need for flexibility is required due to:[358]

(i) the substantial costs involved in debt renegotiations;

(ii) market risk, leading to a need to anticipate negative and positive pricing movements well in advance; and

(iii) the requirement to retain flexibility due to the group's financial needs.

From the interviews, it was evident that the need to replace the original document can be substantially reduced by enabling additional financing and refinancing options for the equity holders, making the ICAs under current practice more long-term contracts than event-based financing arrangements.

(b) Debt subordination and debt categories

1. Categorisation of debt subordination methods

The LMA and sample ICAs divided the acceding creditors into different priority classes.[359] The priority rules reduce creditor fragmentation and heterogeneity by ensuring that each creditor class is regulated under common terms and that control of the amendments,

358 Interview 11.

359 LMA S/M ICA 20 2.

enforcement and the distress scenarios are allocated, at least initially, to the highest-ranking class.

The priority regulation can be divided into structural priorities and contractual priorities. Structural priority of creditors occurs when different creditors grant loans to different entities in the debtor group hierarchy. Such subordination follows from the fact that a lower level operating company is close to the income stream of the debtor group, whereas its parent company can usually only rely on dividends or interest or capital payments under intra-group indebtedness from its subsidiaries.[360] In practice, any other form of subordination in an LBO arrangement is contractual, the subordinated interest being either a monetary claim or security.[361] ICAs also rely on the creditors being able to agree on priority in respect of transaction security.

Although postponing security interests by junior secured creditors in favour of priority secured creditors has not been addressed to a significant extent under English law, variation of priorities among the creditors is generally allowed and does not require the debtor's consent.[362] Debt subordination can be agreed on initially (complete subordination), or it can be triggered by a specific event (springing subordination).[363] The basic methods of subordination are turnover subordination and contractual

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360 Ulf Axelson and others, 'Borrow Cheap, Buy High? The Determinants of Leverage and Pricing in Buyouts' 68 Journal of Finance 2223, 2233-42.

361 Wood, *Project finance, securitisations, subordinated debt* (n 327) Part 10.

362 *Cheah Theam Swee v Equiticorp Finance Group Ltd* [1992] 1 AC 472 (PC*)*. See also *Woodroffes (Musical Instruments) Ltd, Re* [1986] Ch 366 (Chancery Division) in relation to effectiveness of agreeing on priorities to security among fixed and floating charge holders. Despite this, in all cases, the parties should be aware of the rights of the statutorily preferred creditors: See *Portbase Clothing Ltd, Re* [1993] Ch 388 (Chancery Division (Companies Court)).

363 Wood, *Project finance, securitisations, subordinated debt* (n 327) 10-003.

subordination.[364]

Turnover subordination is based on the obligation of the junior creditor, or a trustee if the subordination is effected through a trust,[365] to turn over the proceeds of the junior debtor to the senior creditors, up to the amount of the senior indebtedness. Contractual subordination is a simple form of subordination, being based on the obligation of the debtor to pay to the junior creditor only after the senior indebtedness has been repaid.[366] LBOs and their ICAs rely invariably on turnover subordination.[367]

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364 ibid.

365 See for the basis of trust in such cases: *Re Irving, ex p Brett* (1877) 7 Ch D 419. Turnover trusts are structured to apply to the proceeds of junior debt, not the entire debt itself. This also means that the risk of categorisation of the trust as a charge should not materialise. If the trust applies to the proceeds up to the amount of the senior indebtedness and not the entire debt itself, no 'equity of redemption' would arise, which is considered characteristic of a charge. See eg *Re George Inglefield Ltd* [1933] Ch 1 (CA); *Welsh Development Agency v Export Finance Co Ltd* [1992] BCC 270 (CA) . The risk of recharacterization as a charge carries a risk eg because a charge would have to be filed in accordance with the Companies Act s 859 A4 with the Companies House within 21 days and no such filings are made in connection with subordinated debt.

366 Wood, *Project finance, securitisations, subordinated debt* (n 327) 10-002. A liquidator must distribute the dividends to an assigned under a turnover trust. See *Frost Ex p. Official Receiver, Re* [1899] 2 QB 50.

367 One of the reasons is that a simple contractual subordination would subordinate the junior claims to all other indebtedness as well. The senior creditors are mindful of that and seek a 'double dip' into the distributions by the debtor, first concerning their own claims and, secondly, concerning the junior indebtedness.

2. The main risks of debt subordination

There are two distinct material aspects of corporate insolvency law that we should bear in mind of when evaluating the effectiveness of debt subordination under ICAs: the *pari passu* rule[368] and the anti-deprivation rule.[369] The *pari passu* rule means that the parties cannot exclude the statutory *pro rata* distribution rules by a contract giving a creditor more than its statutory share. The anti-deprivation rule restricts withdrawals of assets from the estate in, for example, liquidation or administration reducing the assets to the detriment of other creditors.[370] The latter is relevant especially in a subordinated creditor's insolvency.

The *pari passu* rule and contractual subordination

First, for the arrangement to be valid in the event of a debtor's insolvency, subordination will have to overcome restrictions required by the statutory *pari passu* rules. Although

368 David Richards J stated in *Revenue and Customs Commissioners v Football League Ltd* [2012] EWHC 1372 (Ch), 4: 'The first principle in issue is the *pari passu* principle, which requires the assets of the insolvent person to be distributed among the creditors on a *pari passu* basis, subject only to such exceptions as the general law may permit. The *pari passu* basis of distribution means that all creditors will receive the same percentage of their debts out of the available assets'.

369 Despite being important for the purposes of any restructuring and insolvency scenario, I have omitted here the questions relating to avoidance of transactions, wrongful trading, and eg director liability issues. The effects of eg the avoidance rules require a separate analysis best carried out in connection with empirical analysis of actual restructuring transactions.

370 *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd Butters v BBC Worldwide Ltd* [2011] UKSC 38, [1]. See: *SSSL Realisations (2002) Ltd (in liquidation), Re* [2006] EWCA Civ 7; see also *Ex p Jay; In re Harrison (1879) 14 Ch D 19, 25* (James LJ): '[a] simple stipulation that, on a man's becoming bankrupt, that which was his property up to the date of the bankruptcy should go over to someone else and be taken away from his creditors, is void as being a violation of the policy of the bankrupt law'. See also *The Football League Ltd* [2012] EWHC 1372 (Ch) (n 368) at 5 (David Richard J): 'The second principle is what is now known as the anti-deprivation rule, but which used to be called fraud on the bankruptcy law. This principle renders void any provision by which a debtor is deprived of assets resulting from insolvency with the effect that they are not available for distribution'.

under the statutory insolvency law distributions in liquidation[371] and administration[372] need to be made *pari passu* to the creditors, the right to contract out of these requirements in relation to the debtor's liquidation has been affirmed under English law in *Re Maxwell Communications* and *SSSL Realisation*.[373] Such a deviation from the *pari passu* rule also appears to conform to the international consensus on the effectiveness of debt subordination in a number of developed jurisdictions.[374]

Lehman Waterfall[375] identified a direct connection between the case law on the *pari passu* rule, the anti-deprivation rule and the nature of debt subordination. Lord Neuberger held that:[376]

> '[O]nce it is accepted that the terms of the Loan Agreements mean that the subordinated debt ranks behind non-provable liabilities, it must necessarily follow that it ranks behind statutory interest. In agreement with all the parties on this appeal, I can see no objection to giving effect to a contractual agreement that, in the event of an insolvency, a contracting creditor's claim will rank lower than it would otherwise do in the 'waterfall'.

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371 s 107 of the Insolvency Act 1986 (applying in voluntary winding up) and r 14.12 Insolvency (England and Wales) Rules 2016 (SI 2016/1024) (applying in compulsory winding up).

372 r 2.69 of Insolvency (England and Wales) Rules 2016 (SI 2016/1024).

373 It was held in *Maxwell Communications Corp Plc* (No 2), Re [1993] 1 WLR 1402 (HC) that the debt subordination agreement was not in breach of the *pari passu* principle or the statutory insolvency set-off rules. See also *SSSL Realisations (2002)* (n 370), in which the Court of Appeal, which upheld the first instance decision. In SSSL Realisations, the first instance, had affirmed in *SSSL Realisations (2002) Ltd (formerly Save Service Stations Ltd) (In Liquidation), Re, Save Group Plc (In Liquidation), Re, Squires v AIG Europe UK Ltd* [2004] EWHC 1760 (Ch) the validity of a subordination clause in favour of AIG. The court held that a subordination clause did not offend the *pari passu* principle. In addition, the clause prevented the creditors of the companies that were in in liquidation from submitting proofs of debt until the senior creditor had been paid in full.

374 Wood, *Project finance, securitisations, subordinated debt* (n 327) 11-027 – 11-029.

375 *Lehman Brothers International (Europe) (In Administration), Re Lehman Brothers Ltd (In Administration), Re LB Holdings Intermediate 2 Ltd (In Administration), Re* [2017] UKSC 38.

376 ibid 66.

Lord Neuberger regarded the dictum by James LJ's in *Ex p McKay*[377] that a person 'is not allowed, by stipulation with a creditor, to provide for a different distribution of his effects in the event of bankruptcy from that which the law provides' as being correct. However, he noted that this rule needs to be qualified: first, that it does not apply if the variation of the distribution concerns a creditor agreeing to rank lower in the waterfall than set out in the law; and secondly, a similar rule applies to an arrangement ranking such a person higher than provided by law if the other creditors being detrimentally affected have agreed to the procedure.[378]

Despite this clear statement by Lord Neuberger, the decision leaves open specific points concerning ICAs, for example, whether the liquidator or the administrator must take into account the payment waterfall of the ICA; whether the debtor should be a party to the ICA; how to handle assignments of indebtedness; and whether the assignee is bound by the subordination?[379] These cases also left open the question concerning when debt subordination might be ineffective or voidable as a divestiture of the junior creditor's assets. For this purpose, we need to take a look at limits of both the *pari passu* rule and the anti-deprivation rule that affect the validity of debt subordination.

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377 *Jeavons Ex p. Mackay, Re* (1872-73) LR 8 Ch App 643 (CA (ch)) *647*.

378 *Re Lehman Brothers International (Europe) (In Administration)* (n 375) 66.

379 See for a more detailed analysis: Johnston Bruce, 'Debt subordination - is all okay following the Lehman Waterfall case?' (2017) 32 Journal of International Banking Law and Regulation 507.

Drawing the line between the *pari passu* and the anti-deprivation rules

Until the Supreme Court Decision in *Belmont*,[380] there was notable concern over the effectiveness of contractual subordination especially when the triggering event of the subordination was connected on some level to the insolvency of the junior creditor. The concerns were primarily based on the House of Lords decisions in *Halesowen*[381] and *British Eagle*,[382] which were considered restricting of contractual subordination, especially when connected to junior creditor's insolvency and how its assets are determined. Both decisions considered the *pari passu* rule to be mandatory and not susceptible to being changed by contract. However, the cases did not sufficiently distinguish the differences between the *pari passu* and the anti-deprivation rules, which meant that the markets had to ensure the effectiveness of debt subordination in ICAs through the turnover trust.

Due to the somewhat overlapping nature of the *pari passu* and the anti-deprivation rule,[383] analysis of provisions regulating debt subordination in ICAs has not been straight-forward under the case law. First, we should bear in mind the distinction between determining what assets constitute the property of the insolvent and how those assets are after that determination distributed to the creditors.

The categorisation of the *pari passu* and anti-deprivation rules was clarified by

380 *Belmont Park Investments* (n 370).

381 *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] AC 785 (HL).

382 *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 2 All ER 390 (HL).

383 *The Football League Ltd* [2012] EWHC 1372 (Ch) at 104 (n 368) per Richards J: 'In my view, if a transaction has the effect of depriving a company of an asset to distribute it among some only of the creditors otherwise eligible to participate in a distribution, it offends both principles but, if the deprivation occurs on the company going into administration, only the anti-deprivation principle will be engaged for the reasons just given'.

the *Belmont* case in 2011.[384] Lord Collins pointed out[385] in relation to the *pari passu* rule in *Belmont* that the true ratio of *British Eagle* was indeed the scope of the *pari passu* rule, being based on *Carreras Rothmans*[386] where Peter Gibson J stated that:[387]

> 'where the effect of a contract is that an asset which is actually owned by a company at the commencement of its liquidation would be dealt with in a way other than in accordance with […the statutory *pari passu* rule…] then to that extent the contract as a matter of public policy is avoided'.

Because debt subordination was already approved in case law before *Belmont*, the case in effect eliminated a large part of the *British Eagle* risk. This is also important because the *pari passu* rule applies irrespective of whether the triggering event is insolvency or not,[388] which means that the arrangement should be effective not only at the onset of bankruptcy but also if triggered by some other event.

The limits of the anti-deprivation rule

In *Belmont*, Lord Mance set out mechanics for the application of the anti-deprivation rule, which is important in the context of ICAs because debt subordination will need to be

384 *Belmont Park Investments* (n 370).

385 ibid 8.

386 *Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd (In Liquidation)* [1985] Ch 207 (Ch).

387 ibid 226.

388 The *pari passu* principle applies not only to the basis on which the relevant office holder carries out the distribution, but importantly it also applies to any contractual or other provision which has the effect of distributing assets belonging to the estate on a basis which is not *pari passu*. The *pari passu* principle applies to all distributions irrespective of whether they are triggered by an insolvency procedure: Belmont (n 370) [14]. This means that the *pari passu* rule is connected eg to the avoidance provisions such as preferences under Insolvency Act 1986 s 239, which protect the estate until the triggering of the insolvency, after which the *pari passu* rule applies. Technically, both the *pari passu* and the anti-deprivation rules are also protected statutorily under, for example, s 127 of the Insolvency Act that prohibits by the disposals of the debtor's assets after the onset of the insolvency, unless otherwise permitted by the court.

effective if the junior creditor becomes insolvent. According to Lord Mance, we first need to determine the scope of the relevant property and determine whether it belongs to the company. Secondly, we need to evaluate whether the potential deprivation is within the scope of the anti-deprivation rules. If so, we then need to determine whether such deprivation is illegitimate, whether contractually or statutorily.[389]

Because the anti-deprivation rule is connected to the onset of insolvency, we should note that it should only be relevant if debt subordination is in some manner connected to the junior creditor's insolvency. It can be argued that the rule can make void a springing subordination clause if it is triggered specifically by the junior creditor's insolvency.

The decision in *Belmont* provides some guidance on what factors are relevant for debt subordination effected through an ICA. First, in cases that are not clear, a transaction should be upheld and considered not infringing the anti-deprivation rule if it is commercially sensible and is entered into in good faith.[390] In addition, there is also a 'particularly strong case for autonomy in cases of complex financial instruments'.[391] Secondly, Lord Collins noted that expressing property to 'determine or to change on bankruptcy' or expressed as being effective at the outset of a particular transaction does not mean that it could not be in breach of the anti-deprivation provision.[392] With this, Lord Collins diminished the role of case law and literature on absolute and determinable interests as being decisive for the application of the rule. Thirdly, although the rule should only

389 *Belmont Park Investments* (n 370) [169].

390 ibid [79].

391 ibid [103] (Lord Collins).

392 ibid [89].

apply when there is a question about the bankrupt's own property, the rule should also cover situations where the original source of the bankrupt's asset is the party who benefits by obtaining the asset as a result of the bankruptcy. However, he continued that if 'the source of the assets is the person to whom they are to go on bankruptcy' that may well be an important and sometimes decisive, factor in a conclusion that the transaction was a commercial one entered into in good faith and outside the scope of the anti-deprivation rule.[393]

Evaluating ICAs within the limits of the anti-deprivation rule set out in the decision of Lord Collins in *Belmont Park*,[394] the concerns with respect to LBO ICAs should be limited because the turnover subordination[395] used in the LMA and sample ICAs takes effect on entering into the agreements and is not connected to the onset of insolvency. Therefore, there is no intention to evade the bankruptcy rules but simply to state the inherent contractually agreed priorities of the creditors.[396] Based on *Belmont*,[397] it would appear that, for example, allowing permitted payments to the subordinated creditors until a specific event should not invalidate the arrangement. Likewise, this should not be the case if the parties provide for a variation of their priorities or rights during the term of the ICA, provided that the arrangement is commercially sensible, entered into in good faith and reflects the priority rights agreed by the parties in the ICA.

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393 ibid [98].

394 ibid [74]-[83].

395 Wood, *Project finance, securitisations, subordinated debt* (n 327) 10-022.

396 ibid.

397 *Belmont Park Investments* (n 370).

Scope for a turnover trust

Despite the recent more facilitative case law in relation to debt subordination, LBO ICAs have long relied on a turnover trust to overcome the risks associated with the earlier case law. It is commonplace that ICAs use a turnover trust to ensure that any proceeds that are not permitted to be paid or if a payment restriction has been triggered under the contract are paid to the trustee (the security agent) for distribution in accordance with the agreed priority schedule. The trust will capture the debtors' payments even after its insolvency, which means that the funds will not be a part of the junior creditor's estate.[398] A turnover trust also avoids most of the risks involved with contractual subordination where, for example, the junior creditor's insolvency, especially if it is connected to the debtor, might jeopardise distribution of the payment to the senior creditor.[399]

Summary of the effectiveness of debt subordination in ICAs

The current English case law on debt subordination is on a commercially sound basis due to helpful categorisations systematised in the recent case law. This applies especially to the limits of the *pari passu* and anti-deprivation rules because the categorisation enhances the certainty of the contractual clauses dealing with debt subordination in ICAs.

In light of the established contracting practice of ICAs and English law subordination agreements and structures, the existing case law sets out a reliable basis for

398 *Re Irving, ex p Brett* (n 365).

399 In addition to the risk of the *pari passu* rule, anti-deprivation rule, recharacterization of trust as a charge, the parties also need to be mindful of the risk of set-off, insolvency anti-avoidance rules, and eg the risk of assignment of the junior debt and other actions that the junior creditors may take to avoid subordination. The methods of ICAs dealing with these are discussed extensively in the following sections.

the effectiveness of debt subordination used in ICAs. However, it also illustrates several matters which we need to examine from the point of view of the sample ICAs and whether they address these concerns or not. These issues concern restrictions on junior creditor actions, the possible failure of the turnover trust (noting different jurisdictions), the ability to control the proving of the junior creditors' indebtedness in insolvency, as well as the triggers and nature of the subordination (complete, springing and connection to the insolvency triggers). Before discussing how the ICAs deal with these questions, we will need to address what types of debt categories are typical in LBOs, ie what types of subordination we are dealing with in such transactions.

(c) Main forms of financing

1. Senior indebtedness

Due to the large size of most LBO transactions, they tend to include syndicated loan and bond facilities.[400] For example, all of the LMA and sample ICAs included a senior debt category. The senior indebtedness also often includes ancillary and trade credit facilities dealing with the on-going financing needs of the debtor group. All of the LMA ICAs and the sample ICAs included hedging liabilities.[401]

The ICA sample included various sub-categories of senior debt which were, subject to certain deviations, regulated similarly but named differently, with the same rights and obligations. These included credit facility, permitted senior secured or pari passu

400 Kaplan and Strömberg (n 6) 124-25.

401 The definition depends on the category of the hedged indebtedness.

liabilities. Senior indebtedness often includes a revolving financing facility used for general financing purposes of the operative companies. Senior secured bonds, which may also be called pari passu indebtedness, rank equally with the senior loan facilities, albeit that they have different control and enforcement rights. If the senior debt consists solely of senior secured bonds,[402] the revolving loan facility is invariably structured as super senior indebtedness ranking in priority before the senior secured bonds.[403] However, if the structure includes term loans, the revolving facility usually ranks equally with the senior loans and bonds.[404] Senior and super senior creditors hold the first-ranking security to all the debtor group's assets. It should be noted that this type of a ranking appears to be a fairly recent development (having emerged within the sample period) and the dynamics concerning priorities are heavily dependent on the market situation. This means that the solutions encountered in the sample ICAs may not be found in empirical studies concentrating on other markets or time periods.[405]

2. Second lien indebtedness

European LBOs often use subordinated external financing in the form of mezzanine indebtedness or second lien indebtedness. The LMA S/M ICA assumes senior debt and mezzanine debt, which is contractually subordinated to the senior debt with a second-

402 The terminology varied within the ICA sample depending on the nature and the use of the bonds and included permitted senior secured notes facilities, permitted senior secured bond facilities, pari passu (loan or notes) liabilities.

403 This structure appears to have been adopted as a market convention; Interview 14.

404 ibid.

405 See generally for the effect of markets developments to contractual solutions and the restructuring law: Sarah Paterson, *Reflections on English Law Schemes of Arrangement in Distress and Proposals for Reform Paterson (March 3, 2017)* (Available at SSRN: https://ssrn.com/abstract=2926848 2017) especially at 6, 17-18 and 21.

ranking priority on the transaction security. Mezzanine debt was not used in the sample ICAs and the documents used second lien indebtedness instead. Such indebtedness has the second-ranking priority on the transaction security but the receivable ranks *pari passu* with the senior debt, except in certain distressed disposals, enforcement scenarios and security agent distributions.[406]

3. Senior unsecured debt

A number of the sample ICAs include a third main form of external financing where the debt is issued at the parent or holding company level as senior unsecured debt. These loan and bond facilities are both structurally and contractually subordinated to the senior and second lien indebtedness, if any. They are often issued in the form of high yield debt.

4. Other indebtedness

LBO capital structures and ICAs may include a number of other types of indebtedness. However, I have excluded from the analysis working capital and trade financing provided by ancillary lenders and issuers and hedging liabilities. The first two are part of the senior liabilities but are subject to distinct payment and control restrictions.[407] Such indebtedness does not materially affect the ICA priority and control mechanisms. Hedging liabilities are usually provided for currency or interest rate hedging purposes and are subject to detailed regulation. Even though they are an important part of the LBO structure, they do not

406 See Part C, Section 5.

407 Hedging liabilities connected to lower-ranking liabilities were encountered in a number of sample ICAs. Their regulation was similar to that of senior hedging liabilities.

directly affect the key propositions of the thesis. All of the LMA ICAs also feature an intra-group debt category, which indebtedness can be paid and transferred within the debtor group normally unless other financial indebtedness is accelerated.

5. Equity and shareholder funding

The equity funding of an LBO transaction comes from the acquiring private equity fund through the fund 'calling in' the partnership investments to finance a transaction and channelling the funds either as an equity contribution to the acquisition group or as deeply subordinated investor, parent or shareholder debt.

(d) Empirical evidence of high leverage in LBOs

In addition to employing several types of debt, private equity-owned groups appear to be also susceptible to high levels of leverage and are likely to create value, for example, by wealth transfers between shareholders and creditors.[408] They are also attentive to the capital structures employed on the fund level and when executing LBO transactions. According to Axelson et al., the use of leverage in LBOs may be unrelated to the factors driving the leverage of public firms, the LBO capital structures being more dependent on economy-wide credit conditions, higher availability of credit and better credit terms.[409] Malenko and Malenko similarly argue that, unlike the leverage of independent firms which is driven

408 Renneboog and Vansteenkiste (n 9) 9.

409 See on this hypothesis and the literature Axelson and others (n 360) 2242-46 .

more by firm-specific factors, LBO leverage is driven more by economy-wide and sponsor-specific factors. [410]

The higher availability and better credit terms for the private equity funds are also closely related to effects on the supply-side of financing, for example, growth of the non-bank lender activity in LBOs, such as collateralised loan obligation (CLO) structures[411] and hedge funds, and this may lead to the loosening of the covenants and other credit terms in LBO financing agreements.[412] This may be caused by the wider syndication, narrower skills and diverse incentives of such lenders, leading to higher creditor coordination costs.[413] Becker and Ivashina note that the rise of covenant-lite loans in LBOs is connected to inflows of such funding from institutional lenders.[414] The covenant levels and the LBO financing terms may also depend on factors other than the composition of the creditor-base or liquidity in the particular market segment.

Shivdasani and Wang conclude that the LBO boom of 2004-7 was fuelled by strong growth in the collateralised debt obligations market and other types of securitisation. The strong LBO lending activity was correlated with CLO underwriting by the banks. They also note that CLO-underwritten LBOs had lower spreads, weaker covenants and a larger relative amount of bank funding.[415]

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410 Andrey Malenko and Nadya Malenko, 'A theory of LBO activity based on repeated debt-equity conflicts' 117 Journal of Financial Economics 607.

411 Gilligan and Wright (n 7) 2.4.6.

412 Matthew T. Billett and others, 'Bank Skin in the Game and Loan Contract Design: Evidence from Covenant-Lite Loans' 51 839.

413 Bo Becker and Victoria Ivashina, 'Covenant-Light Contracts and Creditor Coordination (May 1, 2016)' Riksbank Research Paper Series No 149; Swedish House of Finance Research Paper No 17-1 <Available at SSRN: https://ssrn.com/abstract=2871887> accessed November 26, 2019.

414 ibid.

415 Anil Shivdasani and Yihui Wang, 'Did Structured Credit Fuel the LBO Boom?' (2011) 66 Journal of Finance 66 1291.

It should be borne in mind, when considering the private equity sponsored capital structure strategy and its effects on the debt facilities and the ICAs, that the financing structure of the LBOs is likely to evolve post-acquisition. Cohn, Mills and Towery point out that LBO firms do not actually reduce their indebtedness post-acquisition even when generating excess cash flow and that achieving sustained changes in the LBO capital structures is a conscious goal of private equity funds.[416]

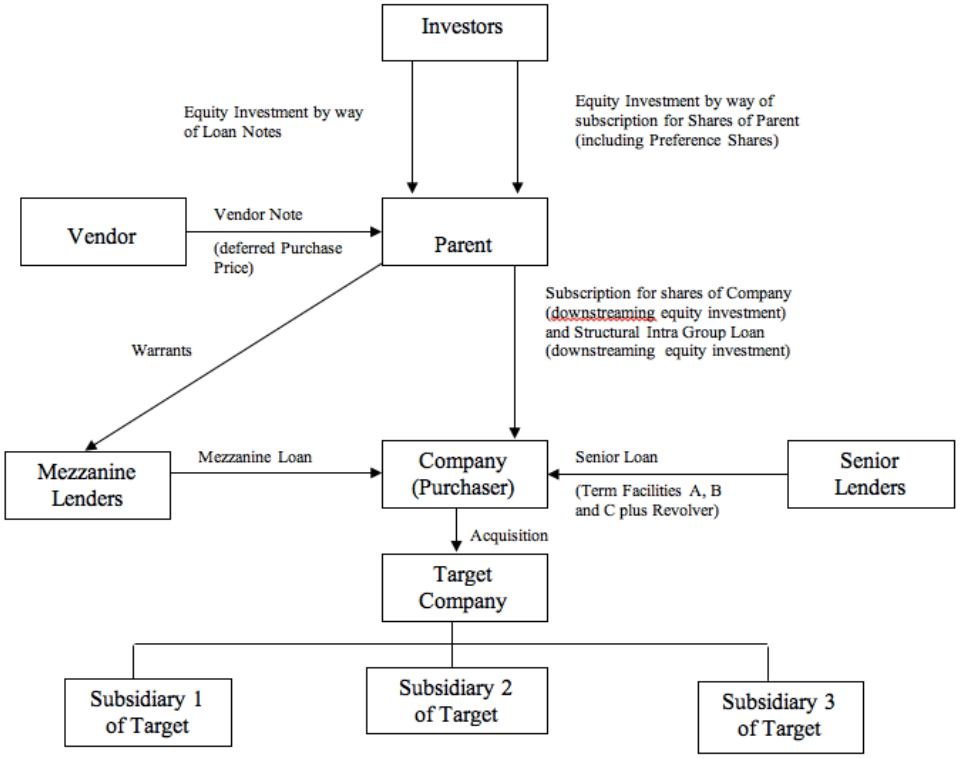
These and the number of different debt categories used in LBOs suggest that private equity firms are very attentive to the debt markets and the cost of credit that also fuels the growth in the private equity markets. When the private equity funds consider the optimal level of leverage in the target entity and the different categories of creditors, it is rational for them to take into consideration the agency costs of debt known or assumed by these creditors. This also means that it would be rational for the private equity fund to structure the transaction in a manner minimising such costs.

(e) The LMA ICA capital structures

Debt subordination is directly connected to the capital structures used in ICAs. It is, therefore, important to understand how changes in the capital structure and their terms and conditions affect the use of control rights and voting within the ICAs as well as the identity of the creditor groups that control the enforcement and restructuring procedures. The capital structure analysis also forms the basis for answering the first key proposition set out at the end of Part B, whether priority structures set out in ICAs can restrict strategic

416 Jonathan B. Cohn, Lillian F. Mills and Erin M. Towery, 'The evolution of capital structure and operating performance after leveraged buyouts: Evidence from U.S. corporate tax returns' 111 Journal of Financial Economics 469, 487-88.

creditor actions in cases of financial distress. The relevant parts of the LMA ICA capital structures are set out in Figures 1-3.



1. **Company** = the party acquiring the target and is financed primarily by Senior and mezzanine loans incurred on the company level.
2. **Debtor group** = the parent, the company and their subsidiaries.
3. The seller of the target group has provided financing in the form of a vendor note (deferred M&A purchase price)
4. The purchaser has financed the arrangement by way of down-streamed investor and parent loans.
5. **Transaction security** = granted both to the senior and the mezzanine lenders.
6. Both the claims of and the security granted to the mezzanine lenders are subordinated to the claims and security held by the senior lenders.
7. The senior lenders grant their loans under the LMA Leveraged Document and the mezzanine lenders' loan facility is based on the LMA mezzanine facility agreement drafting guide.[417]
8. **Hedging liabilities** = incurred on the company level and the hedging letter follows the LMA's recommended form of hedging letter.[418]
9. **Primary liabilities** (secured by the transaction security) = senior facility, refinancing, incremental, hedging and mezzanine liabilities.
10. **Junior liabilities** = all other indebtedness: intra-group, parent, vendor and investor liabilities.
11. **Subordinated liabilities** = vendor and investor liabilities (structurally subordinated with more restrictive repayment and enforcement terms).

Figure 1. The LMA S/M ICA structure[419]

417 Loan Market Association, *Users Guide to Form of Intercreditor Agreement for Leveraged Acquisition Finance Transactions (Senior/Mezzanine) (12 January 2017)* (n 343).

418 ibid 3-5. These cover interest and exchange risks and capped to a specified percentage of the notional loan amounts. In practice, hedging is in most cases documented using the ISDA Master Agreement.

419 Toby Mann, 'LMA Webinar, Introduction to the LMA Leveraged Intercreditor Agreement' (*The Loan Market Association*) <https://www.lma.eu.com/application/files/1714/6859/3218/Introduction_to_the_LMA_Leveraged_Intercreditor_Agreement.pdf> accessed 26 November 2019.

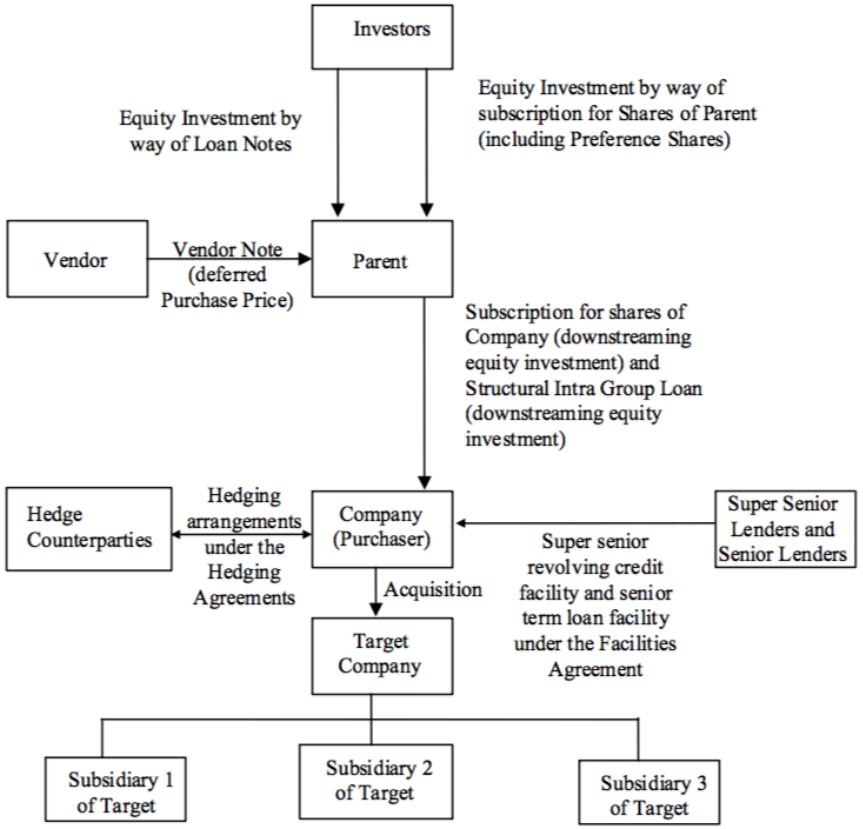


Figure 2. The LMA SS/S ICA structure[422]

1. The document includes a super senior revolving loan facility[420] and a senior term loan facility (or a bond facility).
2. The document assumes that the senior loan agreement is based on a modified version of the LMA Leveraged Document.
3. The transaction security is granted in favour of a security agent for the super senior lenders, senior lenders and hedge counterparties.[421]
4. **Hedging liabilities** = the assumptions applying to correspond to those of the LMA S/M ICA.
5. The secured **primary liabilities** = the super senior facilities, senior lender and hedging liabilities.
6. The senior liabilities rank contractually and in relation to transaction security *pari passu* with the super senior liabilities but receive distributions under the 'application of proceeds' clause only after the super senior liabilities have been fully discharged.
7. **Junior liabilities** = the structure and regulation correspond to that of the LMA S/M ICA.

Material difference to the LMA S/M ICA = no mezzanine lenders, but super senior lenders instead.

420 Multicurrency super senior revolving credit facility is made available under the Facilities Agreement and includes a letter of credit facility and provides for other ancillary facilities.

421 The Loan Market Association, *Users Guide to Form of Intercreditor Agreement for Leveraged Acquisition Finance Transactions (Super Senior/Senior), May 2018* (2018).

422 ibid.

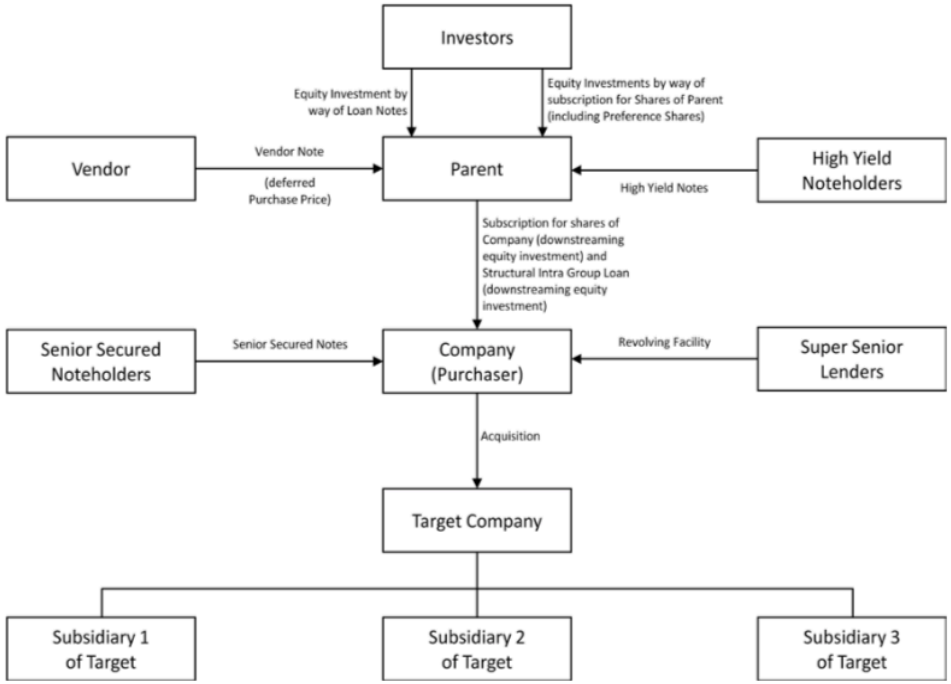


Figure 3. The LMA SS/HY ICA structure[423]

1. Three types of 'external' financing facilities = super senior revolving facility, senior secured notes and high yield notes.
2. LMA published in connection with this document the LMA super senior HY document, which deals with a similar capital structure.
3. Both a structurally and contractually prioritised super senior lender group who provide an initial revolving facility and a possible credit facility to the company.
4. **Pari passu debt liabilities** = incurred by the company to the senior secured noteholders, which can also include other securities or credit facilities.
5. Structurally subordinated **high yield notes** category = which liabilities are owed by the parent of the group.
6. The ranking: (i) credit facility, hedging and pari passu debt liabilities, *pari passu*; (ii) high yield note liabilities of debtors, other than the parent; and (iii) junior liabilities, *pari passu*.
7. The liabilities owed by the parent to the primary creditors in respect of the credit facility, the hedging, the pari passu debt and the high yield note liabilities rank *pari passu*, but in relation to the *parent*, the high yield note liabilities are senior liabilities of the parent. Enforcement measures, especially relating to the transaction security, are regulated and restricted by the ICA.
8. The security interests are divided into priority creditor only transaction security, granted in favour of the priority creditors and the transaction security granted both to the primary creditors and the high yield noteholders.
9. The regulation of the junior liabilities corresponds to those of the other LMA ICAs.

Material difference to the LMA S/M ICA = no mezzanine lenders, but super senior lenders, broader category of senior lenders and structurally subordinated high yield noteholders

423 The Loan Market Association, *Users Guide to Form of Intercreditor Agreement for Leveraged Acquisition Finance Transactions (Super Senior Revolving Facility/Senior Secured Notes and High Yield Notes), May 2018* (2018).

(f) The ICA sample capital structures

1. Structure of the sample

The ICA sample consisted of 23 leveraged financing arrangements carried out between 2011 and 2018 covering different capital structures. Most of the ICA sample documents represented hybrid versions of the LMA ICAs but also included debt categories not regulated by the LMA ICAs. The sample ICAs could not be directly grouped into the three LMA ICA structures, but could be divided into five categories, some of which resembled the LMA ICA structures but were supplemented with different debt categories. This was consistent with the comment of one interviewee that current ICAs are evolving into modular form documents, structured on a case-by-case basis.[424] It should be noted that the capital structures are heavily dependent on particular market conditions and some of the ICA solutions and terms came about within the sample period 2011-2018 and were not seen before that.[425]

2. Structural features and anomalies

The debtor group structures were similar in all sample ICAs. Although I had no access to the capital structure report[426] in a number of transactions, the structure could be implied from the ICAs. All of the group structures were multi-tiered with at least a two-level holding-company structure. If there was a parent company (almost invariably)

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424 Interview 7.

425 See generally: Paterson, *Reflections on English Law Schemes of Arrangement in Distress and Proposals for Reform Paterson (March 3, 2017)* (n 405).

426 This is a document sets out the financial, corporate and tax structure, various phases of an LBO and subsequent measures and is prepared before the transaction takes place.

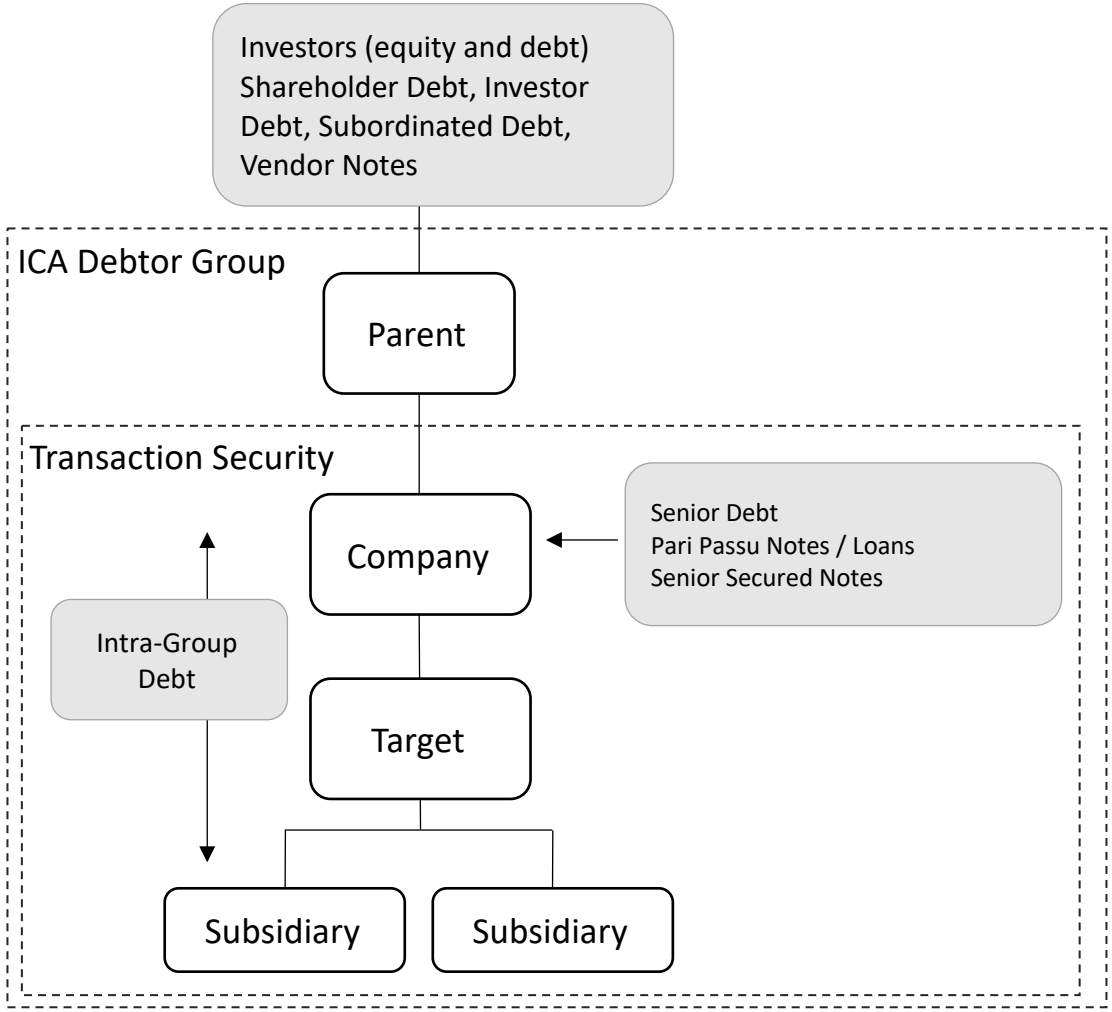
outside the ICA Group, but there existed an intermediate holding company between the parent and the primary debtor (the company), the holding company was in the ICA Group and subject to the ICA (often holding the high yield debt). The main debtor – the company – had incurred (to the extent there were such facilities in the relevant ICAs and capital structures) the super senior debt, the senior debt, the super senior and senior hedging debt, the pari passu indebtedness and the second lien indebtedness. Such indebtedness was guaranteed, depending on the facility, by the operating group companies.

To the extent that there were revolving senior facilities, these could be used by the company and the operative group owned by the company. High yield bonds, senior unsecured loans and notes were in all cases incurred by the parent of the company and were structurally subordinated. However, they were structured as senior obligations of the holding company subject to detailed enforcement restrictions. There were a number of transaction-specific financing facilities, but they did not materially affect the overall capital structure or priorities.

Intra-group debt was treated similarly in all material respects in the sample ICAs. Payments were allowed within the ICA group until a specified trigger event, usually acceleration of the senior facilities. In addition, the junior facilities, that is the investor, shareholder and structurally subordinated debt which were in practice private equity fund financing contributed to the debtor group in the form of debt, were also regulated in a nearly uniform matter throughout the sample.

Figures 4-8 show sample ICA capital structures from the least to the most complex transactions. Although the capital structures were complex and subject to detailed regulation, the terms and conditions of the debt categories were coherent, so it was possible to compare them systematically.

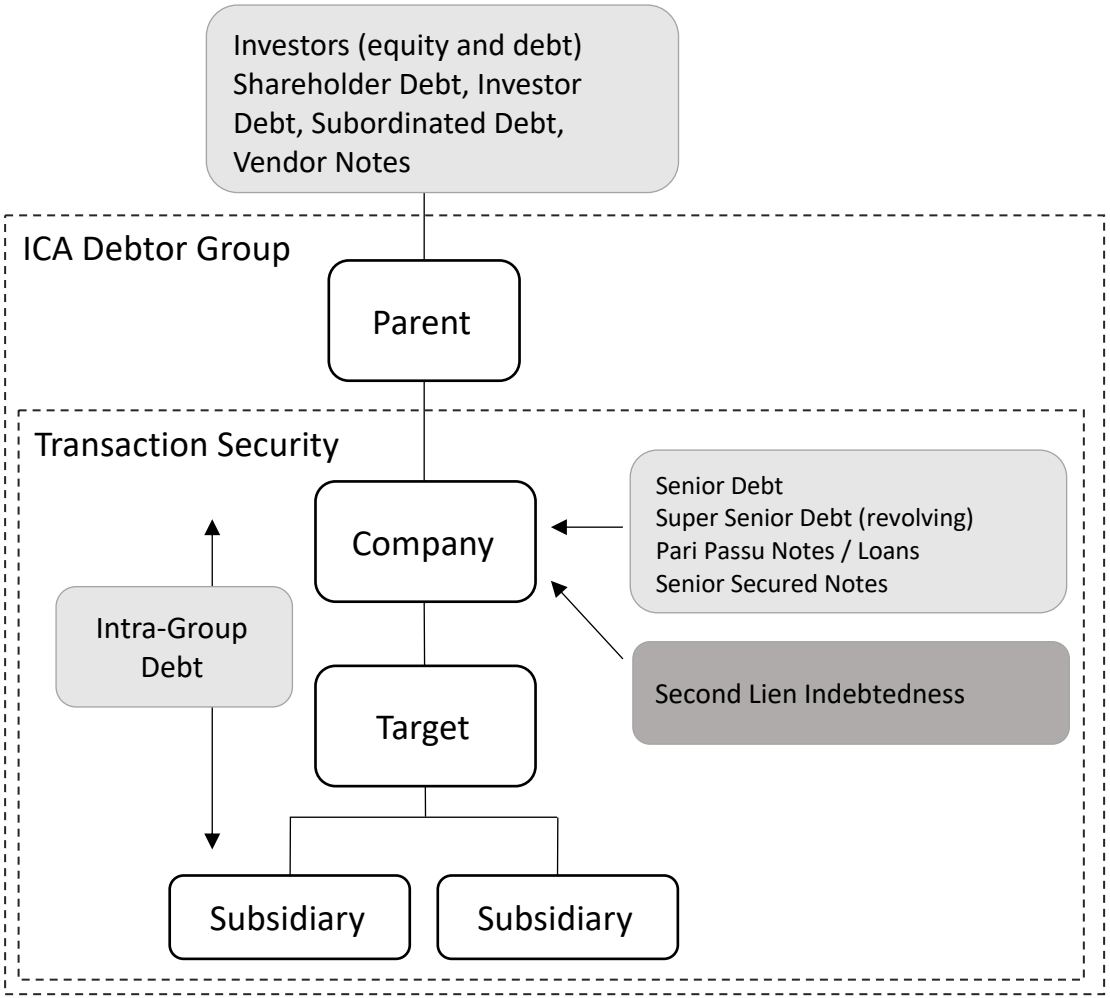
Figure 4. Group 1 ICAs.



Pure senior financing category group (6 ICAs)

Six ICAs: only one senior tranche, called either senior liabilities, senior facility liabilities or initial and refinancing facilities.
One ICA: included bond liabilities ranking *pari passu* and similarly with the senior loan facility.
All senior facilities: regulated almost identically and ranked equally with hedging liabilities.
Transaction security: granted for both the senior and hedging liabilities, but not for lower-ranking liabilities.
All ICAs: second-ranking group of intra-group liabilities.
Two ICAs: Subordinated liabilities category that ranked *pari passu* with intra-group liabilities.

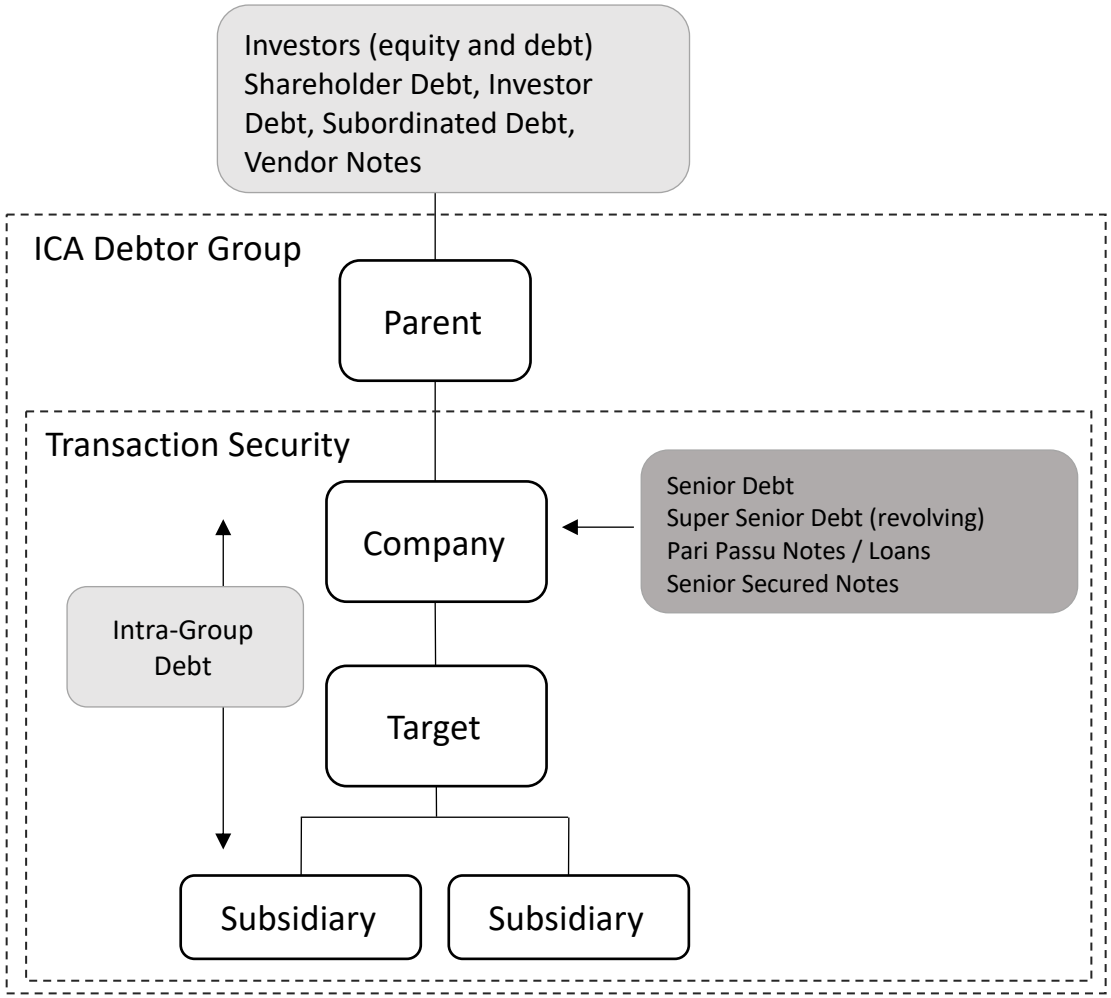
Figure 5. Group 2 ICAs.



Senior and second lien group (3 ICAs)

Three ICAs: all included a senior financing facility and a second lien financing facility, subordinated in relation to claims and the transaction security.
Other debt categories were not secured.
Two ICAs: a single senior facility tranche.
One ICA: Senior financing: transaction credit facility liabilities, senior secured notes liabilities and pari passu debt liabilities.
The clauses regulating creditor control: in all ICAs substantially similar.
All ICAs: included hedging liabilities as a part of the senior liabilities.
One ICA: Hedging liabilities part of senior liabilities without the typical clauses regulating the actions of hedging counterparties.
All ICAs: an intra-group liabilities category subordinated to all other financial claims.
Two ICAs: Subordinated liabilities tranche that ranked *pari passu* with intra-group liabilities.

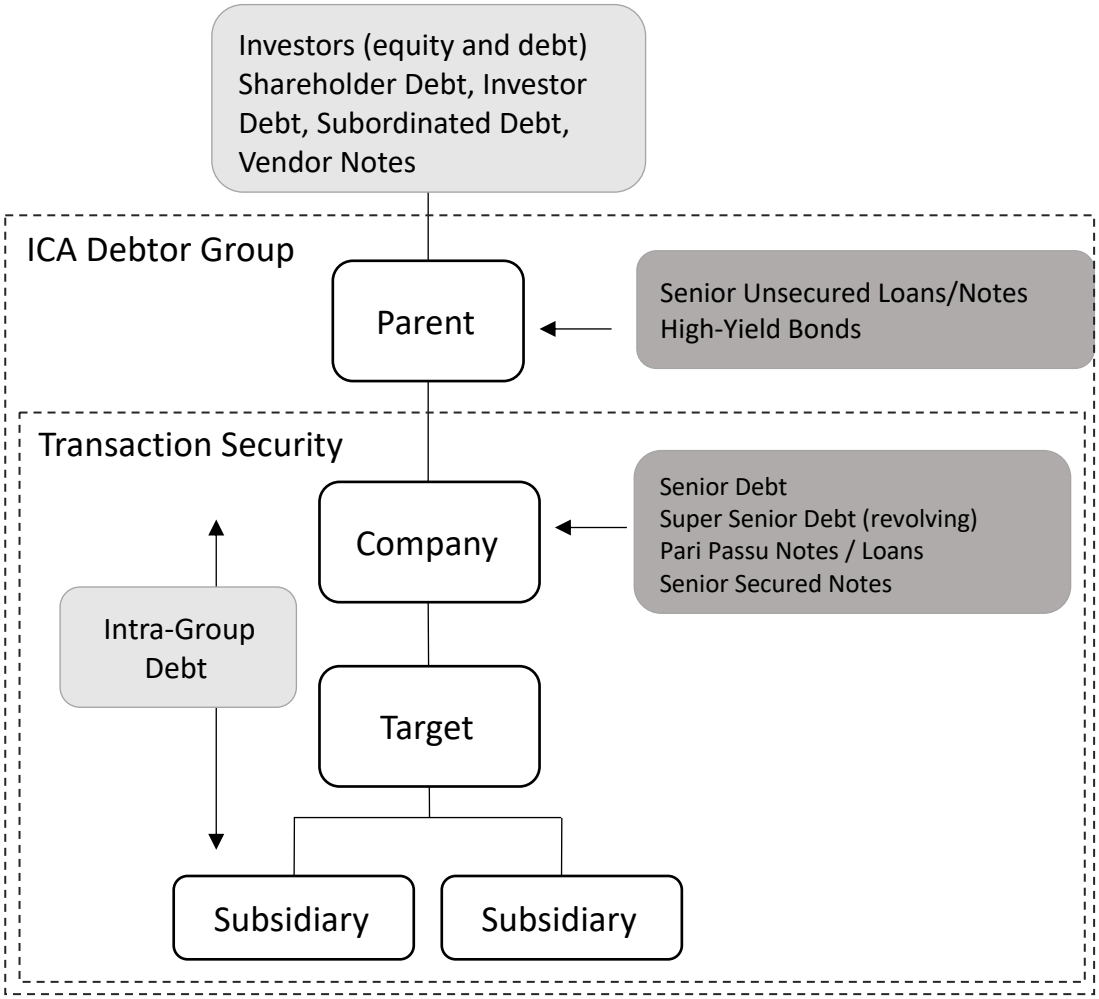
Figure 6. Group 3 ICAs.



Super senior and pari passu group (5 ICAs)

Five ICAs: group did not include a second lien tranche, but the senior financing was divided into super senior liabilities (or credit facility liabilities) and pari passu debt liabilities and similarly regulated senior secured notes liabilities.
However: all of the senior liabilities ranked equally both in terms of claims and transaction security.
All ICAs: included intra-group liabilities and subordinated liabilities or similarly regulated shareholder liabilities subordinated to the senior financing.

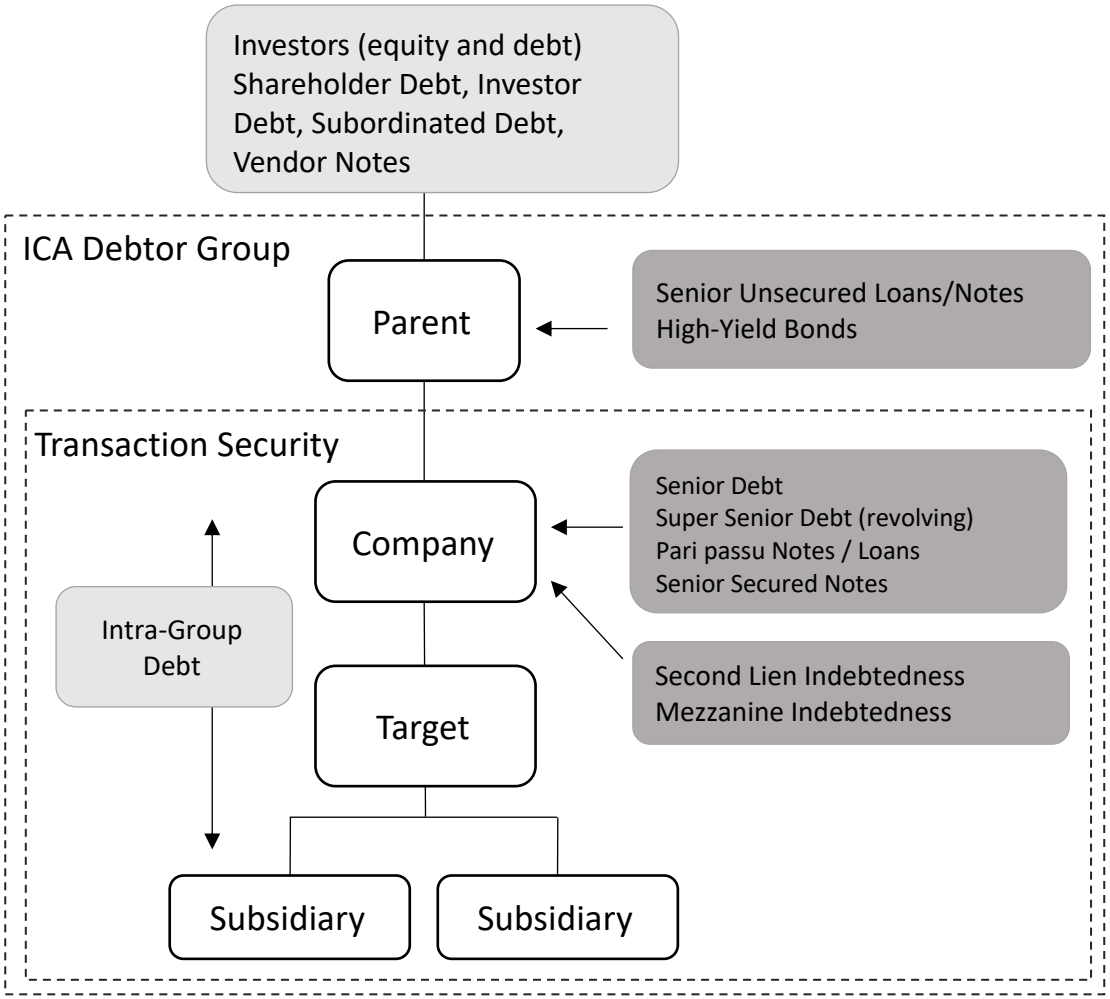
Figure 7. Group 4 ICAs.



Senior liabilities and parent liabilities group (3 ICAs)

Three ICAs: included parent or holding company liabilities within its scope.
All ICAs: senior facilities category, but there were variations in the content and number of the senior tranches.
Two ICAs: included senior lending, senior note, permitted senior financing and hedging liabilities ranking *pari passu* in terms of claims and security.
One ICA: included also operating facility liabilities category, regulated similarly to ancillary and issuer liabilities.
One ICA: included permitted super senior and senior financing liabilities, senior secured notes and hedging liabilities. The rights and restrictions applying within these categories were consistent.
The obligations of the parent of holding company: ranked equally with the senior liabilities on parent/ holding company level (the issuer under such liabilities).
On the debtor or group level: (excluding parent and holding compoany), liabilities were contractually subordinated to the senior liabilities. They also had a second ranking security over the transaction security.
All ICAs: Intra-group liabilities ranked below the other debt categories.
Two ICAs: included subordinated investor liabilities ranking *pari passu* with the intra-group liabilities. Investor liabilities were regulated similarly to subordinated and shareholder liabilities.

Figure 8. Group 5 ICAs.



Senior, second lien and parent liabilities group (6 ICAs)

Group 5 differed from group 4 by including also second lien indebtedness.
Three ICAs: the claims under the second lien tranches ranked *pari passu* with the senior facilities.
Two ICAs: the claims under the second lien tranches were subordinated to the senior liabilities.
In all ICAs: the second lien tranches were subordinated in relation to transaction security.
In all ICAs: the senior liabilities were divided into several categories, ie senior loan, cash management, hedging, senior secured loan or notes (proceeds) liabilities.
The senior unsecured and senior subordinated liabilities: parent or holding company liabilities as in group four and were senior obligations of the parent or the holding companies, ranking similarly as in group four.
Intra-group liabilities were subordinated to all other liabilities and did not benefit of the transaction security.
Four ICAs were subordinated liabilities: holding company, subordinated, investor or affiliated creditor liabilities, all ranking *pari passu* with intra-group

Although the capital structures that emerged evidenced fairly set categories of debt (albeit subject to complex case-specific regulation), they also included extensive regulation concerning new, additional and refinancing facilities that either adhered directly to the ICA or replaced one or some of the existing debt facilities. Before discussing the control rights attached to these debt categories, it is important to set out how the sample ICAs regulate new debt facilities, material changes in the capital structure and any amendments to the material terms of the facilities.

(g) Changes to capital structure

The terms of the LMA and sample ICAs included substantial possibilities for amending their capital structures. In most of the documents, the debtor group's capital structure was assumed to change during the life of the financing facilities and the ICA.[427] I will first discuss the LMA ICAs followed by the sample.

1. LMA ICAs

The LMA S/M ICA includes three alternatives for amending the capital structure and creditor categories. First, the document allows for 'senior headroom', for example, a proportional increase of the covered senior indebtedness under the SFA.[428] Secondly, the debtors can incur 'incremental senior facilities' ranking *pari passu* in terms of claims and security with the senior facilities.[429] Thirdly, the document regulates (qualifying) refinancing facilities used to refinance the senior facilities with new

427 The thresholds allowed for amending and replacing the financing facilities were regulated in the debt documents, however and are, therefore, not addressed here.

428 LMA S/M ICA 27-28.

429 ibid 13.

indebtedness.[430] The creditors and debtor groups are obligated to accept the inclusion of such new facilities subject to compliance with the contractual ICA thresholds.

The amount of refinancing facilities and any possible increase will need to be within the senior headroom and the refinancing yield cannot exceed the agreed senior yield headroom, so new financing will have to be within pre-negotiated thresholds. The maturity and average term of the refinancing facilities are also restricted.[431] The refinancing facilities have the same priority and control rights as the existing senior indebtedness, the representations and undertakings cannot be more onerous and if this is allowed, the same needs to be reflected in the mezzanine documents.

The LMA SS/S ICA provides for the establishment and inclusion of further incremental facilities that are regulated similarly to the terms of the LMA S/M ICA, but without limiting the senior indebtedness to senior headroom or yield.[432] The new 'incremental senior facilities' are governed by the same clauses as senior facilities, that is loan facilities contractually subordinated to the super senior facility liabilities.

The LMA SS/HY ICA enables refinancing of the high yield liabilities through equity issues that do not benefit from any guarantees or by the issuance of new high yield notes by the parent. It also requires that the noteholders or their representatives accede to the ICA and that the terms correspond to individually negotiated 'high yield note major terms'.[433] Even though the document does not contain provisions on incremental or qualified refinancing facilities, it governs accession of: (i) new credit facility creditors; (ii) pari passu creditors; and (iii) high yield note creditors

430 ibid 21-22.

431 ibid.

432 LMA SS/S ICA 14.

433 LMA SS/HY ICA 7.13.

and these clauses fulfil the same function as in the other LMA ICAs.[434] Designation of new credit facilities is possible after the revolving lender discharge date[435] if the new facility complies with the existing debt documents. New pari passu facilities or new high yield notes are not connected to any discharge dates but require compliance with the existing debt documents and accession to the ICA.[436] Even material changes to the capital structure are allowed if the indebtedness falls within the thresholds set out in the debt documents.

2. The ICA sample

All sample ICAs enabled the parent of the group to incur additional financing, designating it to the existing debt categories, amending and releasing security for that purpose, and replacing and refinancing all of the debt facilities, provided that such financing complied with the debt documents. None of these facilities required creditor consent and they were always governed by the ICA. The only practical restriction concerned compliance with the debt documents and the ICA terms. A number of the interviewees noted that the parent and the debtors are in most cases under the SFAs and the ICA entitled to incur additional unsecured financing not covered by the ICA.[437]

Eight ICAs did not include specific clauses regulating refinancing facilities, of which two had a limited qualifying refinancing clause or a possibility of re-tranching the senior notes.[438] In addition, even though some lacked specific clauses, all ICAs

434 ibid 3, 4 and 7.

435 ibid 22.12.

436 ibid 22.13.

437 Interviews 6-14.

438 One of these eight ICAs included extensive reference to 'Permitted Financing' that, although not clear from the terms, most likely also covered refinancing facilities.

included definitions of liabilities or additional liabilities that referred, among other things, to the refinancing of the existing liabilities.

Of the ICAs that did not contain specific refinancing clauses, the capital structure usually had only senior, hedging and intra-group and subordinated liabilities. In four of the contracts, the capital structure was more complex and no connection could be established between the capital structure and the refinancing clauses. None of the ICAs included specific content requirements for the terms of the refinancing debt. However, the documents required all new secured creditors to accede to the ICA and the transaction security be extended to all such parties.[439]

While there was considerable variance in the clauses dealing with the additional and refinancing facilities, they followed in all cases the same pattern: they ranked either *pari passu* with and also, in five cases, in priority to the existing liabilities. Ranking of new debt in priority to senior secured liabilities was, however, restricted in all documents.

Fifteen of the sample ICAs included extensive clauses variously regulating both additional, incremental and refinancing indebtedness, the security interests relating to such debt, designation by the parent of various categories of debt, disapplication of the rights of all the creditor groups to object to such new financing and its inclusion in the scope of the ICA. Only one of these did not mention refinancing facilities, but this may have resulted from refinancing being covered by the 'additional liabilities' definition of the SFA.

All the complex ICAs included broad clauses covering all additional and refinancing debt and security and required that such financing be categorised to one of

439 The majority of the ICAs lacking the relevant clauses belonged to group one, where they were not necessarily required.

the existing liability categories, being subject to the same provisions concerning security interests. The designation was determined in all cases by the parent, giving it broad leverage to change the group's capital structure.[440]

In eight ICAs, there were terms enabling the sharing of existing security among the existing and new indebtedness, the creation of additional security documents and the option to release and retake security in connection with new debt. Six ICAs included even more extensive clauses relating to the release and retake of security in a manner that ensured that the rearrangement did not cause any adverse consequences to the parties. This also meant that existing and new security interests benefitted all the same-priority creditors *pari passu* and in accordance with the ICA, even where there were jurisdiction-specific restrictions. To the extent that the debt documents permitted new financing, the existing creditors were obligated to co-operate with the debtors to enable such financing and sharing of security. In all cases, financial creditors authorised their facility agent to carry out any measures and to execute any amendments reflecting such arrangements, the creditors having no independent right to interfere with the arrangements.

[440] In limited cases, introduction of a new priority revolving credit facility led to the creation of a new 'super senior' category.

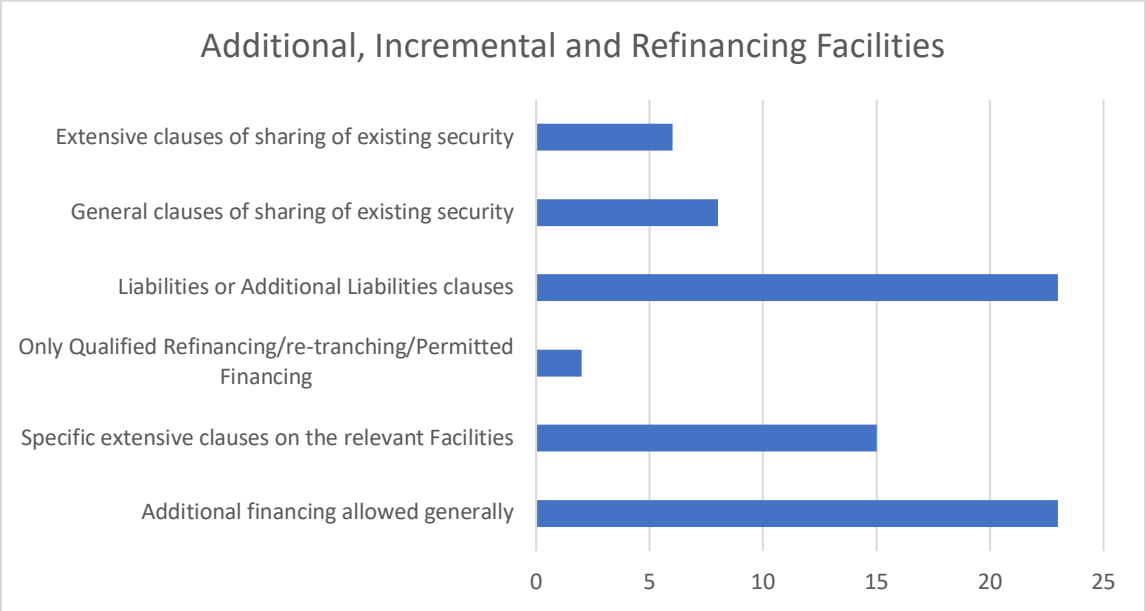


Figure 9. Additional, incremental and refinancing facilities

In summary, the LMA and sample ICAs were consistent in ensuring that any new and refinancing creditors acceded to the existing creditor classes, to the extent approved in the debt documents. There were no systematic deviations from the logic adopted in the LMA ICAs that all incurred financial indebtedness should be regulated under consistent rules and creditor categories. Both the LMA and sample ICAs were, therefore, consistent in maintaining their creditor categories and priority regime even with new indebtedness. The only material deviation was that certain incremental and additional facilities did not have to be included in the ICA (unless they were secured with transaction security) and the parent and the private equity fund could effectively choose to leave certain financing outside the ICA regulation.

(h) Market views on the regulation of capital structures

The results of the content analysis were also reflected in the interviews. One interviewee noted that leveraged loans are becoming more akin to bonds and there is in general more flexibility, for example, to incur additional debt and to trade for longer

before triggering loan acceleration clauses.[441] Some noted that the ICAs need to give as much flexibility as possible for the capital requirements of the business, enabling the incorporation of new financing into the existing structure,[442] and that the private equity houses often require this flexibility.[443]

One interviewee pointed out that the borrower's side is happy to have a full-blown ICA because it allows the flexibility to do various things to the capital structure without having to renegotiate the deal.[444] Some noted that, despite the broad additional financing options, light security packages and non-ICA incremental financing may threaten the effectiveness of the ICA.[445] It was also pointed out that the parties aim to keep the private equity house and the management outside the ICA group, except for their claims from the ICA group companies.[446]

The interviewees expressed strong views about the incremental and additional debt capacity and whether and to what extent they are and should be included in the ICA. Their views depended primarily on the interviewees' business affiliation. Some argued that the levels of permitted non-included debt should not be so high as to impede the effectiveness of the ICA in a distress scenario.[447] The same concerns applied to transfers of assets into companies where the creditors have no recourse, or even to transfers outside the group.[448] Based on the content analysis and interviews, ICAs were used invariably as long-term structural documents capable of accommodating new debt.

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441 Interview 2.

442 Interviews 6, 7, 9, 10 and 11.

443 Interviews 1, 2, 7, 8 and 12. It was also noted that this development has been driven by the need to make ICAs more attractive to US funds; interview 6.

444 Interview 7.

445 Interview 14.

446 Interview 8.

447 Interview 14.

448 Interviews 4, 6 and 14.

(i) Amendments to the terms

The reason why the amendment rights of different debt categories are important for analysing strategic creditor actions, especially the risk of hold-out behaviour, is because material amendments can affect the agreed priority structure in a similar manner to incurring new debt. Amendments to the loan terms also affect the relative leverage of the creditor groups through, for example, changes of maturities, costs, interest and covenants, which are the contractual triggers for control.

1. LMA ICAs

The LMA ICAs restrict all material amendments not allowed in the original debt documents in relation to facilities other than the first-ranking senior liabilities. The restrictions and exceptions applying especially to the mezzanine facilities are extensive. Amendments to high yield bonds are only allowed insofar as they comply with the initial material high yield terms. Amendments to the junior indebtedness are also heavily restricted, whereas intra-group liabilities can be amended without material constraints.

Other than the specific mezzanine exceptions, the amendment restrictions are controlled either by the majority senior creditors or the higher-ranking majorities together, thereby protecting the existing priority structure. The main amendment restrictions in the LMA ICAs are set out in Table 7 for ease of comparison with the ICA sample.[449] The creditor group whose consent is required to waive the restrictions is mentioned on the right-hand column of the table.

[449] Minor amendment provisions are omitted here.

2. LMA S/M ICA

Table 7. LMA S/M ICA amendments

	AMENDMENT RESTRICTIONS	WAIVER/CONSENT
Senior facilities	No general restrictions	
	Hedge counterparties' approval is required for changes to guarantees, indemnities and their release, unless allowed in the debt documents, and in non-distressed disposals. Guarantor resignation is not allowed unless the hedge counterparties approve or there are no payments due from the resigning guarantors.[450]	Hedge counterparties
	Changes to capital and margin allowed within senior headroom or the margin and the fees exceeding the senior yield margin require majority mezzanine creditor approval.	Majority mezzanine creditors
	Deferral of the termination date of the senior indebtedness past pre-agreed dates and certain payment increases are restricted.[451]	Majority mezzanine creditors
Mezzanine facilities	Generally allowed	
	Changes concerning amount, currency, dates or terms of repayment and prepayment of the facilities, waivers of interest, fees or commission, prior to the senior discharge date are restricted.	Majority senior creditors (all of the below)
	Additional or increased payments and to more onerous representations, undertakings, financial covenants or events of default are restricted.	
	Conversion of due cash interest to capital interest, increase of the mezzanine PIK margin (pre-agreed limits) are exempted.[452] Taking additional security not part of the existing or new senior creditor security package is prohibited. [453]	
Subordinated liabilities	Allowed if technical or if consented to	Majority senior creditors and majority mezzanine lenders
	Taking of security in relation to any of the junior liabilities, with the exception of vendor liabilities, is prohibited unless explicitly allowed by the debt documents.[454]	
Intra-group liabilities	No restrictions	

450 ibid 3.4.

451 LMA S/M ICA 3.3.

452 LMA S/M ICA 5.8.

453 ibid 5.10.

454 ibid 7 and 8.

3. LMA SS/S ICA and LMA SS/HY ICA

Table 8. LMA SS/S ICA and LMA SS/HY ICA amendments

	AMENDMENT RESTRICTIONS	WAIVER/CONSENT
Credit facility, pari passu debt, hedging and super senior liabilities	No restrictions for amending the credit facility liabilities, pari passu debt liabilities or hedging liabilities. Changes to guarantees, indemnities and their release require similar consent as with LMA S/M ICA.	Hedge counterparties
High yield liabilities	Only the parent can issue high yield notes, the terms of which will need to comply with separately agreed high yield note major terms.[455]	Required super senior creditors and required pari passu creditors
Subordinated liabilities	The same restrictions apply as in LMA S/M ICA.	Majority senior creditors and requisite high yield noteholders /representative
Intra-group liabilities	No restrictions	

4. The ICA Sample

The limitations applying to all senior liabilities were consistent with the LMA ICAs. However, there were very few restrictions on amending the senior liabilities in the ICA sample, which were encountered in the LMA S/M ICA. The amendment restrictions applying to second lien liabilities also deviated from the LMA S/M ICA provisions applying to mezzanine liabilities. The corresponding LMA clauses were, therefore, mostly absent from the sample, having been in general moved to the SFAs, most likely to their 'permitted amendments' and general and financial covenants clauses.

Regulation of amendments to the parent or holding company liabilities was limited due to their structural subordination, and amendments may have been of little value because the payments allowed to the parent or holding company from the debtor group were heavily restricted by the sample ICAs (see Section 4d of this Part C). No amendment restrictions applied to the intra-group liabilities and the regulation was

455 LMA SS/HY ICA 7.1.

consistent with the LMA ICAs.

Despite the specifically negotiated deviations set out in the sample, the higher-ranking majority creditors effectively controlled all amendments either through restrictions explicitly in the debt documents, or through the majority consent requirements. These restrictions supported the view that the creditor priority regime established by the ICA could effectively be controlled by general and financial covenants used in the debt documents and by the ICA senior creditor majority control clauses that restrict negative incentives to circumvent the agreed priority structure. Table 9 summarises the results of the sample ICA terms amendment restrictions.

Table 9. Sample ICA amendment restrictions.

	AMENDMENT RESTRICTIONS	MAIN EXCEPTIONS	WAIVER/CONSENT
Senior liabilities	**11 ICAs:** no Restrictions	**1 ICA:** amendments subject to a statutory authorisation (transaction-specific matter) **1 ICA:** broad restrictions on any changes to material SFA definitions **6 ICAs:** only a restriction on increasing the senior liabilities with more than a 'principal increase', unless allowed in debt documents **4 ICAs:** explicit restrictions on changes to SFA guarantees and indemnity clauses similar to LMA S/M ICA **1 ICA:** restrictions on senior principal, margin, basis for calculation, payments deferral and increases exceeding senior yield headroom and imposing more onerous obligations on the debtors	Required pari passu creditors Majority second lien creditors / requisite unsecured creditors Hedge counterparties Majority second lien creditor
Second lien liabilities	**6 ICAs (of 9):** amendments not in compliance with the debt documents not allowed **In 2 of these:** restrictions on allowed increase in the liabilities (implicitly assumed in all ICAs)	**1 ICA:** LMA S/M ICA -type restrictions	Majority senior creditors
High Yield Liabilities	**Generally**: no restrictions due to structural subordination (regulated in the debt documents)	**6 ICAs** (more complex capital structure): restricted amendments that would lead to non-compliance with the debt documents	Majority senior creditors or majority senior creditors + majority second lien creditors
Subordinated Liabilities	**9 ICAs:** no restrictions (due to extensive payment and enforcement restrictions)	**14 ICAs:** changes subject to majority consent **4 ICAs:** if intended to enable parent/holding company to make payments to its creditors, if also allowed under the debt documents and the ICA **2 ICAs:** amendments having material adverse effects on the secured parties, ranking of the claims, changes to principal amounts, repayment before the final discharge date and obligations conflicting with the ICA restricted **More complex ICAs:** amendments restricted, if leading to recourse in relation to the debtor group (structurally 'below' the parent or holding company debtor)	As above (for all exceptions)
Intra-Group Liabilities	LMA S/M ICA -type restrictions	-	-

(j) Protective clauses

Despite the robustness of the priority regime and the restrictions applying to the debtor group's capital structure and ICA amendments, the creditors may still be incentivised to circumvent the agreed regime and engage in strategic creditor actions to enhance their position in a distress scenario. For this purpose, we would expect to see protective clauses used in the ICAs to ensure that any remaining negative incentives are eliminated.

All LMA and sample ICAs included provisions protecting the agreed priority regime. The main clauses dealing with this risk were: application of proceeds, anti-layering, purchase option, turnover, redistribution and equalisation clauses. The last three also protect against deviations from the creditor control regime and against hold-out behaviour but, due to their dual function, they are discussed in sections 3(j)5-7. The basic features of these provisions and the times when they can be resorted to during the life of the debt facilities is set out below in Figure 10.

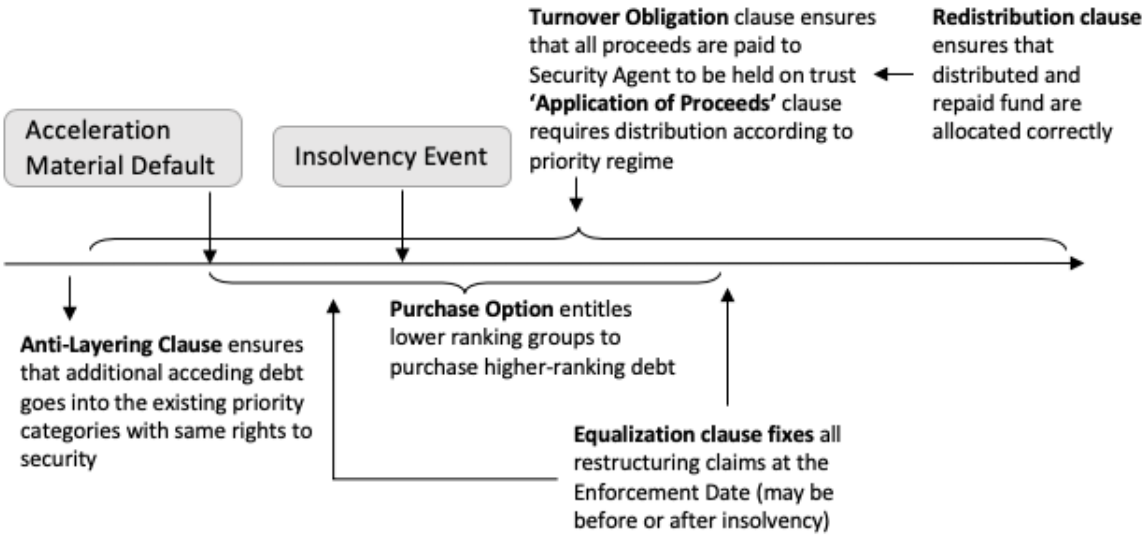

Figure 10. Provisions protecting the priority regime

1. Application of Proceeds

The LMA ICAs

The 'application of proceeds' clause follows the general priority clauses applying to all recoveries received from the debtor group not permitted by the ICA and to enforcement recoveries from the transaction security, guarantees and proceeds received in a distress disposal or liabilities sale.[456] The clause ensures a *pari passu* distribution within each creditor group and in priority between different groups. Possible hold-out behaviour is restricted by the requirement to hold all non-permitted payments and realisations that the creditors may receive on trust and turn them over to a security agent for distribution in accordance with the provision.[457]

In the LMA S/M ICA, the sums owing to the security agent rank first, followed by costs incurred by any primary creditors in connection with the realisation or the enforcement of the transaction security. The senior facility liabilities and hedging liabilities are paid next, followed by the mezzanine liabilities. The last liabilities are any items prioritised to the claims of the debtors. Any remaining balance is paid to the debtor.[458]

The LMA SS/S ICA distribution clauses correspond to those of the LMA S/M ICA, except that the first-ranking super senior facility liabilities and super senior hedging liabilities (*pro rata*) are paid before the senior lender liabilities and senior hedging liabilities (*pro rata*). Although they rank *pari passu* under the general ICA priority clause, any amounts recovered by the security agent, whether under any debt

456 LMA S/M ICA 18.1.

457 ibid.

458 ibid.

document or in connection with the enforcement of the transaction security, are paid first to the super senior creditors.[459]

Under the LMA SS/HY ICA, the credit facility liabilities and the super senior hedging liabilities (*pro rata*) are paid before *any* pari passu debt liabilities or pari passu hedging liabilities (*pro rata*). The high yield note liabilities rank third, but they do not entitle their holders to any recoveries from priority creditor only transaction security. Otherwise, the waterfall provisions correspond to those of the other LMA ICAs.[460]

2. The ICA sample

All of the sample ICAs included an LMA ICA-style 'application of proceeds' clause and standard payment priority clauses in relation to the security agent's costs, enforcement costs, and the costs of trustees and agents generally, in line with the LMA ICAs.

In all the sample ICAs, the application of proceeds clauses reflected the general ICA priority clauses. When the sample ICAs included super senior liabilities and pari passu liabilities, the security agent was required to distribute first to the super senior creditors (if any), then to the pari passu creditors. If the transaction also included term loan liabilities, the claims were distributed *pari passu* and *pro rata*. This corresponded with the views of the market participants.[461] In addition, there were transaction-specific priority provisions that regulated distribution of the enforcement proceeds from specifically carved-out security interests. In other respects, the

459 LMA SS/S ICA 19.1.

460 LMA SS/HY ICA 18.1.

461 Emphasised in interview 14.

application of proceeds corresponded to the LMA ICAs.

3. Anti-layering prohibition

The LMA ICAs include a reference to the parties' possible need to include anti-layering clauses to the ICA, but the LMA ICAs do not themselves provide template wording for such clauses. In the ICA sample, anti-layering clauses were used to prohibit the addition of loan or notes facilities between a particular senior facility and a lower-ranking facility. The clauses did not prohibit incurring additional, incremental, or refinancing debt in any of the sample ICAs if they were included in the existing debt categories.

Ten of the sample ICAs did not have an anti-layering provision, but a majority of these were category one ICAs that included only the senior liabilities class. All but one of the ICAs that had a second lien facility included a standard anti-layering clause according to which, unless subordination was based on statutory law, the consent of the majority senior creditors and majority second lien creditors was required for incurring indebtedness ranking between the senior and the second lien liabilities. Two documents included anti-layering clauses between credit facility or super senior liabilities and senior notes or pari passu debt liabilities. In these cases, the debt categories were all part of the senior class, ranking *pari passu*. The sample contained non-material deviations from these mechanisms.

4. Purchase options

All the LMA ICAs enable the lower ranking financial creditors to purchase the higher-ranking indebtedness, triggered, for example, by acceleration, the material event of default, or on discharge dates. This protects the lower-ranking creditors if enforcement or a distressed disposal is valued lower than the senior liabilities and the subordinated

creditors consider the actual value of the debtor group as more likely falling within their claims, after full payment of the senior facilities. However, the use of a purchase option may not be feasible in practice for the subordinated creditors due to high costs.

The transfer price in all of the LMA documents was the total of the amount of the senior liabilities and other higher-ranking liabilities, the accrued interest, possible prepayment fees, costs and expenses. The purchasing creditors were entitled also to require a transfer of the hedging liabilities simultaneously with the senior liabilities' transfer. Table 10 sets out the purchase option regime in each of the LMA ICAs.

Table 10. LMA ICA purchase options

LMA ICA	Purchase options
LMA S/M ICA (s. 5.14)	Mezzanine creditors have a purchase option in relation to senior liabilities and the hedging liabilities.
LMA SS/S ICA (s. 6.1)	Senior creditors have a purchase option in relation to the super senior liabilities and the hedging liabilities.
LMA SS/HY ICA (s. 6)	Pari passu debt creditors have a purchase option in relation to credit facility liabilities and the hedging liabilities. High yield noteholders have a purchase option in relation to credit facility liabilities, the pari passu debt liabilities and the hedging liabilities.

Five of the 23 sample ICAs did not contain a purchase option although the capital structures of four of these had only senior and hedging liabilities and intra-group and subordinated liabilities (so that no such option was required). In one ICA, the structure included equally-ranking senior facility and bond indebtedness, but in this case, both were regulated within the same debt category.

In eleven ICAs, the purchase options were triggered by a distress event.[462] In four cases this was by virtue of an acceleration event or senior acceleration event.[463]

462 In most ICAs distress event referred to: an acceleration event, the enforcement of any transaction security, or the giving of an initial enforcement notice to enforce transaction security.

463 In all ICAs acceleration event referred to the relevant creditors initiating an acceleration of their claims under the relevant loan or note facility.

In one ICA, the trigger was a material event of default and, in another, the enforcement of shared security. Three of the ICAs, which had second lien facilities, included triggers linked to second lien payment defaults, automatic defaults or second lien acceleration.

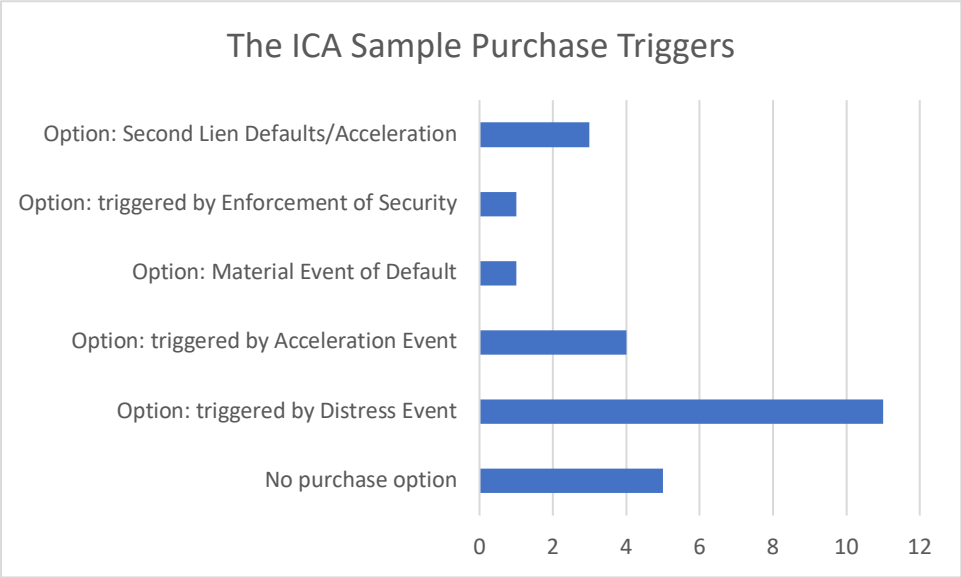

Figure 11. ICA sample purchase triggers

One ICA which had only one senior liabilities class included a purchase option for 'unitranche lenders' concerning the revolving facility liabilities. All of the ICAs that included second lien facilities enabled the purchase of the senior liabilities with a right to require hedge transfer. All ICAs that included pari passu debt, notes liabilities or senior notes liabilities had a purchase option for these lower-ranking creditors. The purchase options were more complex if the capital structure included a parent or holding companies.

In three transactions that did not include second lien financing but included senior unsecured indebtedness, the senior noteholders had the first purchase option in relation to the senior (secured) liabilities and the parent and holding company creditors had a purchase option in relation to the higher-ranking liabilities. When the capital

structure also included a second lien facility, the ICAs always included the second lien creditors' purchase option in relation to senior liabilities. This option ranked before that of possible senior unsecured creditors. The sample ICAs included some deviations from these, but they were non-material.

5. Turnover obligation

The 'turnover' clauses also protect the priority ranking. These obligate a recipient to hold any funds listed below on trust for the security agent and promptly turn over such funds and receipts to the security agent:[464]

> (i) payments concerning liabilities that are not permitted payments under the debt documents;
>
> (ii) payments concerning liabilities by means of set-off (excluding insolvency set-off) if not giving effect to a permitted payment;
>
> (iii) notwithstanding (i)-(ii) and the set-off exemption, any payment of liabilities received after a distress event (or by set-off after such event) or as a result of litigation against the debtor group (not including insolvency-related events);
>
> (iv) proceeds of enforcement of transaction security; or
>
> (v) other than concerning the insolvency set-off exemption, any amounts paid and payment of liabilities after an insolvency event.

The LMA ICAs create a trust over all receipts to protect the creditors from the recipient's insolvency risk. Such a risk is pronounced when, for example, the recipient is a connected party whose solvency is linked to the solvency of the actual debtor. A similar obligation applies to any sums received by the debtors that should

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464 LMA S/M ICA 10. The LMA ICAs exclude close-out and payment netting under hedging facilities and ancillary lenders' rights of netting up to pre-negotiated limits relating to multi-account overdraft facilities.

have been paid to the security agent. The security agent distributes the receipts in accordance with the 'application of proceeds' clause after the receipt of the funds. The LMA ICAs include 'savings provisions' applying if the trust fails for some reason, obligating the recipient to make prompt payments to the security agent.[465]

Consistent with the LMA ICAs, all of the sample ICAs included a turnover clause protected by the creation of a trust, using similar solutions and applying to all creditor categories, including hedging liabilities. The same exemptions applied to refinancing recoveries and recoveries by means of equalisation.[466] The only material differences were connected to the specific capital structures of the transactions. The same logic applied in all cases to sums received by the debtors which should have been contractually paid to the security agent.

In some ICAs, however, insolvency event-related distributions were not covered.[467] The ICAs' 'effect of insolvency' clause[468] leads to a similar obligation to direct payments and distributions to the security agent as the turnover obligation, so the adopted solutions in the ICAs were consistent throughout the sample. If the trust was not recognised in a particular jurisdiction, the documents re-characterised the relationship as one of principal and agent.

If the capital structure allowed permitted parent financing debt to be used for the repayment of the same priority indebtedness, any recoveries were excluded from the turnover obligation. In some ICAs that enabled non-cash distributions, the clause specifically mentioned turnover and valuation of non-cash distributions. In the majority of ICAs, however, the turnover clauses would also have caught such distributions. The

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465 LMA S/M ICA 10.6.

466 See Part C, Section 3(j)7.

467 Insolvency Events clauses are addressed in Part C, Section 4(g)1 and 2.

468 Part C, Section 4(g)2.

majority of the documents also included a 'saving' provision similar to the LMA ICAs. There were some non-material deviations in the sample.

6. Redistribution

A 'redistribution' clause states that any amounts distributed by a creditor to the security agent under the 'effect of insolvency' or the 'turnover of receipts' clause are treated as having been paid by the relevant debtor to the security agent, instead. Any such amounts are then distributed in accordance with the 'application of proceeds' clause.

This clause operates as a mirror-image of the turnover clause. If a creditor distributed a sum to the security agent and the sum was then distributed to the creditors under the 'application of proceeds' clause and, if the amount would have to be repaid to the debtor, all creditors, having received the funds, were obligated to repay them *pro rata*.

The redistribution clauses were consistent in all LMA ICAs,[469] and are protected by a deferral of subrogation clause, which applies to all situations where a creditor would under general law be subrogated to the rights of another creditor resulting from the performance of its obligations under the debt documents, ie potentially having the benefit of ranking ahead of prioritised obligations. Such a subrogation is only allowed if all liabilities owed to prior-ranking creditors have been discharged in full.[470]

Whereas the redistribution clause protects the receiving creditors against clawback of debtor payments, the deferral of subrogation clause protects the priority

469 LMA S/M ICA 11, LMA SS/S ICA 12 and LMA SS/HY ICA 13.

470 ibid. In addition, the LMA SS/HY ICA allows high yield creditors to be subrogated to the rights of the priority creditor liabilities if they are paid out of the proceeds of the high yield note liabilities.

regime and restricts any interference of the lower-ranking creditors concerning the enforcement before the full discharge of the higher-ranking liabilities.

All of the sample ICAs contained a redistribution clause substantially similar to that of the LMA ICAs. One of the ICAs did not include a deferral of subrogation clause, however. The deferral of subrogation applied in the sample documents also to the shareholder lenders and intra-group lenders, until all prior creditor claims were discharged.

7. Equalisation

The LMA ICA 'equalisation' clauses ensure that the total enforcement distributions are allocated in accordance with the claims of the creditors on the date of the commencement of enforcement proceeding, or the enforcement actions.[471] This mechanism ensures that any 'post-trigger event' lending and financing arrangements do not affect the negotiating leverage of the relevant creditors. The total actual claims of the creditors are determined on the enforcement date and any distributions deviating from the *pro rata* exposures are equalised between the relevant creditors.[472]

If the security agent was obligated to make payments to the primary creditors when not all the highest-ranking creditors had been fully repaid, the relevant primary creditors would need to implement the equalisation. The equalisation clauses, therefore, fix the claims to a specific moment during the voluntary restructuring negotiations. The solution is similar to fixing creditor claims taking place at, for example, the commencement of the statutory insolvency procedure.

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471 LMA S/M ICA 19. Eg acceleration of liabilities, making liabilities due and payable or declaring them payable on demand, guarantee claims and steps to enforce the transaction security.

472 LMA S/M ICA 19, LMA SS/S ICA 20 and LMA SS/HY ICA 19.

All but one of the sample ICAs contained an equalisation clause similar to the LMA ICAs. The reason for this one exception appeared to be the relatively simple capital structure. In all of the ICAs, the date for determining the creditor claims was the enforcement date. The time for carrying out the equalisation calculation was in all cases the time at which the controlling creditor group took specific enforcement actions, which all the sample ICAs defined in the same way. The summary of the results relating to the sample ICA clauses that maintain the corporate capital and priority structure is set out in Table 11.

Table 11. Capital structure protective clauses

	LMA ICAS	**SAMPLE ICAS**
Application of Proceeds	Follows the general priority regime	Consistent with the LMA ICAs, but incorporating additional creditor categories
Anti-Layering	Clause mentioned, but not included	Used consistently in all ICAs with more than one external financial creditor category
Purchase Options	Purchase options for lower-ranking external financial creditors and simultaneous right to require Hedge Transfer	Consistent with the LMA ICAs
Turnover	All proceeds (other than specifically allowed) to be turned over to security agent to be held on trust for ICA distribution	Consistent with the LMA ICAs
Redistributions	Incorrectly paid sums remitted, recalculated and redistributed	Consistent with the LMA ICAs
Equalisation	Creditor claims fixed on the trigger date and all distributions equalised in accordance with the set proportions	Consistent with the LMA ICAs

4 Creditor control

(a) Introduction

Breach of the debt documents will, subject to cure rights, entitle a creditor to enforce its claims against the company and its assets, commence judicial and debt collection

proceedings and, if the statutory requirements for administration or liquidation are met, to commence such a procedure. This makes creditor control, in its nature, contingent.[473] In the debt documents, with the exception of statutory insolvency covenants, the triggering of such control rights often occurs prior to the statutory insolvency triggers.[474] The moratoria or protections under the statutory procedures may not, therefore, be available at that time.

The LMA ICAs fix the commencement of contractual standstill periods to events of default and covenant breaches under the debt documents and include creditor control rules that apply before the occurrence of such as trigger events. In such cases, the creditor control operates through the amendment clauses and the controlling group's ability to grant waivers and consents to the debt documents.

The documents provide two mechanisms for dealing with the hold-out risk, payment restrictions and enforcement restrictions. These are supported by protective clauses that reduce the possible remaining incentives of the creditors to affect the operation of the contractual regime.

As I proposed in Part B, the hold-out risk has to be dealt with on two levels; within each creditor class and also between all creditor classes. The horizontal aspect is regulated primarily by the individual debt documents to the extent that they are syndicated, and the vertical aspect by the ICA between the creditor groups. Although not a part of the actual content analysis, I will address the question of creditor control in SFAs first because they form the basis for the use of the highest-ranking creditor group control at the intercreditor level.

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473 Sarah Paterson and Rafal Zakrzewski (eds), *McKnight, Paterson, and Zakrzewski on the law of international finance* (Second edn, Oxford University Press 2017) 3.19.

474 ibid 3.19.5.

(b) Creditor actions on the facility level

1. Collective and individual actions

Control of hold-out creditor behaviour within the creditor groups requires restricting individual creditor actions and entrusting the right to decide on most material actions to the creditor majority. Consistent with this, English law and syndicated lending practice are clear in restricting the actions of the individual lenders in material decisions such as acceleration of claims under the loan facility agreements. These restrictions apply even though loan participations are considered separate and several obligations of the debtor.[475] The LMA Leveraged Document requires that all payments under the facility are made to the agent, not to individual lenders. The document also contains broad-ranging sharing provisions under which any sums received from an obligor must be paid to the agent unless received in accordance with the SFA or from the agent. This procedure ensures *pro rata* payments in almost all cases of payments to individual creditors.[476] If the transaction includes a bond facility, this is regulated by 'no-action clauses' restricting individual bondholder actions.

No-action clauses are recognised under English law as part of the structure enforcing the 'collectivity' of the creditors and preventing disruptive creditor actions[477] and they are not considered to be against public policy.[478] Under English law, the purpose of such clauses is to ensure that all bondholders act through the trustee and that

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475 Ian Gallaghan, Part 10 in Shutter (n 323) 179-181; also Ali Malek, John Odgers and John R. Paget, *Paget's law of banking* (Fourteenth edn, LexisNexis Butterworths 2014) 12.26-7 and A. Mugasha, *The law of multi-bank financing: syndicated loans and the secondary loan market* (Oxford University Press 2007) 5.11.

476 Ian Gallaghan, Part 10 in Shutter 179 (n 323).

477 Philip Rawlings, 'Reinforcing collectivity: the liability of trustees and the power of investors in finance transactions' 23 Trust Law International 14, 20.

478 *Colt Telecom Group plc* [2002] EWHC 2815 (Ch) 62 (Jacobs J).

there is no competition between them that could lead to multiple actions by the trustee and individual bondholders.[479] The English courts have interpreted no-action clauses broadly so that, despite their possibly ambiguous extent, they have been held to prevent nearly all actions and claims under the relevant financing agreements even when a text did not cover them explicitly, or was ambiguous concerning a particular breach of a loan facility.[480]

2. Voting under the SFA

Voting thresholds

Most covenant waivers and general amendments, including acceleration of the claims carried out under the LMA Leveraged Document, require acceptance by half or two-thirds of the 'majority lenders'.[481] Certain other provisions, such as the release of transaction security or group guarantees, generally require the support of 'supermajority lenders', set at 75% to 85% of the value of the total claims under the facility.[482] The number of covenant amendments is therefore within the control of the majority lenders, whereas parties affiliated with the shareholders are excluded from voting.

Amendments involving changes to, for example, voting thresholds, maturity, commitment levels, margin and specifically-negotiated provisions are normally subject to a unanimity requirement.[483] If these thresholds cannot be met, the

479 *Elektrim SA v Vivendi Holdings 1 Corp* [2008] EWCA Civ 1178 [91].

480 Rawlings (n 477) 21-22.

481 Gallaghan in Shutter (n 323) 181.

482 Paterson and Zakrzewski (n 473) 9.2.3.

483 See for the interpretation of entrenched rights or unanimity decisions: *The Bank of New York Mellon v Truvo* NV [2013] EWHC 136 (Comm).

creditors may still be able to effect the changes by resorting to methods such as: (i) a scheme of arrangement,[484] (ii) 'yank-the-bank' clauses[485] combined with a 'snooze-or-lose' clause;[486] or (iii) 'structural adjustments'.[487] Points (ii) and (iii) enable the replacement of a non-acceding creditor in certain restructuring scenarios without resorting to the statutory procedures. The SFAs do not contain mechanisms for releasing the obligors from their repayment obligations, other than through non-distressed disposals clauses, or permitted or mandatory prepayments clauses. This is not a concern if a distress scenario requires, for example, share disposal or another enforcement sale under the ICA. However, if the existing creditors participate in the restructuring through credit-bidding or otherwise write off their claims, the controlling creditors will have to use something like a scheme of arrangement to bind all secured creditors. The alternative is that a sufficiently large proportion of creditors executes a structural adjustment.[488] I will discuss next the two main mechanisms in the ICAs that restrict hold-out creditor behaviour and, after that, the creditor majorities that control the distress scenarios.

(c) Payment restrictions in LMA ICAs

1. LMA S/M ICA

The first aspect of creditor control in ICAs is control of permitted payments to any acceding ICA creditors after a contractually negotiated trigger event has occurred. The

484 Companies Act Part 26, ss 895-899.

485 This enables the transfer or repayment of the opposing creditor's claim.

486 This means that, if the creditor is inactive, it can be deemed to have accepted the proposed change.

487 Paterson and Zakrzewski (n 473) 9.2.3.1.1-2.

488 The LMA Leveraged Document (n 13) 41.5.

payment restriction clauses ensure that the payments within and outside the debtor group are controlled before a default and blocked thereafter. The payment restrictions are supported by the *pro rata* distribution provisions of the LMA Leveraged Document that protect against the risk of a party receiving more than the other creditors in the event of collective enforcement,[489] and by the 'turnover provision'[490] obligating the parties to direct all payments to the security agent for distribution in accordance with the priority schedule.[491] The material payment restrictions are set out in Table 12.

Table 12. LMA S/M ICA payment restrictions

	PAYMENT RESTRICTIONS	WAIVER/CONSENT
Senior Liabilities	No restrictions Payments under hedging liabilities are restricted, unless they are 'permitted payments' and 'permitted enforcement', which enable, for example, payment and close-out netting and 'regular' payments under the hedging agreements without restrictions.[492]	
Mezzanine Liabilities	Permitted only if: 'permitted payments' or 'permitted enforcement',[493] repayment of principal only in limited circumstances[494] All payments are blocked as set out in Figure 12, below.	Majority senior creditors
Subordinated Liabilities	Permitted only with consent or if allowed in debt documents or received from the insolvent debtor[495]	Majority senior creditors or majority mezzanine lenders (if controlling)
Intra-Group Liabilities	Allowed until event of default or an acceleration event,[496] payments facilitating payments of the primary liabilities generally permitted; and payment of 'structural intra-group liabilities' prohibited	As above[497]

489 Gullifer and Payne (n 4) 413.

490 Wood, *Project finance, securitisations, subordinated debt* (n 327) 10-022.

491 Shutter 70-72 (n 323); LMA S/M ICA 10 and 18.

492 LMA S/M ICA 4.3 and 4.9.

493 ibid 3.1.

494 ibid 5.1-2 and 5.12, eg under 'Illegality', 'Right of cancellation and repayment in relation to a single Lender', 'Non-Distressed Disposals', or 'Mandatory prepayment of Proceeds' clauses of the Mezzanine Facility Agreement.

495 ibid 5.1-6.

496 ibid 6.2(b) gives two options which are often heavily negotiated.

497 ibid 6.2.

Mezzanine payments are blocked under the ICA as described in Figure 12.[498]

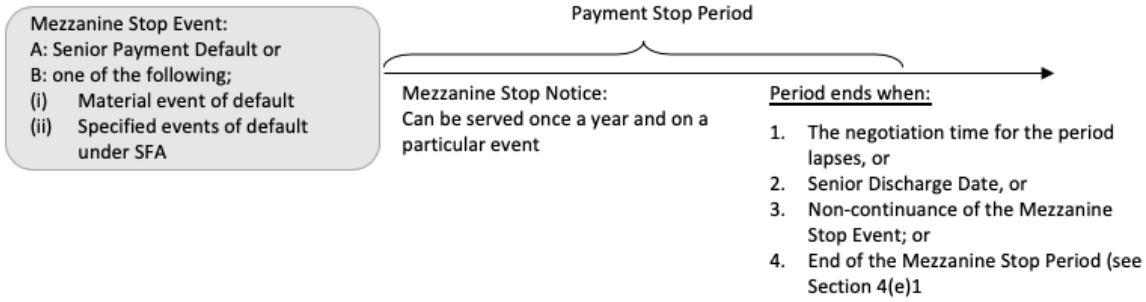

Figure 12. Mezzanine payment stop mechanism

The LMA S/M ICA relies on the debt document for specific clauses allowing payments to the lower-ranking creditors. However, even permitted payments to lower-ranking creditors are always blocked at the latest on payment default or a material default under the debt documents. Because the majority senior creditors control all waivers to the payment restrictions and effectively no payments are allowed during the 'payment stop period' (see Figure 12), they are in control of the hold-out creditor risk. However, the senior creditors will in practice take some action in relation to the default during the standstill period, because payments will resume after the period ends, unless other restrictions apply. Blocking the payments in this manner is connected to the commencement of the enforcement restrictions discussed in Section 4(e)1.

2. LMA SS/S ICA

The document does not contain any payment restrictions applying to the super senior or the senior creditors. Any permitted payments are regulated by the respective facility agreements. The payment restrictions applying to the intra-group liabilities, as well as

498 ibid 3.3. Certain non-material and negotiated payment exceptions are omitted from the analysis.

parent, vendor, investor, and subordinated liabilities conform materially to the LMA S/M ICA.

3. LMA SS/HY ICA

The payment restrictions correspond in material respects to those of the LMA S/M ICA, but I have set out below the differences in the LMA SS/HY ICA. To the extent that the regulation corresponds to the LMA S/M ICA, these are not repeated.

Table 13. LMA SS/HY payment restrictions

	PAYMENT RESTRICTIONS	WAIVER/CONSENT
Super Senior Liabilities	No restrictions	
Credit Facility Liabilities	No restrictions but these are blocked on an acceleration event. Enforcement proceeds applied by the security agent, distribution out of the debtor's unsecured assets by a liquidator, receiver, administrator or a similar officer are exempted.[499]	Required super senior creditors
Pari passu Debt Liabilities	As above, but majority super senior control and restrictions lapse at the super senior discharge date.[500]	Required super senior creditors
High Yield Liabilities	Limited restrictions due to structural subordination. Principal and interest payments, discharge of the high yield liabilities by the debtors or group companies carrying out liabilities acquisitions are restricted, unless under 'permitted payments' or 'permitted enforcement'.[501] All payments blocked: See Figure 13	Required super senior creditors and the required pari passu creditors[502]
Subordinated Liabilities	As in LMA S/M ICA	As in LMA S/M ICA
Intra-Group Liabilities	As in LMA S/M ICA	As in LMA S/M ICA

High Yield payments are blocked under the ICA as described in Figure 13.

499 LMA SS/HY ICA 3.1.

500 ibid 4.1.

501 ibid 7.2-3; for example, facility set-up and listing costs are exempt.

502 ibid 7.5.

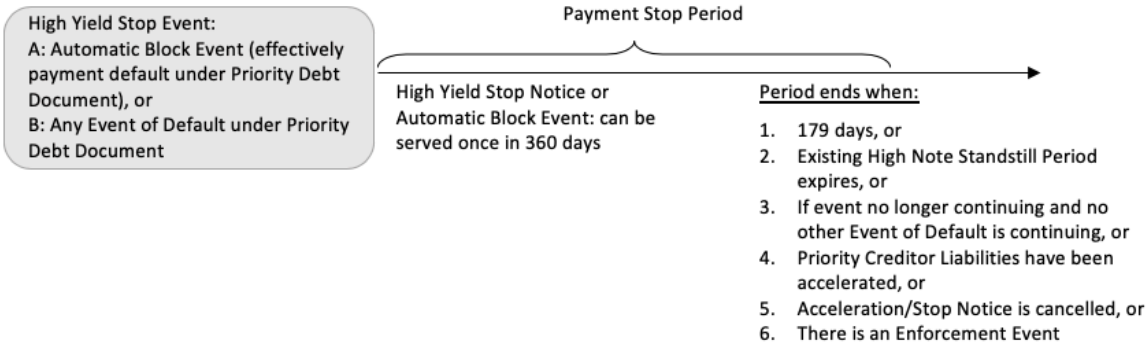

Figure 13. High yield payment stop mechanism

Despite the high yield payment restrictions, payments can be made after the initial due date of the high yield notes. This is also possible if the payment is made by the parent from funds not financed by any of the group companies, even if the payment stop period is pending.[503] In practice, these payments do not affect the hold-out risk because the maturity of the notes is longer than that of the higher-ranking facilities and because the parent receives upstream payments only subject to the restrictions set out in the debt documents.

(d) Payment restrictions in the sample ICAs

1. General structure

In the majority of the sample, payment restrictions were consistent with the LMA ICAs. The definitions of controlling majority creditor groups referred either to two-thirds of the credit participations of the relevant creditor group or to participations exceeding half, often if the capital structure included bonds or notes.[504] There were market-based deviations in the sample connected to the control rights among different creditor

503 ibid.

504 Some of the questions concerning creditor majorities are discussed further in Part C, Section 5(c).

categories within senior creditor groups. The solutions adopted in capital structures that included a second lien or subordinated unsecured creditor classes were consistent with the LMA S/M ICA and the LMA SS/HY ICA. The ICAs that included second lien financing included the most extensive payment restrictions. The specific restrictions are set out in Table 14.

Table 14. ICA sample payment restrictions

	PAYMENT RESTRICTIONS	WAIVER/CONSENT
Senior Liabilities	**13 ICAs:** no payment restrictions PIK toggle pari passu liabilities or the pari passu liabilities: no payment restrictions before distress event, but after that, subject to consent, carried out in accordance with the ICA distribution mechanics or by means of a non-cash debt-to-equity swap **10 ICAs:** payment prohibition after an acceleration event, security notice or a distress event, after which payments were allowed only in accordance with the application of proceeds clause **3 ICAs** of these: payments restricted after the trigger event, if not subject to turnover obligation and payments by a liquidator or an equivalent officer, if subject to turnover obligation to the security agent[505] **2 ICAs** of these: payments also allowed post-trigger event, subject to consent **1 ICA** allowed limited payments also in relation to fees and costs	Majority super senior creditors Majority senior creditors (also the other exceptions below)
Second Lien Liabilities	**9 ICAs** (all that included such facilities): restrictions and exceptions were consistent with the LMA S/M ICA[506] with case-by-case additions, ie allowing debt to equity swaps, debt purchase transactions and capped restructuring costs. Payment restriction triggers: - **2 ICAs:** events of default and payment defaults under SFA - **5 ICAs:** events of default if caused a material adverse effect - **7 ICAs:** all these and insolvency, insolvency process, creditor processes and similar events - **3 ICAs:** all breaches of SFA, if constituting a material adverse effect - **2 ICAs:** also, acceleration, cross-default situations and breach of financial covenants - **3 ICAs:** also individually negotiated triggers (eg breach of negative pledge, disposals exceeding the allowed limits) Standstill regulations correspond with the LMA S/M ICA and the periods varied in accordance with Figure 14.	Majority senior creditors (also, the other exceptions)

505 Most of the differences applying to senior liabilities could be explained by the fact that even though some exceptions were specifically drafted in some ICAs, in other ICAs similar, or close to similar, procedures could be inferred from other sections.

506 See Part C, Section 4(c)1.

High Yield Liabilities	**9 ICAs** (all that included such facilities): restrictions were consistent with the high yield restrictions in LMA SS/HY ICA.[507] In ICAs with a second lien tranche, however, the second lien agent was entitled to issue a stop notice independently of the senior agent.[508] The payment standstill periods were 179 days in all the ICAs. Payment restriction trigger events and exceptions: - **9 ICAs:** events of default and payment defaults under SFA - case-by-case negotiated, permitted payments definitions, applying before default - certain costs, administrative payments and restructuring advisory fees and certain non-prohibited payments made from the own assets of the parent or a holding company debtor allowed case-by-case - payments not financed by debtor group and, in some cases, payments by means of a non-cash debt-to-equity swap allowed (restrictions lapsed after the discharge of the higher-ranking liabilities)	Majority senior creditors and majority second lien lenders
Junior Liabilities	**18 ICAs** (all including such facilities): allowed if expressly permitted under the debt documents, or results from 'permitted enforcement' - **5 ICAs:** allowed if permitted under the SFA and facilitated payment of parent's or holding company external financial indebtedness (such as senior parent unsecured debt) - **3 ICAs** (of these): permitted debt-to-equity conversion, in payment-in-kind, or capitalisation or write-off of the claims without cash consideration - **4 ICAs:** allowed if also allowed under the facility agreements (implicitly required in others as well) - **2 ICAs:** acceleration event prohibited all payments (the same restrictions implicitly assumed in other ICAs)	Majority senior creditors or majority senior unsecured creditors (if made on parent level)
Intra-Group Liabilities	Allowed until event of default or an acceleration event. Payments facilitating payments of the primary liabilities are generally permitted.[509]	As above[510]

507 The LMA SS/HY ICA contains similar rules that codify the existing practice.

508 Senior finance company payment stop notice and senior payment default.

509 Three ICAs enabled payments required to be made by the board under mandatory law. These involved a German debtor that was subject to statutory requirements.

510 ibid 6.2.

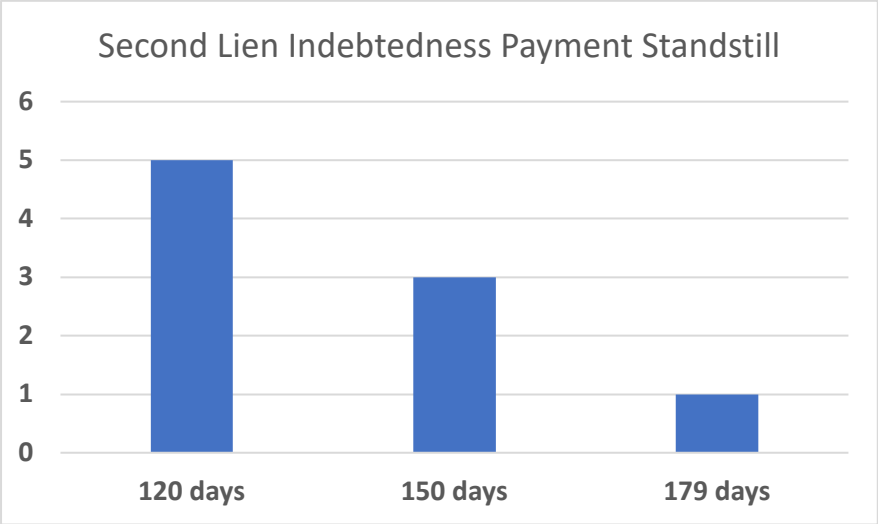

Figure 14. Second lien payment standstill periods

2. Summary

Despite the variation in payment restrictions within the senior creditor groups, these effectively applied only in acceleration and enforcement scenarios, where the instructing group and the security agent are invariably in control. The variation of the payment restrictions within the second lien and high yield categories was extensive, however. This may have resulted from commercial interests in negotiating tailor-made solutions to the permitted payment mechanics in each creditor category. Notwithstanding this, the payment restrictions were in all ICAs under the control of the highest-ranking majority creditors and all payments were effectively blocked in material default scenarios, restricting strategic creditor actions close to an insolvency or financial distress scenario. Also, pre-defined trigger events in all sample ICAs led to the commencement of a standstill period of 120-179 days concerning the second lien and high yield debt and to categorical payment restrictions in relation to the junior liabilities.

(e) Enforcement restrictions in LMA ICAs

1. LMA S/M ICA

The LMA Leveraged Document restricts individual enforcement actions by the senior lenders and acceleration of the indebtedness is considered a majority lender matter, requiring the support of two-thirds of the outstanding senior liabilities. The facility agent carries out the actual enforcement of the claims under the SFAs on the instructions of the majority lenders.[511]

However, even if there is default under a specific loan facility leading to a right to take enforcement action, the LMA ICAs restrict them on the debtor group level. The LMA S/M ICA does not contain any enforcement restrictions on the senior creditors, but the security agent can only exercise the actual enforcement measures on the instructions of the instructing group. The enforcement restrictions applying to the other debt categories are set out in Table 15.

511 LMA S/M ICA 12.2-3 and 12.7.

Table 15. LMA S/M ICA enforcement restrictions

	ENFORCEMENT RESTRICTIONS	WAIVER/CONSENT
Senior Liabilities	No restrictions, but actual enforcement measures can only be exercised by the security agent as instructed by the instructing group.[512] Ancillary lenders and issuing banks are only allowed to enforce simultaneously with the Senior Creditors.	Majority senior creditors
Hedging Liabilities	Credit-related close-outs are possible following: - a distress event - insolvency events and insolvency proceedings - full cancellation or refinancing of the senior facilities In addition: - A payment default entitles the hedging counterparties to enforce subject to a pre-negotiated standstill period, unless the security agent commences enforcement of the transaction security. - The security agent may require that the hedging counterparties terminate and close-out any hedging agreements after an acceleration event or if the instructing group requests termination and close-out.[513]	Majority senior creditors
Mezzanine Liabilities	Mezzanine creditors are entitled to take the same enforcement actions as the senior creditors if there is an existing senior acceleration event.[514] The mezzanine creditors are entitled to enforce only after lapse of the mezzanine standstill period[515] described in Figure 15 below.[516]	Majority senior creditors
Junior Liabilities	No enforcement actions are allowed prior to the final discharge of the primary liabilities.[517] Allowed after occurrence of an insolvency event, unless the security agent is taking measures on their behalf.	Majority senior creditors or majority mezzanine lenders (if controlling)
Intra-Group Liabilities	See above[518]	See above[519]

512 LMA S/M ICA 12.2.

513 ibid 4.8-9.

514 LMA ICA 5.12.

515 For example, the capitalisation of interest (PIK interest) is usually carved out from the scope of the payment and enforcement restriction.

516 Rodrigo Olivares-Caminal, *Debt restructuring* (Second edn, Oxford University Press 2016) 3.26-29; The LMA ICA 5.12.

517 LMA ICA 6.6-7, 7.7-8.

518 ibid 8.7-8.

519 ibid 6.2.

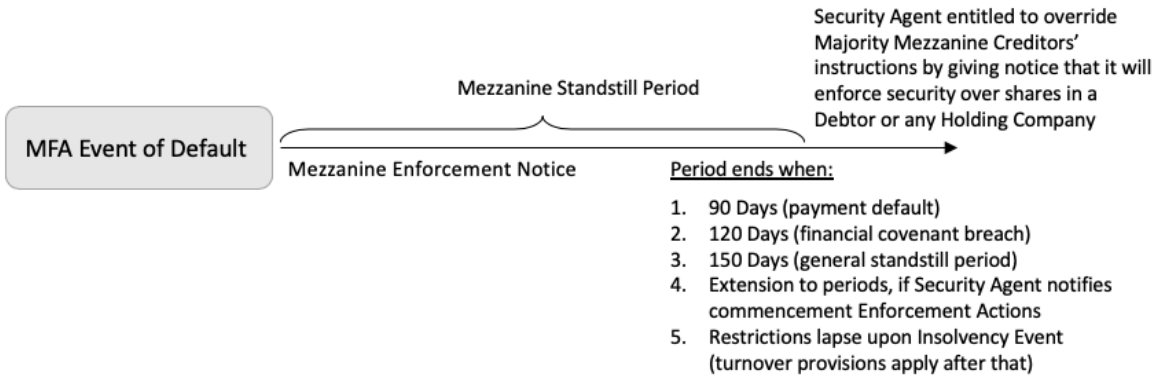

Figure 15. Mezzanine enforcement restriction mechanics[520]

The enforcement restrictions governed by ICAs are akin to a statutory moratorium triggered by either an administration or a liquidation and result in a contractual 'standstill'[521] during which the parties engage in negotiations concerning the specific restructuring measures.[522] It should be noted that the mezzanine enforcement restriction is similar to that of the payment restriction but commences when there is a default under the mezzanine facility agreement. The length of the standstill period depends on the nature of the breach.

2. LMA SS/S ICA

The enforcement restrictions are based on weighing the interests of the super senior creditors and the senior creditors. The super senior creditors cannot take enforcement actions before the senior discharge date. They are, however, entitled to act if there is an acceleration event in relation to the senior lender liabilities, a super senior step-in event, or the initial instruction group consents. As with the other creditor groups, enforcement

520 Shutter (n 323) 67; LMA S/M ICA 5.11-12.

521 The standstill may be documented either in a separate standstill agreement or be a 'silent' contract.

522 See 5.11-12.

actions occurring after an insolvency event are permitted.[523]

The document balances the enforcement control between the super senior and the senior classes using a 'flip-clause' called the super senior step-in event. This is triggered if there is no initial instructing group enforcement after a material event of default[524] within the super senior standstill period (discussed below), there is a continuing material event of default, and no super senior lender liabilities transfer has taken place. The same applies if both the super senior standstill period and the enforcement realisation period have lapsed, the material event of default is continuing and there has been no super senior cash discharge or super senior lender liabilities transfer.[525]

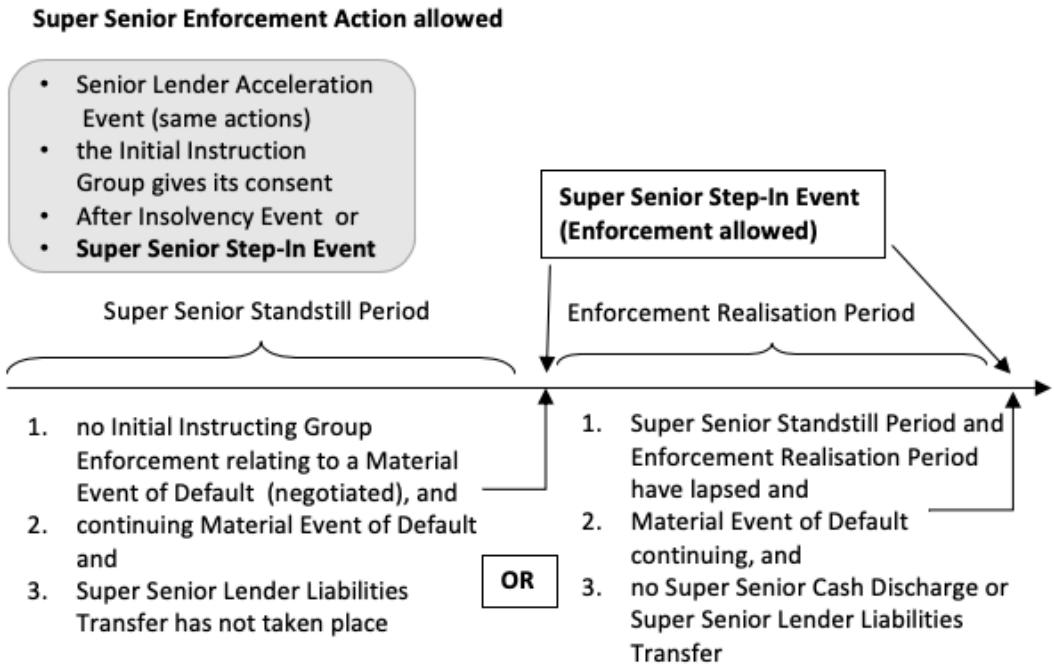

Figure 16. Super senior enforcement restriction mechanics

No enforcement restrictions apply to the senior creditors, other than the rules allocating the decision-making rights to the instructing group and the security

523 LMA SS/S ICA 3.5-6.

524 In the LMA ICAs the definition is left for the parties to negotiate.

525 LMA SS/S ICA 3.6.

agent. The enforcement restrictions applying to hedging and junior liabilities correspond to those of the LMA S/M ICA.[526]

3. LMA SS/HY ICA

Other than the requirement for an instruction from the instructing group concerning enforcement and distressed disposals, the document does not contain any enforcement restrictions applying to the credit facility or the pari passu debt creditors. The restrictions applying to the hedging liabilities conform materially with the LMA S/M ICA, but with required super senior creditors and the required pari passu creditors controlling any measures that the hedging counterparties can take.

High yield creditors are not entitled to take enforcement action against the debtors concerning the high yield liabilities or guarantees, or in respect of the transaction security. These restrictions do not apply if there is a continuing event of default under the high yield notes and the standstill period (see Figure 17) has ended and if the default is still continuing. Enforcement actions are permitted concerning the same event of default under the high yield notes after the standstill period. However, even if there is a new standstill period as a result of another event of default under the high yield notes, the enforcement actions based on an earlier continuing default are allowed after the relevant standstill period has ended.[527]

If the security agent is taking enforcement actions in relation to a debtor, priority creditor only[528] or common charged property,[529] high yield creditors are not

526 ibid 7.6-7, 8.7-8, 9.7-8.

527 LMA SS/HY ICA 7.11.

528 Security is granted only to priority creditors, and not the high yield noteholders.

529 Security is granted also to the high yield noteholders.

entitled to take enforcement action if this is reasonably likely to adversely affect the enforcement or enforcement proceeds. Other enforcement actions are allowed.[530]

The high yield note standstill period lasts 179 days from the serving of the enforcement notice to the security agent. It ends prematurely, however, if the security agent takes enforcement actions against any high yield note guarantor, in which case the same actions are allowed. Enforcement actions are also allowed as a result of an insolvency event against a particular debtor, on expiry of a standstill period started prior to the current one and due to payment failure at the initial maturity of the high yield notes. Alternatively, enforcement actions are possible with the consent of the required super senior creditors and the required pari passu creditors.

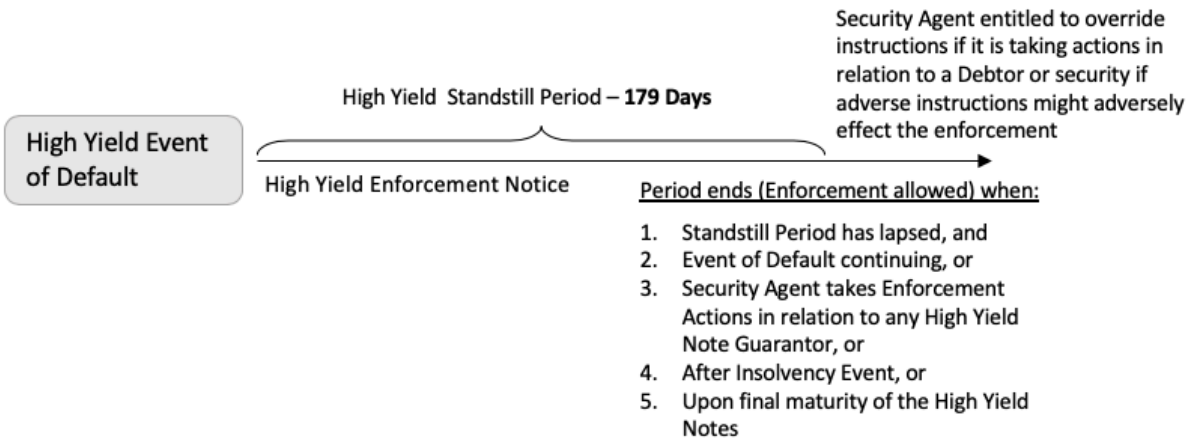

Figure 17. High yield enforcement restriction mechanics

The enforcement restrictions applying to the junior liabilities correspond to those of the LMA S/M ICA.[531]

530 LMA SS/HY ICA 7.10.

531 ibid 8.6-7, 9.7-8, 10.7-8.

(f) Enforcement restrictions in the sample ICAs

1. General structure

All of the sample ICAs included extensive restrictions on the enforcement of all subordinated indebtedness. In the case of external financial indebtedness, the restrictions were connected to enforcement standstill periods ranging from 90 to 179 days, sometimes with an option to extend. All of the 'internal financial indebtedness' categories were subject to categorical enforcement restrictions, with the notable exception of insolvency events, which were in all cases regulated separately. In that case, all payments were made through the security agent, using a turnover trust. In all the sample ICAs, the enforcement restrictions were connected to the 'enforcement instructions' clauses. The relevant subordinated creditor groups were able to issue enforcement instructions, but only in accordance with the procedures discussed below, after the enforcement standstill periods had lapsed. The regulation of the second lien and high yield enforcement restrictions conformed materially to the LMA ICAs.

2. Senior indebtedness

Nineteen of the sample ICAs did not contain any enforcement restrictions applying to the senior creditors. In all cases, however, the enforcement was subject to the control of the instructing group (or equivalent group). The remaining ICAs allowed restricted enforcement measures without the majority control in relation to other security than the transaction security and the specified guarantee liabilities. Other restrictions were non-material. These did not interfere in the actual control of the enforcement process, however. The important question of how the enforcement control is transferred from the highest-ranking creditor group to the next under the enforcement instructions

clauses is discussed in Sections 5(b)-(c).

3. Second lien indebtedness

All nine ICAs that included second lien indebtedness regulated second lien enforcement restrictions in a similar fashion to the LMA S/M ICA. All of the second lien enforcement actions were, therefore, controlled by LMA S/M ICA-style enforcement standstill mechanisms. The standstill periods of the nine relevant ICAs are set out in Figure 18.[532]

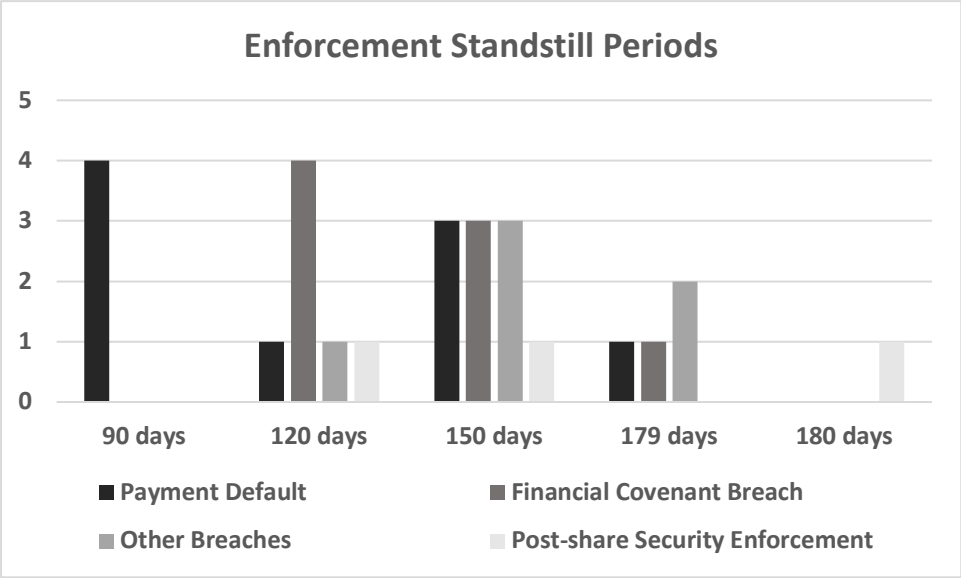

Figure 18. Second lien enforcement standstill periods

4. Senior unsecured indebtedness

Ten of the ICAs included a senior unsecured indebtedness category whose regulation corresponded to the LMA SS/HY ICA provisions.[533] There were certain differences in

[532] Interviewees 2 and 7 noted that standstill provisions and the periods are fairly standard, and that the market just accepts them.

[533] See Part C, Section 4(e)3.

the definition, but in all cases, the category referred to both the structurally and contractually subordinated financing category. The restrictions concerned particularly common transaction security, the security documents and the group guarantees. Any enforcement actions against the parent or holding company itself were considerably less restricted. There were no material differences in the ICA sample compared to the LMA ICA regulation and the standstill periods were set at 179 days in all transactions. The only notable differences concerned enabling enforcement at the final or original maturity date of the senior unsecured debt if the senior discharge date had occurred, or in any case 72-85 months from the date of the ICA. The latter clauses were included in two sample ICAs.

5. Parent, shareholder and investor indebtedness

Five of the ICAs did not include the parent, the shareholder or the investor indebtedness categories. All of the ICAs that had one or more of these categories had an LMA ICA-style clause that restricted, with minor modifications, all enforcement actions except in connection with an insolvency event. Three of the ICAs included carve-outs of the restriction applying to transactions related to the acquisition of possible liabilities, roll-up, write-off or capitalisation of the claims and facilitation of payments of the senior facilities or payments otherwise permitted under the debt documents.

6. Intra-Group Liabilities

In the 22 ICAs that included intra-group liabilities, the contract had an LMA ICA-style enforcement restriction triggered by an acceleration event, with only non-material modifications in the definition. Five ICAs included carve-outs from the enforcement restriction allowing for capitalisation of the claims and write-offs. Two explicitly

mentioned the possibility of a waiver by majorities of the highest-ranking creditor groups, although this appears to have been implicitly allowed in all contracts. Three of the ICAs had an exception in which the board of the debtor could make a payment if it was obligated to do so under domestic law applying to that particular debtor. A summary of the sample ICA enforcement restrictions is set out in Figure 19.

Figure 19. Summary of ICA sample enforcement regulation

7. Enforcement restrictions and hold-out value

Despite considerable variation in the contents of the enforcement restrictions applying especially to second lien and high yield liabilities, the ICA solutions for controlling possible hold-out actions by creditors were comprehensive and robust. In all cases, actions due to an event of default under a subordinated facility were either categorically prohibited (junior creditors and intra-group creditors) or subject to enforcement standstill periods. These periods were extended in all cases if the security agent took action to enforce transaction security. Waivers and consents to enforcement actions

were controlled either by the higher-ranking creditor majorities or the instructing group. Technically, enforcement restrictions of the main financial creditors lapsed after the standstill periods, a situation that was apt to give them leverage in the negotiations should the enforcement or restructuring be prolonged.

The interviewees were consistent in pointing out the effectiveness of the ICA enforcement restrictions, but also emphasised several issues restricting their use. First, the efficiency of the payment and enforcement restrictions was considered dependent on the covenants of the debt documents. Some of the interviewees noted that, for example, covenant-lite[534] loans lead to a scenario where the need to control the syndicate may be negligible.[535] Some interviewees, however, noted that while ICAs reflect the loosening of credit terms in recent years, the enforcement provisions are simultaneously becoming more complex.[536] Some of the sponsor advisors considered that a robust ICA offers some level of assurance that one will not face the risk of a minority hold-out representing the wrong kind of attitudes to the credit.[537]

The risk of local enforcement measures and statutory procedures were believed to increase the unintended hold-out value. However, English law ICAs were considered to contain enough certainty and sufficient provisions to prevent such hold-out value from arising.[538] Additionally, despite the robustness of the ICA terms, it was noted that threatening a delay during the standstill period might give leverage to the hold-outs.[539] For example, bondholders were considered entirely rational in leveraging

534 Debt documents that have fewer restrictions on the borrower and usually no, or few, financial covenants.

535 Interview 12.

536 Interview 6.

537 Interviews 7 and 8.

538 Interview 2.

539 Interview 14.

their position irrespective of the restrictions, pricing any decision they were asked to make when in default 'on the marginal cost to you or marginal benefit to them'.[540]

One bank interviewee noted that the super senior creditors' hold-out risk is usually kept under control by limiting the amount of super senior debt to annual projected EBITDA. It was pointed out, however, that the debtors could easily incur the incremental debt, which begged the question of mandatory or optional adherence to the ICA.[541] The danger of a hold-out position by hedge funds was considered problematic because a build-up of position would necessarily raise the price of the relevant securities, making it less feasible. This results in a need to build up positions over time, which may be restricted by the debt documents' transfer restrictions.[542]

In line with the content analysis part, the interviewees were consistent in considering the payment and enforcement restrictions material and effective in restricting hold-out actions of the lower-ranking creditor classes.

(g) Protective clauses

1. The LMA ICAs

The provisions restricting hold-out behaviour require that creditor actions and representation of creditor classes are sufficiently regulated in insolvency scenarios. First, all LMA ICAs irrevocably authorise the security agent to take any enforcement actions against the parent or any member of the debtor group, except for certain set-off and netting situations. This authorisation extends to a right to make all demands and

540 ibid.

541 Interview 14.

542 Interview 4.

claims, sue the group companies for any liabilities, take any necessary action and to collect and receive all distributions in relation to the liabilities.[543] These clauses apply both before and after insolvency.

Secondly, although an insolvency event in most cases results in the ending of the enforcement restrictions under the LMA ICAs, the creditor priority rules are also protected by the parties' obligation to turn over to the security agent any distributions for application in accordance with the payment waterfall. This is regulated in the 'effect of insolvency' clause of the LMA ICAs, which also ensures that any distributions that may have to be paid under law or otherwise directly to a certain party become subject to the ICA distribution regime. [544] The set-off of creditor claims against the obligors' receivables is also subject to equalisation. This means that the set-off recoveries are effectively distributed *pari passu* to the same ranking creditors for distribution according to the payment waterfall. There are exceptions relating to hedging facilities and sometimes multi-account overdraft facilities.

Thirdly, the security agent is also entitled to file any insolvency-related claims, represent the creditors and to have all required powers of attorney to carry out its administrative function during an insolvency procedure. The security agent will need to seek the approval of the majority creditors or the instructing group for material enforcement actions, however.[545]

Fourthly, these clauses are supported in all the LMA ICAs by the 'further actions' clause obligating all creditors to undertake all actions required to enable the security agent to act on their behalf in all insolvency events. If the security agent would

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543 LMA S/M ICA 9.5, LMA SS/S ICA 10.5, LMA SS/HY ICA 11.5.

544 LMA S/M ICA 9, LMA SS/S ICA 10, LMA SS/HY ICA 11.

545 Richard Hooley, 'Release provisions in intercreditor agreements' (2012) 3 Journal of Business Law 213, 222-223.

not be entitled to carry out such actions, the creditors are obligated to take the measures required by the security agent or grant a separate power of attorney for this purpose.[546] In practice, these protective clauses ensure that the contractual control and distribution regime works even if some of the debtor group members would, for some reason, enter a statutory insolvency procedure. The connections between these protective clauses in relation to insolvency events are set out below in Figure 20.

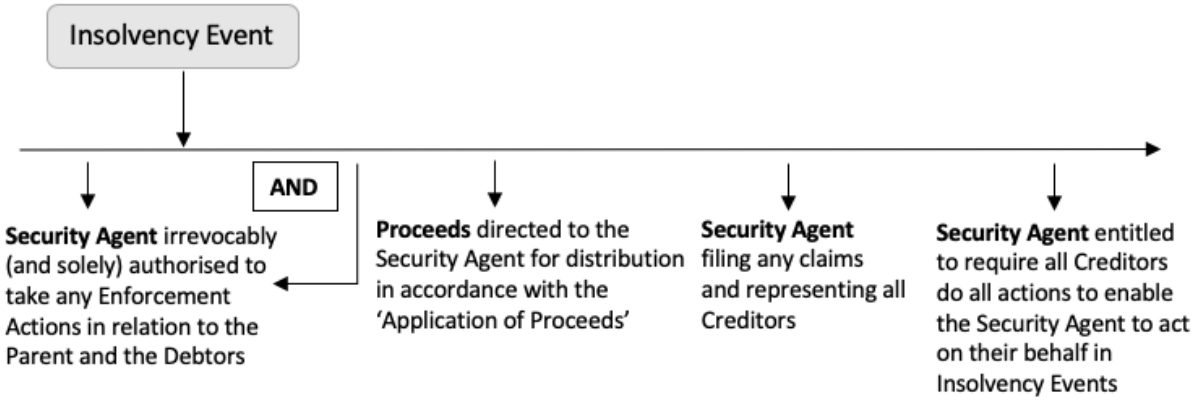

Figure 20. LMA ICA protective clauses

2. The sample ICAs

All the sample ICAs had a clause protecting the agreed creditor priority and control regime in connection with debtor distributions in the case of an insolvency event. Any distributions received due to an insolvency event were to be paid to the security agent for distribution in accordance with the 'application of proceeds' clause. Similar rules applied to payment by means of a set-off, subject to case-specific exceptions in relation to hedging obligations.

All of the sample ICAs also contained a 'filing of claims' clause similar to

546 ibid 17 and 18.

those of the LMA ICAs. The security agent was, in all cases, irrevocably authorised to take any enforcement action, make any claims and demands and collect any distribution after the insolvency event. All of the ICAs included a 'further actions' clause similar to the LMA ICAs obligating all creditors subject to the ICA to do everything required by the security agent and to carry out such measures if the security agent was unable to act accordingly. This meant that the sample ICAs effectively defused the incentives of the hold-out creditors to undermine the priority and control regime agreed in the ICA, enabling the parties to decide on the optimal responses to the distress scenario. Circumventing the contractual regime was in all material respects blocked.

5 Enforcement and distressed disposals

(a) Introduction

1. Strategies in the vicinity of distress

Even though ICAs effectively restrict all material hold-out actions by the acceding creditors, they must also facilitate creditor coordination in financial distress and deal with the incentives of the stakeholders that could restrict optimal enforcement or restructuring. These two issues are addressed in ICAs by the enforcement and distressed disposals clauses and by specific protective clauses ensuring that incentives to deviate from the main rules and to engage in 'free-rider' behaviour are eliminated.

If a distress scenario leads to the triggering of a standstill period under the ICA and the parties cannot reach a purely consensual arrangement concerning the restructuring, the senior lenders usually form a coordination group to lead the

negotiations.[547] The standstill is often formalised in a standstill agreement based on the enforcement restrictions of the ICA. After the 'first bank meeting' and the determination of the need to carry out a comprehensive restructuring, the controlling creditors usually aim to negotiate a restructuring agreement detailing the elements of the restructuring.[548] However, it should be noted that the actual procedures are most often case-specific and there is a lot of variation between actual solutions.

Based on the views expressed in the interviews, it is very common that these measures are preceded by more informal negotiations between the stakeholders and such negotiations operate in the shadow of the control, priority and enforcement provisions of the ICA and the law.[549] However, it was pointed out that, as long as the borrower can service the loan, the private equity fund does not have to care about the identity of the other side.[550] Some of the respondents from the sponsor side, however, considered that the identity of the parties will be material if the distress scenario deepens,[551] an issue which was seen to be driven primarily by the leverage and flexibility afforded by the documents.[552]

In practice, the fact that distress scenarios can come in varying forms means that the actual response is always handled on a case-by-case basis, but noting the relevant trigger event.[553] Several participants emphasised the game-theoretical framework established by the ICA, which is supplemented by negotiating leverage held by the various actors based, for example, on new liquidity, management skills,

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547 Olivares-Caminal (n 516) 3.31-2.

548 On the pre-contractual phase see Howard and Hedger (n 163) 2.3-2.96.

549 Interviews 2, 7-10 and 14.

550 Interview 12.

551 Interviews 11 and 12.

552 Interview 14.

553 Interviews 7 and 8.

reputation and investment perspective.[554] This was considered to determine the parties who should have an actual seat at the table and their strategy.[555]

It was also pointed out that, for example, distressed investors that purchase their interest at a reduced nominal value have a different motivation to the original lending banks and will carry out due diligence on the credit documents and evaluate the possible hold-out value and efficiency of the enforcement provisions and national enforcement regimes.[556] The banks' motivation to get involved in such arrangements was considered limited, which increases the borrower's influence in the shaping of the restructuring.[557]

One interviewee pointed out that private equity will usually look at the ICA more intently at the 'preventative' stage, that is before they reach the point of default and the fund has 'raised its hands' and bailed out.[558] The interviewee also pointed out that private equity firms know well in advance of any problems that may emerge and can deal with them accordingly.[559] Some interviewees noted that the private equity houses often facilitate the restructuring, sometimes for reputational rather than contractual reasons.[560] However, if the parties are unable to reach a negotiated restructuring or other arrangement dealing with the distress scenario, the ICAs offer two connected mechanisms for carrying out the restructuring: enforcement of transaction security and a distressed disposal, including a liabilities sale. All of these rely on comprehensive release of liabilities in connection with the arrangement.

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554 Interviews 1, 11-14.

555 Interviews 1, 6, 9, 10 and 14.

556 Interviews 2 and 4.

557 Interview 3.

558 Interview 7.

559 ibid.

560 Interviews 7, 13 and 12.

2. Some restrictions on the use of creditor influence

Before discussing the ICA enforcement provisions, it is important to note certain restrictions on the use of creditor actions and voting, especially in connection with distress situations. Certain types of creditor behaviours may constitute 'creditor oppression' and affect the creditor control provisions of the facility agreements and the ICAs.[561] English law rules on creditor oppression are built on company law cases dealing primarily with an obligation to act *bona fide* in the best interests of the company as a whole. As Howard and Hedger have noted, however, in a distressed syndicated loan scenario nothing comparable to a company exists, but rather 'the economic interest of lenders in a pre-existing contract that had regulated the rights of those lenders *inter-se*'.[562]

A leading case dealing with the question of misuse of powers and bad faith in financial agreements is *Redwood Master Fund v TD Bank Europe Ltd*.[563] The case concerned a multi-tiered syndicated lending facility (facilities A, B and C) for which a revolving facility had not yet been drawn. The debtor entity was in potential breach of its loan covenants and seeking a waiver of a breach and granting of access to the agreed facilities from the existing senior creditors. The requests were supported by the required two-thirds majority, primarily facility B creditors. Consequently, the amendments enabled the use of the undrawn facility A for the repayment of facility B. Having not waived the breach, facility A could not have been drawn. Facility A lenders subsequently brought claims against the other creditors declaring that they were not bound by the amendments, the powers granted to the creditors should have been

561 *Allen v Gold Reefs of West Africa, Limited* [1900] 1 Ch 656 (CA).

562 Howard and Hedger 2.40 (n 163).

563 *Redwood Master Fund Ltd v TD Bank Europe Ltd* [2002] EWHC 2703 (Ch).

exercised in good faith for the purpose of benefiting the class as a whole, and such powers could not be used in a disadvantageous, discriminatory or oppressive manner. The claimants asked that the Court imply a term to effect such an obligation.

Although Rimer J considered that such a term may be implied on certain grounds, he found no evidence of bad faith on behalf of the majority lenders.[564] He held that the use of powers granted in the facility agreement to the majority would have been impossible in a manner benefitting the lender constituency as a whole.[565] He noted that the proper way to assess the validity of the of exercise of the power is to evaluate, in the light of the evidence, 'whether the power was being exercised in good faith for the purpose for it was conferred'.[566] In essence, the majority decision would have had to have been 'sufficiently discriminatory or unfair' or 'so manifestly disadvantageous, discriminatory or oppressive' towards the affected parties to be avoided.[567] The importance of *Redwood* lies in the distinction of the creditor oppression rules applied in connection with syndicated facilities from voting in schemes of arrangement and resolving on amendments under company law.

The use of creditor control measures under ICAs does not automatically mean that they have been exercised improperly if the minority is relatively disadvantaged compared with the majority.[568] Rimer J held that in a commercial contract between a large number of parties, the lenders cannot be regarded as a unified class and that interests of each tranche are peculiar to it.[569] Consequently, any majority

564 ibid 87.

565 ibid 94.

566 ibid 105.

567 ibid 87 and 105.

568 ibid 105.

569 ibid 94.

decision would inevitably have favoured one class over another and it would have been impossible for a class of creditors to exercise power in accordance with the decision of Evershed MR in *Greenhalg*,[570] benefitting each hypothetical member of the class.[571] Rimer J pointed out in *Redwood* that the fact that the waiver letter was not beneficial to all lenders because it was disadvantageous to a small subclass of facility A lenders should not make the arrangement of the letter void.[572]

In addition to being based on a syndicated facility control issue, what distinguished *Redwood* from *Greenhalg* was that there were three affected classes of creditors.[573] Although in *Redwood* the creditors of the different tranches did not vote separately but rather collectively, it is arguable that the rule also applies to voting among different classes of creditors; for example, junior and senior creditors.[574] There appears to be no reason to treat a situation in which the lenders are part of a same loan document with different tranches differently from a situation where separate loans are of different priority. This is significant for ICAs because the use of creditor control is always exercised in relation to the other creditor groups that are either subordinated to it or not yet otherwise in a control position.

Redwood reflects a broader authority under English law that the courts are slow to interfere with complex commercial arrangements and agreements entered into by sophisticated parties and advised by experienced advisors.[575] The most notable

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570 '[a] special resolution of this kind would be liable to be impeached if the effect of it were to discriminate between the majority shareholders and the minority shareholders, so as to give to the former an advantage of which the latter were deprived'. *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 (CA) 291.

571 *Redwood Master Fund Ltd v TD Bank Europe Ltd* (n 563) 93-4.

572 ibid 89-90.

573 ibid 99.

574 Hooley (n 545) 226.

575 *IFE Fund SA v Goldman Sachs International* [2006] EWHC 2887 (Comm), where the Court was reluctant to impose negligence-related terms into the contract; and *Raiffeisen*

recent case evidencing the strong inclination of the courts to adhere strictly to the contractual regime is *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd*.[576] Although *Belmont* primarily concerns the so-called anti-deprivation rule, it is also of relevance in the context of contractual interpretation. As Lord Collins outlined, there is a strong case for respecting and giving effect to the contractual terms of complex financing agreements entered into in good faith.[577] In addition, Billington has noted that the junior creditors do, in fact, receive compensation for their negotiated subordinate position during the life of the facilities by means of interest.[578] This is a commercial risk assumed on the basis of a well-advised comprehensive commercial transaction. However, it is not easy to distinguish between what is a prudent, contractually agreed action and what is an invalid abuse of powers. Two recent cases – *Azevedo v Importacao Exportacao E Industria De Oleos*[579] and *Assenagon Asset Management v Irish Bank Resolution Corp*[580] – have clarified the *dicta* in *Redwood*.

Azevedo concerned a Uruguayan company that had issued guaranteed loan notes for $100 million. The issuer sought amendments to the trust deed requiring a majority of 75% for both the quorum and decision-making. The noteholders were offered a consent payment for their acceptance of amendments to the bond terms. One of the noteholders that voted against the proposal, therefore, did not receive the consent payment. Accordingly, it sought repayment of the invested funds, damages for

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Zentralbank Osterreich AG v Royal Bank of Scotland Plc [2010] EWHC 1392 (Comm) where the Court did not imply additional representations into a contract in a securities mis-selling case.

576 *Belmont Park Investments* (n 370).

577 ibid 103, 108-109.

578 See Billington, 'Interactions with other Creditors' at 4.5 in Shutter (n 323).

579 *Azevedo and Another v Importacao Exportacao E Industria De Oleos Ltda and others* [2013] EWCA Civ 364 (CA).

580 *Assenagon Asset Management SA v Irish Bank Resolution Corp Ltd* [2012] EWHC 2090 (Ch).

repudiatory breach and a declaration that the resolutions were invalid. Lloyd LJ held that there was 'nothing wrong or unlawful, in general terms, in a process of putting to all members of a class a proposal which offered benefits open to all who voted in favour of the resolution, but not to the others'.[581] The Court considered that there was full disclosure, that the members of the relevant class were not treated differently, that none were excluded from the scheme and that the argument based on the existence of the noteholders' different underlying interests was not relevant in that case.[582] One of the decisive factors in *Azevedo* was that the company gave the noteholders an option to consider what would be in their best interests and those of the company, even though this offered an incentive for participation.[583] Schillig has stated that this type of a 'bribe' payment is theoretically consistent with the 'bankruptcy contract approach' of insolvency law theory and provides evidence of the fact that the debtor in effect participates in the division of the 'going concern surplus'.[584] The 'bribe' is explicable through an enhanced bargaining position of the debtor, because the possibility of an exchange offer provides powerful protection either against an uncoordinated creditor-base or creditors that do not hold comprehensive security over the debtor's assets. Especially in covenant-lite capital market transactions not supported by an ICA, the bargaining position of the debtor will often outweigh that of the creditors.

Assenagon provides a stark contrast to *Azevedo* in relation to the nature of the disputed actions proposed by the debtor and the majority noteholders. The matter concerned an offer to exchange subordinated floating-rate notes to unsubordinated

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581 *Azevedo and Another v Importacao Exportacao E Industria De Oleos Ltda and others* (n 579) 63.

582 ibid 63.

583 ibid, especially at 63 and 69-71.

584 Schillig (n 55) 27.

notes with a value one-fifth of the old ones. The debtor bank convened a noteholders' meeting to pass an extraordinary resolution to amend the terms of the existing notes, thereby enabling their redemption for the value of €0.01 per principal amount of €1,000. The exchange of the notes was conditional on those creditors who voted in favour of the exchange to amend the terms of the existing notes. The decisions passed the quorum and voting thresholds, but one of the noteholders filed a claim challenging a number of points in the arrangement,[585] one of them being that the resolution constituted an abuse of power by the majority conferring no conceivable benefit to the existing noteholders as a class and only affecting the notes held by the accepting minority creditors.

The Court considered it unlawful for the majority to 'lend its aid to the coercion' of the minority creditors through a voting process that expropriated the minority creditors' notes for an insignificant consideration.[586] Briggs J distinguished the first instance decision in *Azevedo*, noting that, in *Azevedo*, the substance of the voting was to postpone the interest payments whereas in *Assenagon* it was to substitute the existing notes with the new notes. He pointed out that the resolution in *Assenagon* was in effect nothing more than a 'negative inducement' deterring the existing noteholders from refusing the exchange.[587] Secondly, in *Azevedo,* the consent payments were capable of being beneficial to all noteholders, as they were designed to facilitate the issuer's restructuring, whereas in *Assenagon* the resolution was designed 'to destroy rather than to enhance the value of the notes'.[588] In *Assenagon*, the consent was considered a coercive threat, which the 'issuer invited to levy against the minority' and

585 This also included an *ultra vires* argument. Furthermore, the bank was barred from voting on the notes it held beneficially in effect at the time of the noteholders' meeting.

586 *Assenagon Asset Management SA v Irish Bank Resolution Corp Ltd* (n 580) 84.

587 ibid 83.

588 ibid.

which was contrary to the purposes for which the majority powers were conferred.[589]

The possible oppressive nature of exit consents can be evaluated based on matters such as the threatened abrogation of the minority creditors' rights as compared to the commercial objectives that the arrangement seeks to achieve.[590] However, the problem is that an ICA-based restructuring always seeks to achieve an economically feasible rescue of the debtor or its business, while the notion of the 'benefit of all of its creditors' appears too vague in terms of commercial certainty. This view would be more convincing in light of the Australian case *Peters American Delicacy* in which Rich J noted that where the problem includes an inherent element of conflict between different stakeholders, the powers of alteration should not be paralysed, but that 'the only reason for bringing up the decision must not be simply the enrichment of the majority at the expense of the minority'.[591] From this perspective, the real test in *Redwood* was whether there is dishonest abuse of that power, including the intent to obtain collateral benefits not based on agreed contractual rights, determined based on the available evidence.[592]

Peel has argued that the expropriatory exit consent in *Assenagon* does not necessarily lead to all restructuring tactics that impose adverse consequences on the minority being invalid.[593] He notes that such consequences may be allowed within the 'abuse principle', unless no reasonable men would consider them beneficial to the class, such as in *Assenagon*, where the only purpose of the exit consent was to coerce the

589 *Assenagon Asset Management SA v Irish Bank Resolution Corp Ltd* (n 580) 85.

590 Paterson and Zakrzewski (n 473) 9.2.3.1.7.6. They raise an important question of the difficulty of ascertaining what is in effect the benefit of the class in question.

591 *Peters' American Delicacy Company Limited v. Heath and Others* (1938-39) 61 CLR 457, 495.

592 *Redwood Master Fund Ltd v TD Bank Europe Ltd* (n 563) 105.

593 Robert Peel, 'Assessing the legality of coercive restructuring tactics in UK exchange offers' (2015) 4 UCL Journal of Law and Jurisprudence 162, 165 referring also to *Shuttleworth v Cox Bros and Co (Maidenhead)* [1927] 2 KB 9, 18.

minority to accept. However, as stated in *Assenagon*, it would have been more difficult to criticise a drag-along exit consent permitting the non-consenting creditors to exchange for a 'potentially beneficial' substitute.[594]

Peel also notes that coercive tactics often lead to a prisoner's dilemma for the minority creditors, effectively forcing them to co-operate with the proposal.[595] This is somewhat misleading because a prisoner's dilemma leads to a non-optimal outcome for both stakeholders that is similar to the equilibrium state discussed in Part B Section 3(b). In the creditor oppression scenario, however, the majority creditors actually obtain an optimal benefit from the arrangement and are thus not trapped in a prisoner's dilemma. The creditor oppression problem is rather a question of what are the proper legal requirements for removing the right to make the decision from the dissenting minority. Logically, the majority should not be entitled to coerce the minority to approve the arrangement with the intention of oppressing the interests of the minority by removing a true option of dissent. However, the limits of the rule are by no means clear.[596]

Unless the prejudice to the minority is too severe, the debtor or senior creditors might overcome the risk of a successful challenge by showing that there is a rational, broader restructuring benefit from the amendments.[597] According to Peel, the threshold for showing that the tactics 'manifestly exceed' the commercial necessities

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594 Peel (n 593) 184.

595 ibid 164.

596 See also on the majority and majority conflict in financing agreements: Philip Rawlings, 'Majority rule and minority rights in syndicated loans' [2016] JIBFL 70. It appears difficult to apply the creditor oppression argumentation to senior creditor enforcement sales because a resolution concerning a sale leads to the same result for the majority and minority (*pro rata*) if the sale is carried out. However, this is only a case if the arrangement does not include other elements that differentiate between the groups based on their voting behaviour.

597 Peel (n 593) 187. See also Paterson and Zakrzewski (n 473) 9.2.3.1.7.7.

leading to irrationality, is high.[598] Although the view on balancing the 'restructuring benefit' with the 'level of creditor oppression' appears commercially sensible, it does not assist much in the evaluation of what the allowed 'coercive' LBO restructuring tactics can be. In a normal scenario, junior creditors are left within a shell company that has, after the distress sale, no real assets. They may receive nothing, their claims will be discharged or released as a result.

In most LBO restructurings the controlling creditors have the power to vote on and affect the restructuring measures and such powers are invariably used to effect the restructuring as intended. The evident way of dealing with secret or diverging benefits and interests of the parties is increasing the transparency of the process. However, even more important than disclosure and transparency is whether a process controlled by the instructing group can be 'manifestly disadvantageous, discriminatory or oppressive' in relation to the valuation of the debtor group, even though the process is properly conducted under the ICA, no changes are proposed to the junior facilities, or the material decision is merely instructing the security agent to enforce.

The types of inter-creditor disputes discussed above are likely to materialise in distressed disposals and enforcement procedures. Consistent with the focus on the 'horizontal' and 'vertical' aspects of dealing with the strategic creditor actions, possible challenges from the 'creditor oppression' case law must be evaluated from both perspectives. I will next discuss how the ICA enforcement and distressed disposals clauses are structured and what the concerns of creditor oppression, ie the risks to the effectiveness of the decision-making regime, mean for these solutions.

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598 Peel (n 593) 187.

(b) Enforcement in the LMA ICAs

1. LMA S/M ICA

The group controlling the enforcement of the transaction security and distressed disposals under the LMA S/M ICA is the 'instructing group', which is defined as the senior lenders whose participation aggregates to more than a set percentage of the senior liabilities.[599] The threshold is linked to the majority senior lender definition within the LMA Leveraged Document, in which the majority also controls the most important decisions under the SFA, such as acceleration of the indebtedness. After the senior discharge date, the mezzanine lenders become the first ranking creditors with similar voting thresholds.[600] The instructing group is entrusted with the authority to make enforcement decisions under the ICA.[601] If the instructing group has chosen not to enforce, or in the absence of its instructions, or if it has not required any debtor to make a distressed disposal, the majority mezzanine lenders become entitled to instruct the security agent.[602] This is possible only after the mezzanine standstill period has elapsed.

If the mezzanine lenders are entitled to give enforcement instructions, however, release of claims and security would require that the senior liabilities are paid in full and that any non-cash consideration is pre-approved by the instructing group.[603] The subordinated creditors cannot, therefore, bypass the senior lenders, unless there is

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599 This is left open for parties to decide.

600 LMA S/M ICA 16.

601 Such decisions include distressed disposals, enforcement actions, termination of hedging, consents to payment or acquisition of intra-group liabilities, and instructing the security trustee concerning the use of voting in insolvency.

602 LMA S/M ICA 12.2(c).

603 ibid 14.6.

full and final discharge of their claims. This is reinforced by the provisions restricting the scope of the duties owed to the mezzanine creditors to those owed to debtors under general law.[604] In the absence of any instructions from the instructing group or the majority mezzanine creditors the security agent is entitled to carry out the enforcement as it considers appropriate.[605]

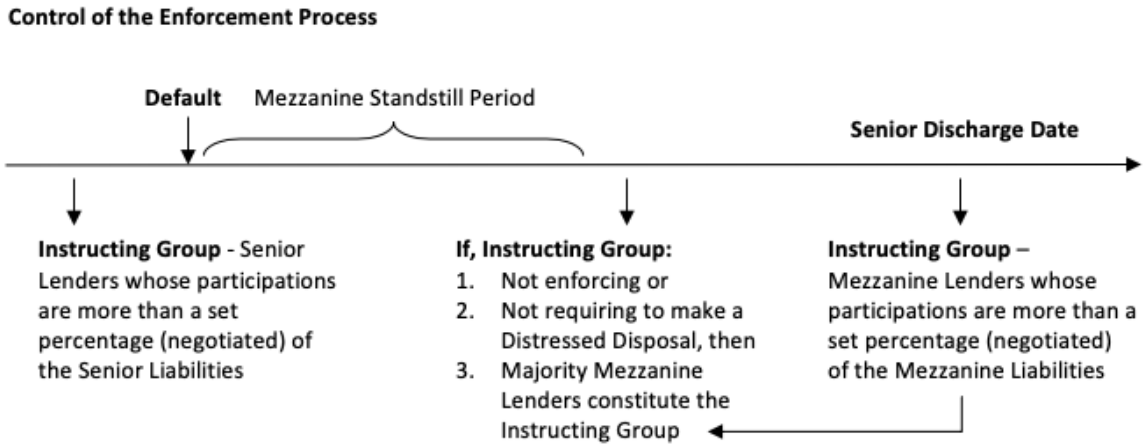

Figure 21. Control of the mezzanine enforcement process

The actual enforcement measures are delegated to the security agent, which may refrain from enforcing the transaction security unless otherwise instructed by the instructing group.[606] The security agent is a trustee,[607] shielded from the creditor actions by far-reaching limitations of liability and broad discretion in effecting the enforcement.[608] There are also broad contractual limitations on the trustee's obligations and liability for administrative actions in the ICA and in respect of the enforcement mechanics and decision-making process. Initially, the extensive limitations in the LMA ICAs appear to be inconsistent with the 'irreducible core of trustee's obligations' set out by Millet

604 ibid 12.6.

605 ibid 12.3.

606 ibid 12.2.

607 ibid 21.1.

608 ibid 21.4.

LJ in *Armitage*[609] and may be subject to challenge by other creditor groups, as in *Saltri III*.[610] However, the narrow scope of trustee's obligations in LMA ICAs may be based, as Trukhtanov has noted, on the fact that the financial markets only care in complex financial agreements about the beneficial proprietary interest in the fund securing the parties' credit risk.[611] On the other hand, Trukhtanov questions the feasibility of this view in light of the special personal relationships and remedies intended to be protected by the relevant equitable rules.[612] Despite this, the bar for acknowledgement of a trust in LBO arrangements is not too high. For example, Rawlins notes that that a trust will exist as long as there may be situations 'when the trustee will be obliged to use its own discretion, as, for instance, when the minority or the investor fails to issue directions'.[613] These concerns are acknowledged in ICAs by ensuring that the security agent is able to act independently in the absence of instructions from the instructing group.[614] Therefore, the risk for trust failing appears to be low.

2. LMA SS/S ICA

Similar to the LMA S/M ICA, the triggering and the manner of enforcing the transaction security are controlled by the instructing group. The document leaves it to

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609 'There is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of a trust. If the beneficiaries have no rights enforceable against the trustees there are no trusts […] The duty of the trustees to perform the trusts honestly and in good faith for the benefit of the beneficiaries is the minimum necessary to give substance to the trusts': *Armitage v Nurse* [1998] Ch 241 (CA Civ Div). See for a stricter interpretation in *Walker v Stones* [2001] QB 902 (CA).

610 *Saltri III Ltd v MD Mezzanine SA Sicar (as Mezzanine Facility Agent) and others* [2012] EWHC 3025 (Comm).

611 Alexander Trukhtanov, 'The irreducible core of trust obligations' 123 Law Quarterly Review 342, 346.

612 ibid 436.

613 Rawlings (n 477) 18, referring to *Citibank NA v MBIA Assurance SA* [2007] EWCA Civ 11 (CA (Civ Div)).

614 LMA S/M ICA 12.2-3, 12.7 and 14.8.

the parties to choose the initial instructing group, but under other clauses this appears to be assumed to be the majority senior creditors. The general creditor control in relation to enforcement actions therefore remains with the majority senior creditors and the majority super senior creditors are only entitled to take enforcement actions after an acceleration event; in an insolvency event; with the consent of the initial instructing group; or after super senior step-in events, which are defined as the following:[615]

(i) existence of a material event of default;[616] and

(ii) the initial instructing group has not issued instructions concerning enforcement after such an event; and

(iii) there has been no super senior liabilities transfer; or

(iv) the super senior standstill period and the enforcement realisation period relating to a material event of default have elapsed and:

a. the event is continuing; and

b. there has been no super senior discharge date; and

c. there has been no super senior liabilities transfer.

3. LMA SS/HY ICA

The enforcement instructions

In the LMA SS/HY ICA, the enforcement instructions are given by the majority super senior creditors or the majority pari passu creditors.[617] If the instructions conflict, the

615 LMA SS/S ICA 3.7.

616 The definition is left open for the parties to negotiate.

617 LMA SS/HY ICA 23-24.

instructions of the majority pari passu creditors prevail, unless they have not given instructions or appointed a financial advisor within a pre-agreed time from the enforcement notice or if the super senior discharge date has not occurred within a pre-agreed time from the enforcement notice. In these cases, the security agent follows the instructions of the majority super senior creditors.[618]

These time limitations do not apply to majority super senior creditors, however, if they determine in good faith that a delay in issuing enforcement instructions could reasonably be expected to have an adverse effect on the distressed disposal or on the expected realisation proceeds. In such a case, their enforcement instructions need to correspond to the 'enforcement principles' and need to be given before the majority pari passu creditors have issued instructions. After the priority discharge date, the control is transferred to the majority high yield creditors.[619]

The high yield creditors are also entitled to override the controlling creditor group if the relevant instructing group, or the next-ranking creditor group, has instructed the security agent to cease the enforcement or if no enforcement instructions are issued. The initial creditor majority group may subsequently override such instructions. Consistent with the other LMA ICAs, the majority high yield creditors are only entitled to issue the enforcement instructions after the respective enforcement standstill period has elapsed.[620] I have described in below Figure 22 the control of the enforcement process following a default and a priority discharge date.

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618 LMA SS/HY ICA 14.2-3. The majority super senior creditors control right applies also in an insolvency event, if that event occurs prior to the super senior discharge date.

619 ibid 14.2(e).

620 ibid 7.10.

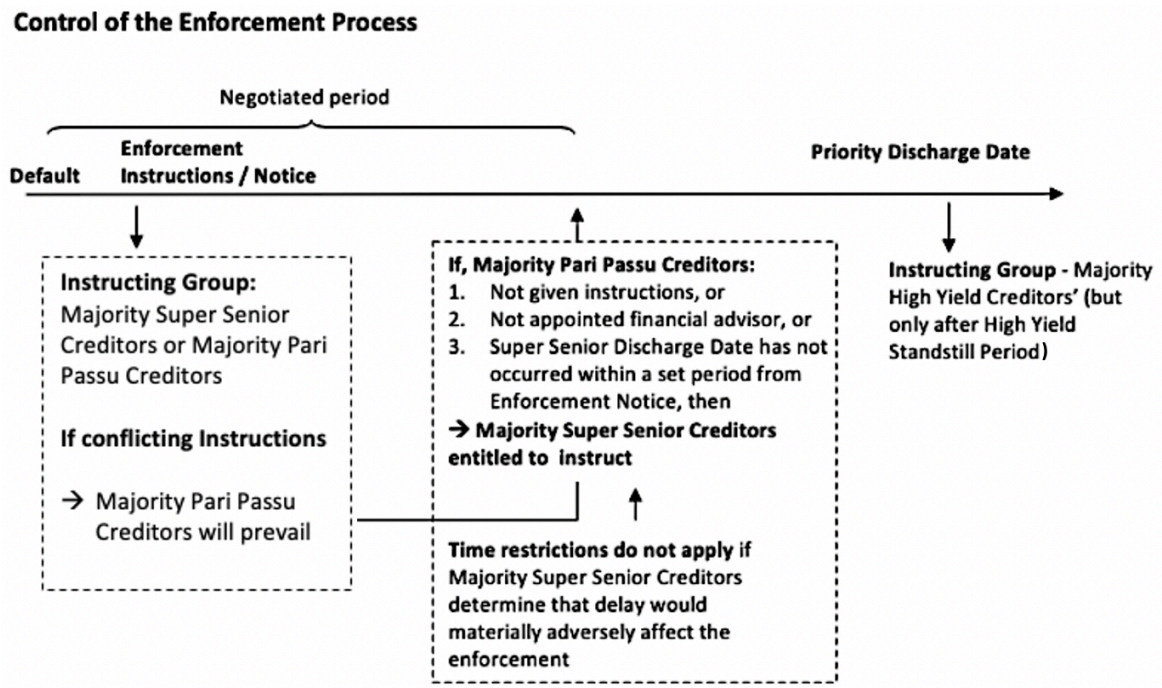

Figure 22. Control of the high yield enforcement process

Instructions as to the manner of enforcement are given by the instructing group then in charge and in accordance with the enforcement principles.[621]

The enforcement principles

The document does not contain so-called 'fair value' or 'value protection' clauses like the other two LMA ICAs. Rather, it links the manner of enforcement in certain circumstances to the enforcement principles. The principles state the objective of enforcement to be 'maximising, to the extent consistent with a prompt and expeditious realisation of value, the value realised from enforcement'.[622] The main rules are set out below:[623]

621 ibid 14.4.

622 ibid Schedule 4.

623 ibid.

(i) If the instructing group is the majority super senior creditors, the proceeds are in cash; or

(ii) If the instructing group is the majority pari passu creditors,

1. all proceeds are in cash; or

2. sufficient proceeds are in cash to ensure that the super senior discharge date occurs; and

(iii) If there is no public auction, the security agent appoints a financial adviser to issue a valuation fairness opinion if the enforcement:

1. involves share security; or

2. other assets, the value of which exceeds a pre-agreed sum; but

(iv) No fairness opinion is required if the arrangement complies with the distressed disposals clauses and enforcement leads to:

1. pari passu discharge date occurring, if the majority super senior creditors issue the instructions; or

2. super senior discharge date occurring, if the majority pari passu creditors issue the instructions.

The structure of the regulation concerning enforcement instructions was built on the use of cash proceeds or, in other situations, discharge of equally ranking senior debt and on public auctions or fairness opinions. Therefore, the process deals directly with the moral hazard risk of the controlling creditor group seeking a non-optimal enforcement of distressed disposal, the risk of which is pronounced if the value of the assets is close to or above the claims of the controlling creditor group.[624] However,

[624] See Part B, Section 5(e).

although the fair value and value protection rules are extensive, they provide little contractual remedies for the creditors should the enforcement of sale be made for less value than in the optimal scenario. The parties will necessarily have to resort to courts for this purpose.

(c) Enforcement instructions in the sample ICAs

1. Introduction

All the sample ICAs were consistent in granting the right to make decisions concerning enforcement of transaction security and distressed disposal to the instructing group. The enforcement instructions clauses were found in all ICAs having multiple external creditor classes and the clauses were materially consistent with the LMA S/M ICA and LMA SS/HY ICA.[625] The enforcement principles discussed in the end of Section 5(b) were consistent with the LMA SS/HY ICA. This meant that, subject to the support of the majority controlling creditor group, the entire debtor group could be subjected to the enforcement process.

2. The instructing group and majorities

The term 'instructing group' term is used in the LMA ICAs and throughout the ICA sample except for in single senior facility transactions, where a static 'majority senior creditors' definition was used. The group controls enforcement instructions and distressed disposals.[626]

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625 See Figures 21 and 22.

626 The instructing group also controls several other waivers and amendments under the ICA. These are not relevant here, however.

In the ICA sample, the definition of the instructing group was based on the underlying creditor majority definitions. There were material differences between and within the sample ICA categories. In several ICAs, the definition referred to the debt documents, so the thresholds could not be determined. However, the SFA definitions commonly refer to majorities exceeding either half or two-thirds of the credit participations, that is the value of the claims. It was characteristic of the sample ICAs that the majorities were defined as exceeding half of the relevant participations if the capital structure included, or could include, notes or bonds. The two-thirds threshold was in most cases connected to the definition of the majority super senior (the revolving facility) or the majority senior secured creditors. The documents were not uniform in this respect and in some cases even these categories were defined only as exceeding half the relevant participations.

3. Between senior, second lien and senior unsecured creditors

The regulation concerning enforcement instructions was consistent throughout the sample. The right to give enforcement instructions was subject to the lapse of the relevant enforcement standstill period and fulfilment of one the following conditions. The next-ranking debtor group majority (whether half or two-thirds) constituted the instructing group after the discharge date of the next higher-ranking indebtedness. The instructing group changed to the next-ranking group also if the higher-ranking creditor group had not given enforcement instructions or cancelled enforcement and the instructing group had not required any debtor or a security provider to make a distressed disposal.

The same solution was adopted both between the senior and the second lien creditors and between the second lien and senior unsecured creditors throughout the

sample. This was consistent with the LMA ICA regulation. These solutions applied in all sample ICAs only to creditors prioritised to the junior creditors. Their enforcement rights were in all cases restricted or prohibited.

4. Within the senior creditor constituency

The instructing group solutions that applied within the senior liabilities class were based on a similar logic in all the sample documents that included at least two senior creditor categories. The only exceptions concerned group 1 ICAs,[627] which, in some cases, had a loan and a bond facility that voted as a single group. In non-enforcement matters, such as distressed disposals, the instructing group invariably consisted of both the majority super senior creditors and majority pari passu creditors or majority senior creditors. In enforcement matters, all the relevant ICAs used the LMA SS/HY ICA mechanism discussed in Section 5(b)3 and set out in Figure 22.

5. Consultation obligations

The sample ICAs deviated from the LMA ICAs in that a majority of them included a consulting obligation before actual enforcement. For example, eight of the nine ICAs that had second lien liabilities included an obligatory consultation period between the senior and second lien creditors of between ten and thirty days before enforcement. This requirement could be avoided in most cases if the delay would have adversely affected the enforcement proceedings.

Five ICAs included a consulting obligation between the super senior creditors and pari passu creditors, both part of the senior creditor group. These

627 See Figure 4.

consultation times were longer at 30-45 days. Two documents set out an additional consultation period of 10-15 days, if the security agent was not considered to be enforcing in accordance with the enforcement principles.

6. Enforcement principles

Eleven sample ICA documents included a schedule regulating enforcement principles. All of these primarily regulated the main objectives of the enforcement: the extent of allowed cash or non-cash consideration; requirements for public auctions; and the requirement to obtain a fairness opinion from an investment bank. The schedules partially overlapped with the 'value protection' clauses that were used extensively in connection with distressed disposals.[628]

The enforcement principles conformed materially to the LMA SS/HY ICA.[629] Enforcement principles were included in all of the super senior and pari passu debt group[630] (group three) documents and in half of the group five[631] documents. In group five ICAs, they were included only if there was a 'senior term loan discharge date', after which the instructing group and enforcement instructions rules became similar to the LMA SS/HY ICA. This means that enforcement principles were included in ICAs with underlying capital structures involving super senior and pari passu indebtedness, if the senior term loans were either absent or discharged. Therefore, the use of enforcement principles was mostly characteristic of LBOs involving capital market instruments.

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628 See Part C, Section 6.

629 See Part C, Section 5(b)3.

630 See Figure 6.

631 See Figure 8.

The enforcement principles also applied in distressed disposals and the security agent also needed to comply with them if majority super senior creditors enforced without being bound by the 3- or 6-month standstill periods and when the majority unsecured creditors were enforcing.

7. Detailed results on enforcement

The detailed results are set out in Table 16, grouped into the five sample ICA categories discussed in Section 3(f).[632] The variation of the specific rules applying to the enforcement was high throughout the sample, but the specific solutions followed the capital structure groups of the ICAs. However, the general solutions to the hold-up creditor risks were coherent. The controlling creditor group effectively controlled also the enforcement instructions.

However, the next ranking group was often entitled to give the enforcement instructions instead if, for example, the higher-ranking group did not take action. This was only possible for external financial creditors and only after the lapse of the enforcement restriction periods. To the extent all of the conditions for lower-ranking creditors' instructions were present, the protective provisions ensured that the higher-ranking creditors were either entitled to take over the process or be economically protected against all other groups by cash payment, full discharge of senior obligations, or eg through strict enforcement principles. Economically, the use of hold-up tactics was not feasible against higher-ranking creditors. Hold-up behaviour risk, however, within the controlling creditor group existed, but was lower than eg with a scheme of arrangement, because the voting thresholds were either 50% or 2/3.

632 See Figures 4-8.

Table 16. Sample ICA enforcement provisions

SAMPLE ICA GROUP	INSTRUCTING GROUP DEFINITION AND SENIOR ENFORCEMENT INSTRUCTIONS	WITHIN SENIOR CREDITORS	WITHIN SECOND LIEN CREDITORS	WITHIN SENIOR UNSECURED CREDITORS
1	**6 ICAs:** > 2/3 Senior credit participations[633]	**Only instructing group** **1 ICA:** Super senior and senior creditor structure[634] **1 ICA:** included enforcement principles	N/A	N/A
2	**2 ICAs:** > 50% of credit participations **1 ICA:** > 2/3, if no bonds or notes **1 ICA:** Only reference to debt documents	**Instructing Group:** Majority senior creditors **3 ICAs:** - after senior discharge date - no instructing group instructions - instructing group had ceased the enforcement - no distressed disposal taking place	**Enforcement standstill** periods: see Figure 18. **2 ICAs:** Majority second lien creditors **1 ICA:** same, but no restrictions set out on the left[635] **2 ICAs:** 10-30-day consultation obligation **1 ICA:** enforcement principles[636]	N/A

633 One of the ICAs referred to majority initial senior creditors as defined in the SFA and subsequently the majority refinancing creditors, being more than two thirds.

634 Structure was similar to LMA SS/S ICA enforcement instructions regulation. Standstill period was 180 days with possible 60-day extension.

635 All ICAs (also this one) contained a clause materially consistent with the LMA S/M ICA 'restriction on enforcement against Debtors', which prohibited enforcement by the second lien creditors if the security agent was enforcing the transaction security over shares in a debtor or, for example, any holding company of a debtor.

636 In this case, the enforcement principles operated effectively as fair value clauses enhanced with the standard enforcement objective.

3	**Enforcement**: See mechanism **General matters:** Majority super senior creditors **and** majority pari passu creditors[637] (also distressed disposal) **1 ICA:** PIK toggle note pari passu creditors, until their discharge. after that, majority pari passu creditors **Majority super senior creditors:** >2/3 and in one 50% of the participations **Majority (and PIK toggle)** *pari passu* creditors**:** > 50% of participations[638]	**Both majority super senior creditors and majority** pari passu creditors (**in 1 ICA:** Majority super senior creditors and the majority PIK toggle pari passu creditors) were entitled to instruct. Conflicting instructions were resolved similarly to **LMA SS/S ICA** mechanism (see 5(b)2) but implemented in the sample ICAs within the enforcement instructions, instead.[639] **3 ICAs:** 30-45-day consultation obligation[640] **2 ICAs:** additional 10-15-day consultation if security agent not considered enforcing according to enforcement principles	N/A	N/A
4	**Enforcement:** **2 ICAs:** See mechanism **1 ICA:** > 2/3 of senior secured creditor participations	**1 ICA:** Both majority super senior creditors and majority senior creditors were entitled to instruct. Conflict in instructions were resolved similarly to **LMA SS/S ICA** mechanism.	N/A	Senior unsecured creditor majorities were defined in the SFA, not in the ICA.

637 In some cases, majority super senior creditors and senior required noteholders.

638 In one ICA the majority credit facility lenders were defined in the SFA but after the revolving lender discharge date, the threshold was two thirds of participations.

639 In all ICAs, insolvency events were carved out from this mechanism and the majority super senior creditors were entitled to give the instructions in these cases.

640 This did not apply if the instructing group determined, acting reasonably and in good faith, that the consultation could reasonably be expected to have a material adverse effect on the ability to enforce or on the realisation proceeds. The obligation did not apply to insolvency events.

	General matters: **1 ICA:** Majority super senior creditors **and** majority senior secured creditors[641] (also distressed disposal) **1 ICA:** Senior instructing group creditors and majority senior creditors **1 ICA:** > 2/3 of senior secured creditor participations **1 ICA:** both > 2/3 of super senior and > 50% of senior participations[642] **1 ICA:** before senior discharge: > 50% and after that > 2/3, of Senior participations **Majority super senior creditors:** >2/3 of the participations **Majority senior secured creditors:** > 50%, of senior participations **Senior instructing group creditors:** > 50%, of participations **Majority Creditors:** > 2/3%, of senior participations	**1 ICA:** These enforcement mechanics were embedded in the consultation provisions but led to the same outcome. The relevant creditor categories were also atypical, ie senior instructing group creditors and majority senior creditors. **2 ICAs:** 30-day consultation obligation before enforcement (similar structure to above 'super senior and pari passu debt' category'[643] **1 ICAs:** qualified enforcement required (similar to enforcement principles) similar to LMA SS/HY ICA[644] **3 ICAs:** - after senior discharge date - if no instructing group instructions, - instructing group had ceased the enforcement - no distressed disposal taking place	→	**3 ICAs:** Majority (FinCo/parent/permitted) (unsecured/subordinated) creditors

641 In some cases, majority super senior creditors and senior required noteholders.

642 After the discharge of the super senior indebtedness, the instructing group included only majority senior secured creditors.

643 In both cases, the actions were limited to ones necessary to protect the senior secured creditors' interests, if no consultations were carried out.

644 Three of the documents contained case-specific differences on a six-month enforcement period objective, exclusion of a minimum values for asset disposals, the requirement that a share and an asset enforcement only required a fairness opinion, not a competitive sale process. In one ICA, there was an absolute requirement of a cash consideration, granting bidding rights to *pari passu* creditors on super senior enforcement and enabling, for example, a sale under US Bankruptcy Code s 363.

5	**<u>No</u> <u>senior term loan facility maturing before other debt:</u>** **3 ICAs:** Majority senior secured creditors **<u>With senior term loan facility</u>** **Enforcement:** **3 ICAs:** before senior term loan discharge date: majority senior secured creditors **3 ICAs:** after senior term loan discharge date: see mechanism → - Majority super senior creditors and majority *pari passu* lenders **General matters:** **3 ICAs:** before senior term loan discharge date: - Majority senior secured creditors **3 ICAs:** after senior term loan discharge date: - Majority super senior creditors and majority pari passu lenders **5 ICAs:** > 50% of relevant creditor group participations **1 ICA:** > 2/3 of relevant participations (>50% after senior lender discharge)	**6 ICAs:** - after senior discharge date - no instructing group instructions - instructing group had ceased the enforcement - no distressed disposal taking place **3 ICAs:** Both majority super senior creditors and majority pari passu creditors entitled to instruct. Conflict in instructions were resolved similarly to **LMA SS/S ICA** mechanism. **6 ICAs:** 10-day consultation obligation between senior and second lien creditors **3 ICAs:** Enforcement principles schedule consistent with the LMA SS/HY ICA	**6 ICAs:** Majority second lien creditors - after second lien discharge date - no instructing group instructions - instructing group had ceased the enforcement - no distressed disposal taking place	**6 ICAs:** Majority senior unsecured creditors

(d) Connection between the ICA and the statutory procedures

1. The interviews

Consistent with the sample ICA analysis, the interviewees considered the ICA enforcement rights to be effective and based on strong contractual protections and comprehensive transaction security. Most considered that the majority thresholds and the enforcement rules form the basis for all restructuring and enforcement measures. The interviews also evidenced that the ICA mechanisms are a part of a broader solution to deal with distressed LBO transactions.

Some interviewees pointed out that a contractual solution or enforcement is always the preferred plan and that it is really hard to see that insolvency would ever be the best option.[645] In particular, the private equity representatives emphasised that the parties will always aim for pre-distress voluntary mechanisms and reorganisation measures.[646] As one interviewee noted, however, when this scenario has passed, 'the intercreditor is everything and the map'.[647]

Two bankers noted that the deficiency of the formal procedures is their inability to deal with various companies and jurisdictions, which problem can be addressed by a contractual regime.[648] The parties might opt for the statutory route instead of a voluntary arrangement or ICA enforcement due to a failure to achieve the

645 Interviews 3, 6 and 11.

646 Interviews 12 and 13.

647 Interview 12.

648 Interviews 9 and 10.

voting thresholds,[649] or if required due to a board's obligations to file for insolvency.[650] Further reasons for resorting to a statutory route were short time thresholds, purchaser's concerns over transactions at an undervalue[651] and the borrower's need to avail itself of burdensome non-ICA covered contracts.[652]

Despite such strict confines for the statutory procedures, an English law scheme of arrangement was seen in some cases as a preferred way of dealing with a comprehensive restructuring that would otherwise require unanimity from the relevant secured creditor group.[653] Although enforcement under an ICA usually requires a lower voting threshold than under a scheme of arrangement, a restructuring involving, for example, a debt-write-off (where the existing creditors restructure their claims) was considered to be most easily effected by means of a scheme, or a threat of a scheme, of arrangement.[654] According to one interviewee, however, even if the parties would have to resort to a statutory procedure, such procedures take as their baseline the contract between the parties; for example, a 75% threshold under a scheme of arrangement was argued to be usable merely to carry out some of the measures regulated by the ICA under more lenient thresholds.[655]

A number of interviewees noted that when European companies go into insolvency, it is because the directors have filed for insolvency arising from their duties under the law in that jurisdiction.[656] For example, one interviewee observed that, in the

649 Interview 5.

650 Interview 2 and 6.

651 Interviews 7 and 8.

652 Interviews 9 and 10.

653 Interview 14.

654 Interview 14.

655 Interview 4.

656 Interviews 1, 6-8.

UK, one would only use administration if the directors saw no reasonable prospect of continuing to trade solvently.[657] There were also views supporting the contention that, in deeply stressed scenarios, the parties have to resort to the legal procedures.[658] One reason for that was that, unlike bonds that can be substantially modified eg with a 90 percent majority, the LMA SFAs contain unanimity requirements for actions like the write-off of debt albeit a matter capable of being amended by the market.[659] Before discussing the ICA distressed disposals regulation, it is necessary to address some aspects of schemes of arrangement and why ICAs do not contain similar rules.

2. Scheme of arrangement and contract

The enforcement clauses used in ICAs are extensive but leave open whether: (i) there are scenarios in which a statutory procedure, such as an administration or a scheme of arrangement is necessary; or (ii) the parties always have to resort to a statutory procedure. The last claim is at odds with the empirical findings. The structure and enforcement clauses are clear in granting the controlling creditor group options to carry out the arrangement through a voluntary or a statutory mechanism or through any combination of these. None of the ICA clauses obligates the controlling creditor group to opt for a statutory procedure.

However, the question of the necessary situations where a statutory procedure is required is more challenging. Could the parties not draft in the ICA or in the debt documents clauses either replicating or in line with, for example, the scheme of arrangement voting process or control provisions applying in administration? We

657 Interview 1.

658 Interview 5.

659 ibid.

can argue that we would see such clauses in the documentation unless the statutory procedures are either always necessary or there is some other reason for their omission. Alternatively, the question may be misled in its assumptions. We cannot really detach the ICA from the statutory regime because it necessarily operates within it. We cannot answer the counterfactual of what if the legislation did not include regulation on schemes of arrangement or administration. Noting this, the proper way to answer the question is to look at the empirical findings and evaluate whether they signal any features of ICAs or market practice from which we can infer whether there is a necessary connection.

First, some interviewees had encountered that the junior creditors may try to include clauses into ICAs that they should be treated as a distinct creditor category. This may have an impact in a scheme of arrangement where the possibility of a blocking the vote in a separate class may be easier if the junior creditors' argument of a separate class-treatment prevails. However, the interviewees stressed that such a request is unlikely to be approved by the sponsors, ie the private equity fund, or the senior creditors.[660] One interviewee noted that the senior creditors are unlikely to agree to any particular process beforehand.[661] This is consistent with the earlier finding that ICAs are designed to keep open for the controlling group an *ex post* feasible liquidation or restructuring option, while at the same time understanding that the *ex post* bargaining scenario is also affected by other matters and the leverage of different stakeholders. The private equity fund will also wish to retain its leverage in the bargaining by ensuring

660 LMA S/M ICA 12.4 provides for a clause intending to do the exact opposite. The 'exercise of voting rights' clause obligates each 'Creditor (other than each [Senior]/[Facility] Agent and each [Senior] Arranger) will cast its vote in any proposal […] or under the supervision of any judicial or supervisory authority in respect […] insolvency, or […] similar proceedings relating to any member of the Group as instructed by the Security Agent', which in turn acts in accordance with the instructing group.

661 Interview 6.

that the flexibility afforded by the ICA is maintained, which will also increase its chances of retaining control of the enterprise post-restructuring.

Secondly, even though the documents were governed by English law, it may be that there is no evident connection to the UK so that the parties would have initially contemplated resorting to a scheme of arrangement.[662] The number of jurisdictions covered may be large and preparing for jurisdiction-specific eventualities or statutory procedures may not be practical or economical. Execution of deals involving a large number of jurisdictions may not enable the parties to negotiate on the specifics of certain solutions to a possible financial distress scenario.

However, the facility agreements and bond indentures still include contractual thresholds for various decisions, so the negotiation dynamics cannot themselves explain why ICAs do not directly incorporate voting provisions equivalent to schemes of arrangement.[663] The easy answer is that schemes are already so flexible that the parties take the likelihood of a scheme occurring into consideration when drafting the contracts without giving much thought to the contractual solution. Current case-law enables the use of a scheme in cases where there is little connection to the UK, so the parties are likely to expect this where, for example, some of the entities are located in the UK or some of the debt documents are governed by English law.[664] However, a scheme is still only one of the restructuring options so it may not be economically efficient for the parties to negotiate similar voting rules in their ICA.

In addition to the need for efficiency and flexibility of the ICAs, the

662 Interview 6.

663 The parties cannot, naturally, incorporate a statute within their contract and schemes of arrangement require that the court convenes the meetings and evaluates the fulfilment of the conditions of the approval of the scheme. Therefore, I am referring in this context only to the scheme voting rules.

664 See eg: *Re Rodenstock GmbH* [2011] All ER (D) 62 (May) (Ch).

interviews and the content analysis supported the argument that the creditors are not comfortable of being dragged into a debt-to-equity conversion or financing of a restructured company, at least by an *ex ante* commitment. Some of the creditors may, for example, be CDOs[665] and debt funds that cannot hold equity positions. Effectively, the restructuring alternatives, which cannot be mandated by the ICA or the facility agreements are left to be resolved in the eventual bargaining scenario with the information available at that time.

From the perspective of the entire capitalisation of the group, inclusion of the scheme voting provisions may not be feasible because the company also has other creditors, not just those having acceded to the ICA. A large enough non-acceding creditor-base can constitute a hold-out group, effectively blocking the deal. This may signal an approach that the ICA creditors do not want to have a worse relative bargaining position *ex post* than the non-ICA creditors. But, as I have argued, the creditors have an incentive to fix the level of acceptable non-ICA debt when entering into the debt documents and the ICA. This enables the parties to reach a level of ICA indebtedness sufficient to control the distress scenario. The fact that the level of non-exceeding indebtedness fluctuates may make it difficult to determine whether the potential hold-out group would jeopardise the deal.

Therefore, it is a more plausible explanation that the scheme-type provisions on voting or twinned administration and scheme voting or control provisions are not seen in ICAs because the ICAs and the debt documents already regulate the acceptable level of non-ICA indebtedness. Dragging the non-acceding creditors along is not possible contractually, so the best strategy may be to rely on a scheme or a twinned administration and scheme to bind all creditors alike, while binding the

665 Collateralised debt obligations.

financial creditors by the ICA.

This suggests that the statutory measures are likely to be needed: (i) if the senior secured creditor group (or the group whose claims have value but will not be paid in full) has a material disagreement on the need to enter into a debt-to-equity conversion in the debtor group restructuring; or (ii) the size of the acceptable non-ICA debt is too large and there are no other mechanisms to restrict its or their hold-out or hold-up behaviour. Possible contractual scheme provisions will lose their effect if the level of non-acceding creditors is too high and reaching 75% of the total indebtedness becomes difficult to achieve.

We have to bear in mind that some corporate bonds include a 90% threshold for amending most of their terms, including debt maturity and reductions in capital. This implies that the lack of contractual write-off thresholds in loans is somehow connected to the market conventions or requirements. A dispersed bondholder-base is unlikely to be as coordinated in negotiating the terms of the financing as large commercial banks. As a result, creditor fragmentation and the fragmentation of capital sources indicate a higher likelihood of inclusion of such terms in the debt document, whereas a more concentrated creditor-base is able to safeguard write-off discussions better.

Therefore, the financial creditors could technically include the scheme or administration voting provisions in their contracts, but this has not happened. The likely reasons for this are the market dynamics, concentration of the creditor base which gives a better bargaining position, market restrictions for mandatory debt-to-equity conversion with some debt investors, the number of jurisdictions involved (negotiation time), and the fact that both the senior creditors and the private equity funds wish to retain their relative bargaining power in a distress scenario. However, if the creditor

fragmentation continues further in the markets, the analysis suggests that private equity funds may be incentivized to incorporate clauses in the ICAs replicating the solutions provided by the statutory procedures, especially when it enhances their bargaining leverage *ex post*.

6 Distressed disposals and value protection

(a) LMA S/M ICA

In addition to enforcement of the transaction security, the security agent will need to be able to carry out releases of various liabilities, guarantees and security and to effect transfers of assets, shares and liabilities. Such measures are governed by the LMA ICAs' 'distressed disposal' rules.

The LMA ICA defines distressed disposal as disposal of an asset of a member of the group affected: (i) at the request of the instructing group when the transaction security has become enforceable; (ii) by enforcement of the transaction security;[666] or (iii) after a distress event, by a debtor to other parties than the debtor group.[667]

The definition is broader than enforcement or transaction security and captures all enforcement, disposal and restructuring measures.[668] In practice, the instructing group may require any type of disposal to carry out the restructuring, including enforcement, asset disposal or appropriation, whether on behalf of the creditors or the debtors. The security agent may carry out a distressed disposal through

666 This also includes disposal of any property of a member of the group, the shares in which have been subject to an appropriation.

667 Eg LMA S/M ICA 8.

668 ibid 14.

a public or a private process, or a 'credit-bidding' transaction, in which the assets or the debtor is transferred to the controlling creditor group.[669]

This also means that the security agent is not constrained by a particular insolvency or enforcement method. Distressed disposals clauses allow the instructing group and the security agent to choose the best enforcement method available. The only contractual restrictions for the use of the distressed disposals rules are the fair value or value protection clauses discussed below. The instructing group can choose *ex post* which manner of restructuring will result in the highest creditor recoveries.

Consequently, assuming that the transaction costs are low, the instructing group, acting rationally, is likely to use the range of options afforded by the LMA ICAs to carry out a distressed disposal either on the debtor or an LBO debtor group level as an economic enterprise. For example, one interviewee noted that the discussion going into the transaction is really about identifying the contractual point of enforcement and the particular share pledge that would be enforced.[670] The fact that the creditors can control the 'spider's web, a sprawling empire of entities' by bringing it all back to one single point of ownership pledged to the lenders means that the parties can sell the enterprise without disturbing perhaps hundreds of entities below the single point of enforcement.[671] This can be carried out without the interests of the equity holders interfering with the arrangement,.[672]

Release of claims and security are not covered by the general law rights of security trustees or secured creditors. Although statutory procedures covering most of the debtor group entities can achieve this, it is very difficult to achieve. Therefore, the

669 ibid 14.7.

670 Interview 2.

671 Interview 6.

672 Interviews 7 and 8.

ICAs set out detailed measures concerning releases of claims, security and guarantees by the security agent in relation to all debtor group companies, while restricting individual creditors' actions. If the security agent effects a distressed disposal or an appropriation,[673] it is authorised to:[674]

1. release:
    a) transaction security/non-crystallisation certificates;
    b) all liabilities and transaction security on a share sale/appropriation (debtor and/or holding company);
2. carry out a:
    a) facilitative disposal of liabilities on a share sale/appropriation;
    b) sale of liabilities on a share sale/appropriation; and
3. transfer of obligations in respect of liabilities on a share sale/appropriation (all intra-group liabilities).

A distressed disposal or debt disposal can be made for cash or non-cash consideration. The use of non-cash consideration is allowed if the security agent obtains a valuation statement of the assets from a financial adviser.[675] Also, the security agent is irrevocably authorised to release or transfer the transaction security and 'out-of-the-money' obligations[676] to effect a clean transfer of business, without any legacy obligations of the debtor group.[677] If the restructuring involves a share sale of

673 The term refers to the appropriation (or similar process) of the shares of an ICA group company (other than the parent) effected by enforcement of the transaction security.

674 LMA S/M ICA 14.

675 See Part C, Section 6(a)2-3.

676 These do not include claims of non-ICA creditors. These may have to be dealt with under a scheme of arrangement. See of the importance of the comprehensive release: Olivares-Caminal (n 516) 3.377.

677 Hooley 214 (n 545). The security trustee may wish to transfer some of the liabilities instead of releasing them. Howard and Hedger (n 163) 6.243-44. LMA ICA 14.1.

appropriation, the release powers extend also to debtors and their holding companies and to the sale of liabilities and the transfer of all obligations in relation to the liabilities.[678]

The above means that after a comprehensive distressed disposal the out-of-the-money creditors will either be left behind in a non-disposed shell company or released if the debtor company is a part of the disposed companies. The release provisions of the LMA ICAs were consistent in all ICAs and were drafted unambiguously to avoid the risk of adverse contractual interpretations resulting in full release.[679]

1. Value protection

Despite the extensive enforcement rights and the senior creditor majority control, the distressed disposals and releases are conditional on the security agent fulfilling the procedural obligations set out in the ICA.[680] These obligations protect the subordinated creditors and the investors and aim to deal procedurally with the risk of senior creditor moral hazard that may result from extensive enforcement and release rights.[681] If the security agent follows the provisions, it has fulfilled its obligations under the ICA and the general law.[682]

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678 LMA S/M ICA 14.1.

679 *Barclays Bank plc, European Directories (DH6) BV, Alcentra Limited, Allied Irish Banks plc, Bank of Scotland plc, Lloyds TSB Bank plc, The Royal Bank of Scotland plc, The Royal Bank of Scotland NV v HHY Luxembourg SARL, AMP Capital Investors Ltd* [2010] EWCA Civ 1248; Howard and Hedger (n 163) 6.243-4.

680 Caroline Leeds Ruby, Joshua Thompson and Michael Steinberg, 'Spot the difference' [2012] IFLR 58, 60.

681 Westbrook (n 46) 845-46.

682 LMA ICA 14.5(b).

2. Obtaining a fair price in distressed disposals

The security agent must take reasonable care to obtain a fair market price in the prevailing market conditions.[683] It does not have any legal obligation to postpone a distressed disposal or disposal of liabilities to achieve a higher price.[684] This is consistent with the English law view that the courts are unwilling to second guess the commercial determination of the security agent.[685] This also coincides with the general obligations of a security trustee under English case law, which are built on the law applying to a mortgagee's obligations.[686]

A mortgagee does not have a duty to exercise its powers as mortgagee but can remain totally passive.[687] Because a mortgagee is not considered a trustee of the power of sale for the mortgagor, it can act for its own benefit and has an unfettered discretion to sell when it likes to achieve repayment of the indebtedness[688] and 'is at all times free to consult his own interests alone as to whether and when to exercise his power of sale'.[689] As the Court held in *Saltri III*, 'the mortgagee's decision is not constrained by reason of the fact that the exercise or non-exercise of the power of sale will occasion loss or damage to the mortgagor'.[690]

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683 ibid 14.4.

684 *Silven Properties Ltd v Royal Bank of Scotland plc* [2003] EWCA Civ 1409; *Saltri III Ltd v MD Mezzanine SA Sicar (as Mezzanine Facility Agent) and others* (n 610) [127]; *Tse Kwong Lam v Wong Chit Sen* [1983] 3 All ER 54 (Privy Council) 1355b.

685 *Saltri III Ltd v MD Mezzanine SA Sicar (as Mezzanine Facility Agent) and others* (n 610).

686 ibid.

687 ibid [127(a)].

688 ibid [127(b)] where Eder J cited *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] Ch 949 (CA (CivD)), 969g.

689 *Saltri III Ltd v MD Mezzanine SA Sicar (as Mezzanine Facility Agent) and others* [59] (n 610).

690 ibid [127].

For distressed disposals, the duties may be more specific when selling the assets and in such cases, the duty is to behave 'as a reasonable man would behave in the realisation of his own property, so that the mortgagor may receive credit for the *fair value* of the property sold'.[691] Hooley is of the opinion, however, that there is no distinction between obtaining the 'true market value', 'proper price' or 'fair market value'.[692] Furthermore, he notes that the view expressed eg in *Bell v Long*[693] that the obligation to obtain the best price reasonably obtainable at the time of the sale should not be interpreted retrospectively as an 'absolute test of liability regardless of the circumstance prevailing when the decision to sell was taken' is the correct one.[694] This view is also reflected in the ICA provisions limiting security agent's obligations in relation to enforcement and disposal measures.

3. Other requirements

The LMA S/M ICA requires that the disposal is made pursuant to an insolvency process or court-supervised insolvency process under the control of a liquidator, receiver, administrative receiver administrator, compulsory manager or similar officer'[695] or pursuant to a competitive sales process.[696] Alternatively, the security agent may seek a fairness opinion from a financial adviser concerning the arrangement to show it has

691 *McHugh v Union Bank of Canada* [1913] AC 299 PC (Canada) (PC) 311; see also *Downsview Nominees Ltd v First City Corp Ltd* [1993] AC 295 PC (New Zealand) (PC).

692 Hooley 229 (n 545).

693 *Bell v Long* [2008] EWHC 1273 (Ch) [14].

694 Hooley 230 (n 545).

695 LMA S/M ICA 14.5(b)2.

696 Referring to a public or private auction or other competitive sale process which can also be conducted through a court, with the help of a recognised investment bank or other professional.

fulfilled its obligations to obtain a fair market price.[697]

Stricter conditions apply to releases of transaction security and liabilities at the time the majority mezzanine creditors are entitled to give enforcement instructions. In that case, releases of liabilities owed to the senior creditors are conditional on full repayment of all senior and hedging liabilities for cash consideration, unless the instructing group gives its consent.[698]

(b) LMA SS/S ICA

Prior to a super senior step-in event, a distressed disposal or a liabilities sale may be carried out only if the transaction results in a super senior cash discharge, or the majority super senior creditors give their consent, or the super senior discharge date has already occurred.[699] On the other hand, after the super senior step-in event, a distressed disposal or a liabilities sale requires that:

1. the transaction is carried out by means of a court-supervised process, under the direction of a liquidator, receiver or an equivalent officer, or pursuant to a competitive sales process;

2. a financial adviser has delivered a fairness opinion on the transaction;

3. the arrangement is based on an agreement duly made prior to the trigger event; or

4. the initial instructing group gives its consent, or the senior discharge date has occurred.[700]

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697 LMA S/M ICA 5(b).

698 ibid 14.6.

699 LMA SS/S ICA 15.4.

700 LMA SS/S ICA 15.5.

(c) LMA SS/HY ICA

The value protection clauses of the LMA SS/HY ICA are intended to balance the rights of the primary creditors[701] and the high yield creditors. If a distressed disposal, liabilities sale or debt disposal is carried out, the consideration must be in cash, unless non-cash consideration is allowed in the enforcement principles. If the arrangement is completed when the high yield creditors are entitled to give the enforcement instructions, releases of the borrowing or guarantee obligations of the higher-ranking creditors are conditional on the full repayment of such obligations.[702]

It is a condition of the release of the high yield liabilities, transaction security, high yield guarantor's and the parent's assets that the sale or disposal proceeds are in cash and distributed according to the general ICA waterfall. Such a sale or disposal will also need to be made by a competitive sales process, in which a financial adviser has issued a fairness opinion concerning the disposal. The relevant priority creditors will also need to affect a simultaneous unconditional release or transfer of all liabilities and guarantees owing to the priority creditors by the relevant debtor and its subsidiaries'.[703]

Release of the high yield note liabilities,[704] transaction security, or the assets of the high yield guarantor is also subject to compliance with the enforcement principles:[705]

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701 These are defined as the super senior liabilities and the pari passu liabilities.

702 LMA SS/HY ICA 16.3.

703 ibid 16.4.

704 Interviewee 14 noted that 'moving up' the written-off subordinated debt in the group structure after default was possible but difficult considering that it would be preferable to have the debt in a holding company from day one.

705 LMA SS/HY ICA 16.4.

1. the high yield note trustee's approval; or

2. the proceeds being in cash applied in accordance with the application of proceeds clause and the disposal is by means of a competitive sales process or a financial adviser fairness opinion taking into consideration all relevant circumstances; and

3. [optional] The priority creditors affect a simultaneous unconditional release of liabilities owed to them by the relevant debtors and their subsidiaries.

The general requirements for release of transaction security and other distressed disposals transactions in the LMA ICAs are summarised in Figure 23 below.

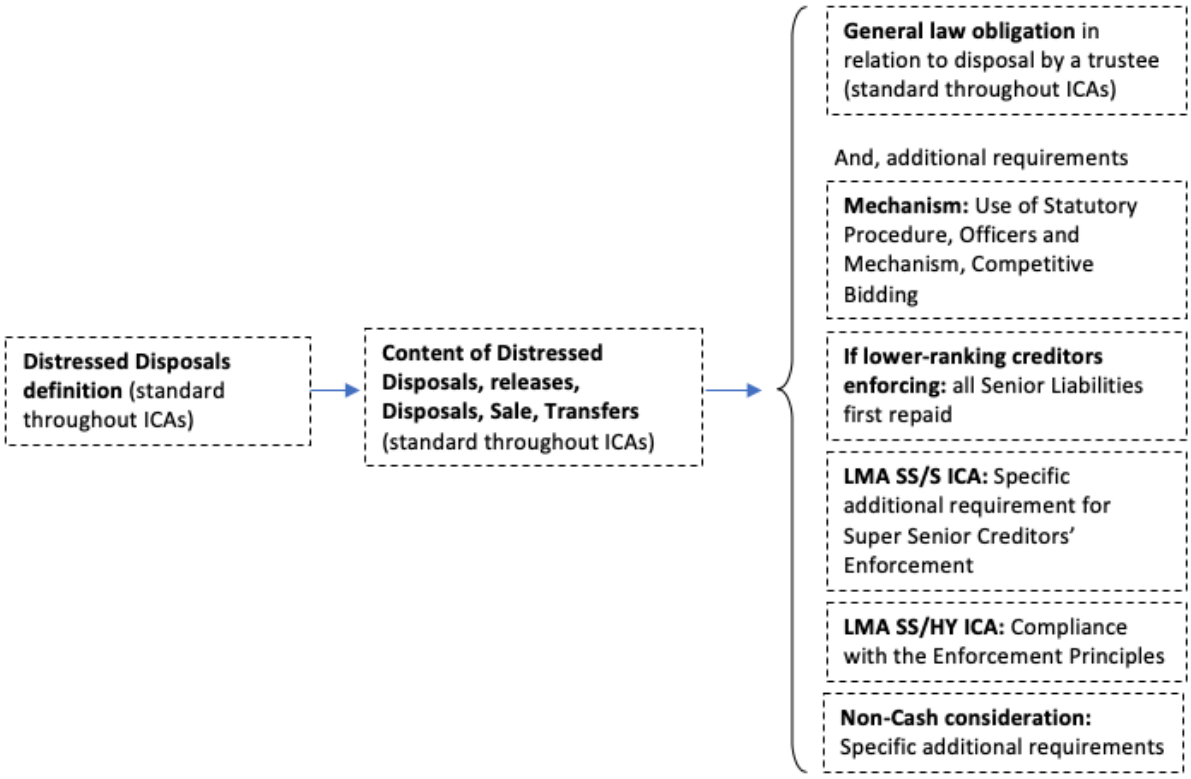


Figure 23. LMA ICA distressed disposals - general legal requirements

(d) Distressed disposals and value protection in the sample ICAs

1. Scope of use

The interviewees noted that a correctly drafted ICA should contain provisions that allow for the release of all junior debt, a clean enforcement, and identification of the correct point of enforcement.[706] One interviewee was concerned that the release system might operate better if the junior debt was incurred at the holding company level and is, therefore, outside the share enforcement.[707]

Some interviewees pointed out that, despite the contractual protections, the level of covenant triggers has in practice a significant impact on the protection afforded by the distressed disposals clauses.[708] Furthermore, the level of 'non-acceding' indebtedness and the ability to move assets outside the debtor group, restrictions in the security documents, confidentiality questions, tax structuring, the due diligence timeframe and so-called anti-pre-pack provisions may also hinder the effectiveness of the enforcement.[709]

A number of interviewees pointed out that, despite the broad nature of the distress disposals protections, they are seldom applied because most of the restructurings are based on the comparative negotiating power of the parties and their commercial and legal leverage, and the case-by-case needs of the business.[710] However, most considered the enforcement and distressed disposals clauses efficient and robust,

706 Interviews 2, 9 and 10.

707 Interview 14.

708 Interviews 2 and 6.

709 Interviews 1, 4 and 14.

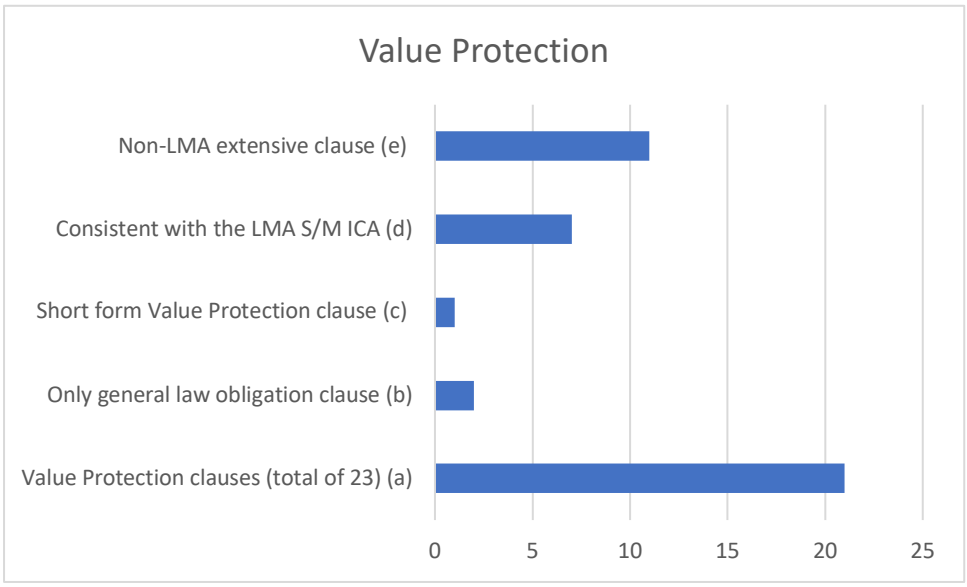
710 Interviews 7, 8 and 14.

as well as, operating as a binding backstop to the negotiations.[711]

2. The sample ICAs

The distressed disposal clauses and definition were consistent with the LMA ICAs throughout the sample. Value protection rules were included in 21 of the 23 sample ICAs. The two that lacked specific clauses included only the general legal obligation encountered in all ICAs that the security agent needs to take reasonable care to obtain a fair market price in the prevailing market conditions but has no obligation to postpone a distressed disposal or liabilities sale to achieve a higher price. One ICA included a short-form value protection clause requiring a cash disposal, carrying out the transaction in accordance with the distressed disposals rules and that all primary liabilities are released simultaneously. The value protection clauses of seven ICAs were consistent with the LMA S/M ICA, with limited deviations concerning the rights of the creditors to bid in the process, the requirement for full repayment of senior liabilities on their release, and the consent requirement for a non-cash transaction. Eleven included non-LMA ICA-style extended value protection clauses, discussed below. All but one ICA containing a second lien tranche were in this group, as were all group four ICAs. The scope of the fair value regulation correlated with the complexity of the capital structure. The figure below outlines the structure of fair value regulation across the ICA sample.

711 Interviews 5 and 6.



(a) Includes all ICAs with a specific value protection clause
(b) Both in ICA group 3
(c) In ICA group 3
(d) Four in ICA group 1, one in category 2 and two in group 3
(e) Two in ICA group 2, three in group 4 and six in group 5

Figure 24. Fair value clauses.

The interviewees considered that the fair value opinions provide protection to the security agent and undoubtedly also to the senior creditors who are enforcing.[712] The process was defined as entailing properly valuing the asset, market testing and giving the worst-affected parties the ability to put forward their own offer.[713] One interviewee noted that security agents are generally concerned about their duties, have nothing to gain by favouring certain parties and, consequently, act according to the ICA and the general law.[714] Despite there being some contrary views on the importance of value-protection clauses,[715] some interviewees emphasised the clients' need to ensure the 'valuation is absolutely spot-on' and noted that these are the provisions closest to

712 Interview 2.

713 Interview 5.

714 Interview 14.

715 Interviewee 1 stated that: 'an opinion is only someone's opinion and there are risks associated with effectively being able to check the box with an opinion'.

the private equity funds' commercial and financial objectives of business valuation.[716] However, a number of interviewees considered that these form part of the backstop for the restructuring negotiations and the parties' negotiating power.[717]

From the point of view of negotiating leverage, the issues relating to where the 'value is breaking',[718] additional liquidity and contractual rights were also considered particularly important, the leverage being dependent both on the contractual rights and the commercial scenario.[719] The ICA and security rights were seen as a massive part of setting up such rights and structure. According to one interviewee, it does not matter whether one uses the ICA or not; it sets the regime, rights and leverage of the parties to resolve the distress scenario.[720]

3. Extended form clauses

The extended form value protection clauses were not based on the LMA ICAs, but on the market practice. The variance in these clauses was broad, but common features emerged in the majority of the eleven ICAs. First, if distressed disposal was carried out at a time when the creditors subordinated to the senior creditors were entitled to give enforcement instructions, release of any debtor or group companies from any liabilities owed to the senior creditors required their full repayment. Secondly, in limited cases, the creditors subordinated to the senior creditors could elect to have their claims against the debtors transferred to the parent instead of releasing them outright in connection with a distressed disposal or liabilities sale.

716 Interview 6.

717 Interview 14.

718 Interviews 1, 2, 5, 6, 9, 10 and 14.

719 Interviews 6 and 14.

720 Interview 14.

If the senior creditors carried out the distressed disposal on the basis of a decision by the instructing group, the mechanism used and the right to release the transaction security and the liabilities were more complex. I have set out in Figure 25 the structure of the extended form clauses encountered in all eleven sample ICAs.

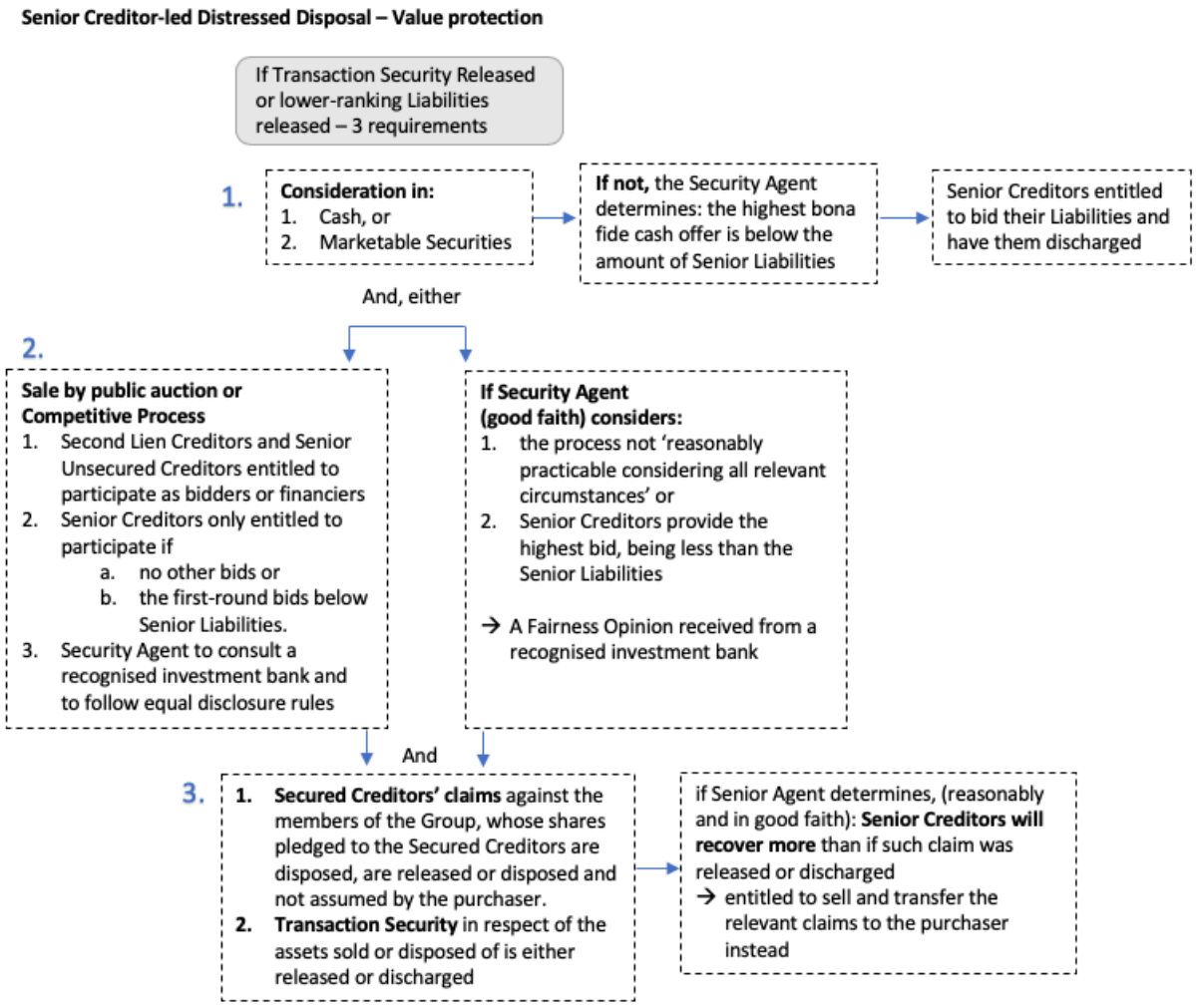


Figure 25. Extended form value protection.

The mechanism was market-developed and applied systematically. Release of the transaction security and the lower-ranking liabilities required fulfilment of three requirements. The first concerned consideration, which was allowed to be cash or marketable securities. If this was not the case, additional requirements for the release of the senior liabilities were applied. The second stage concerned the nature of the sales

process, in which a competitive bidding or a public auction was the starting point. This could be avoided if the process was not reasonably practicable and the senior creditors provided the highest bid. The third stage required release or discharge of the transaction security and the senior liabilities. 'Credit bidding' – that is, using liabilities as consideration or transferring the security and assets to the purchaser by, for example, conversion – was allowed if the security agent considered that such a transaction would result in a greater recovery to the senior creditors.

There were a number of variations to this structure in the eleven sample ICAs. One important variation was providing a more lenient bidding procedure, enabling all of the primary creditors to participate in the bidding. In addition, a number of the ICAs included similar value protection for the senior unsecured creditor class and the second lien creditors. In most release scenarios, it was obligatory that the claims of the creditors that ranked above the instructing creditor group were fully repaid.

4. Summary

The distressed disposals clauses, together with the value protection clauses, effectively enabled the controlling creditor group or the instructing group to effect the most feasible enforcement and restructuring procedure possible. Importantly, the ICA procedure enabled the controlling creditor group to choose the most feasible point of sale in relation to the debtor group. This was seen in all the sample ICAs. Therefore, the contractual clauses effectively eliminated the risk of the opposing creditor classes interfering with the process, provided that the majority controlling creditors – that is, the instructing group – supported the arrangement.

The value protection clauses, on the other hand, created procedural protections against misfeasance by the senior creditors against the lower-ranking-

classes, but also laid out a mechanism for ensuring enforcement or restructuring free of any existing liabilities, claims and security both at the debtor and at the debtor group level. While the subordinated creditors could in certain cases give the sale and enforcement instructions, none of these resulted in by-passing the economic rights of the senior creditors.

(e) Protective clauses

1. Voting, waivers and duties owed

(a) The LMA ICAs

The LMA ICA enforcement and distressed disposal clauses are protected by several ancillary clauses in all the LMA ICAs. First, the security agent is in all material scenarios obligated to follow the instructions of the instructing group.[721] The same applies to creditor voting. Secondly, all the secured parties and debtors waive their rights to require that the transaction security is enforced in a particular manner or at a particular time, or that any distributions or enforcement of transaction security is carried out or applied in a particular manner. Under all the LMA ICAs, this obligation is subject to the specific enforcement provisions, the value protection clauses, and the 'application of proceeds' clause.[722]

Thirdly, in the LMA S/M ICA, the secured parties and the debtors agree that any duties owed by the security agent and duties owed by any receiver or their delegates to the mezzanine creditors in relation to enforcement are no different to, or

721 LMA S/M ICA 12.4.

722 ibid 12.5.

greater than, the duties they owe to the debtors under general law.[723] In the LMA SS/S ICA and the LMA SS/HY ICA, the limitation of the duties is extended to all secured creditors and debtors. These limitations are in all LMA ICAs subject to the value protection clauses.[724] Fourthly, the LMA ICAs also contain a 'further assurances' clause under which none of the secured parties has an independent power to enforce or resort to any other rights under the security documents. The only party entitled to carry out such actions is the security agent. All of the LMA ICAs are consistent in regulating these matters.[725] These provisions are intended to eliminate remaining incentives of the junior creditors' hold-up behaviour.

The sample ICAs

The clauses protecting the enforcement mechanics in the ICAs were consistent throughout the sample and corresponded materially with the LMA ICAs. Table 17 sets out the form of the enforcement protection rules and how they were adopted in the sample ICAs. The questions concerning non-cash consideration and structural adjustments are discussed below separately.

Table 17. Protective clauses

LMA ICA PROVISION	SAMPLE ICAs
Manner of enforcement	Contents materially corresponding to LMA ICAs. The clauses followed the 'enforcement instructions' clauses.
Voting in proceedings	Contents materially corresponding to LMA ICAs.
Waiver of certain creditor rights	Contents materially corresponding to LMA ICAs.
Duties owed	Contents materially corresponding to LMA ICAs.
Further assurances	Contents materially corresponding to LMA ICAs.

723 ibid 12.6.

724 ibid 12.6.

725 ibid 12.7.

2. Non-Cash Consideration

The LMA ICAs

Both the LMA S/M ICA and the LMA SS/S ICA include a clause specifically allowing the use of non-cash consideration in enforcement and distressed disposals.[726] This facilitates debt-to-equity swaps and alternative consideration in distressed disposals. First, the non-cash clauses entitle the security agent to distribute the recoveries in the same way as cash proceeds and to manage, hold and dispose of such proceeds in any appropriate manner. Valuation of non-cash consideration is carried out by a financial adviser. If it would be unlawful, or against its constitutional documents, for a creditor to receive non-cash distributions, the security agent is entitled to hold such assets for the creditor, manage and dispose of them for cash consideration and distribute the proceeds under the 'application of proceeds' clause. The LMA ICAs include protections for the security agent against any claims and in relation to circumstances relating to the non-cash assets and their realisation that might adversely affect the security agent. This possibility enables the prompt realisation of the assets.[727] Supporting this, the enforcement principles of the LMA SS/HY ICA allow the use of non-cash consideration under specified conditions.[728]

The sample ICAs

The sample ICAs had two mechanisms for dealing with the permitted use of non-cash consideration in the enforcement of transaction security, distressed disposals, and

726 LMA S/M ICA 15, LMA SS/S ICA 16.

727 ibid.

728 Part C, Section 5(b)3.

liabilities sales. In sixteen of the ICAs, there was only a general non-cash distribution clause according to which, if the security agent received a non-cash distribution in respect of the liabilities, the liabilities were not reduced before the realisation proceeds of such non-cash consideration were actually applied to the liabilities.

Seven ICAs included a long-form non-cash consideration clause similar to that of the LMA S/M ICA. Most of the ICAs were in group one, having the simplest capital structure.[729] There was no clear rationale for the lack of use of the template clauses, but all of the agreements assumed, at least implicitly in connection with other clauses, that non-cash consideration was allowed. Because the use of non-cash consideration was approved in all ICAs, individual creditors could not hinder, based on the nature of consideration, a restructuring or a disposal procedure involving, for example, a debt-to-equity swap or a transfer of control in the debtor group through a sale involving credit-bidding or an exchange for new indebtedness or securities.

3. Structural adjustments

The LMA ICAs

If a distressed disposal is carried out by sale to a company held by the controlling creditor group, the scenario is more complicated. Conversion of a part of the 'out-of-the-money' indebtedness into shares of the acquiring entity, combined with a release of all of the existing liabilities and security, raises several questions. The first is the adequacy of the valuation of the debtor group or its business if the sale is not being made to an independent third party. Even if the parties effect an enforcement of security under the ICA, a creditor is not generally obligated under the ICA or the SFA to become

729 See figure 4.

a shareholder or a creditor in the purchasing entity.

To deal with this risk, the LMA Leveraged Document includes the possibility of carrying out a 'structural adjustment' that can include an extension to the availability or payments under the SFA; a reduction in the margin or principal; re-tranching of the loan facilities; an increase, extension or reduction of creditor commitments; and additional loans.[730] Structural adjustments require the consent of the majority lenders and each lender participating in the existing or additional facility or increasing, reducing or otherwise modifying its commitments. Although the hold-out problem can technically be reduced, therefore, the opposition of a large enough minority will in practice prohibit a restructuring that requires such adjustments to the facilities. In the LMA S/M ICA and the LMA SS/S ICA, structural adjustment rules authorise the security agent to release all or part of the transaction security and amend the security documents, if approved by the parent and the senior creditors.[731]

The ICA sample

None of the ICAs included clauses similar to those in the LMA ICAs regulating structural adjustments to the capital structure and loan facilities. It appears that the additional facilities, incremental facilities and refinancing facilities included in a majority of the ICAs had replaced the use of structural adjustment clauses in the sample. The restructuring options enabled by the structural adjustment clauses, therefore, were effectively included in the ICA through somewhat broader additional and refinancing

730 LMA Leveraged Document (n 13) 41.5.

731 In a structural adjustment, the transaction security, guarantees and indemnity are immediately retaken by the new secured creditor-base after their release. LMA S/M ICA 28.5 and LMA SS/S ICA 28.5.

clauses.[732] It is likely that, because structural adjustment clauses require in any case negotiations between the creditors in the 'horizontal aspect' of the debtor's financing, ie within a particular creditor group, it is more appropriate to regulate them in the SFAs.

(f) The effectiveness of the ICA process

Despite the comprehensive nature of ICAs in regulating these matters, it was clear from the ICA structures and clauses and from the interviews that strong contractual protection, agency, security interests and trust law, and the ability to fall back on procedures squeezing out dissenting creditors were material for the use of English law ICAs and their enforcement rules.[733]

Some interviewees pointed out that the broad use of English law in these agreements relied primarily on the validity of the specific contractual clauses.[734] As one interviewee noted, 'In an international context your contract is king and if it is New York law or English law, you know your contract will survive'.[735] Some of the interviewees argued, however, that the reason for extensive reliance on contractual enforcement and restructuring measures was due to the deficiencies in the UK insolvency regime, meaning that the parties prefer to arrange their matters via financial documentation, relying on the mature, high-level advisory community and the set of behaviours, understandings, agreements and consistency of approach, thereby excluding local insolvency law.[736] In addition, and consistent with the 2001 analysis by

732 See Part C, Section 3(g)2.

733 Interviews 2 and 12.

734 Interviews 7 and 8.

735 Interview 4.

736 Interview 3.

Armour and Deakin,[737] the efficient and consistent social and market behaviours and informal standards of the market participants as well as the matrix of their relationships were considered to be the driving factors in distressed scenarios.[738]

The views of the interviewees were consistent with the observation that ICAs are less used in US transactions because Chapter 11 is thought to provide a comprehensive regime for dealing with most distress scenarios. It was noted, however, that more limited ICAs are often used in the US, especially if there are assets or companies located in different jurisdictions. As one interviewee noted, 'we are trying to regulate with the ICA the same things as Chapter 11 regulates in the US'.[739]

Despite the consistent view of the effectiveness of contractual restructuring procedures, most market participants emphasised the importance of dealing with the business needs of the group on a voluntary basis backed by effective contractual protections and also focusing on, for example, the interests of the sponsor in supporting the underlying business. In practice, most distress scenarios would not be restructured under the ICA, but through negotiations in the 'shadow of the ICA' and the financing agreements.[740] The content analysis and the interview evidence shows that the ICAs restrict the strategic creditor actions in relation to distressed debtors and ICA provisions facilitate better creditor coordination to support the controlling creditors to reach a value-maximising solution in any enforcement or restructuring. The results of this empirical evidence and their connection to the key propositions at the end of Part B are analysed in detail in the next Part D, which also sets out the general requirements for the effectiveness of contractual insolvency solutions.

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737 Armour and Deakin (n 64) 21.

738 Interviews 3, 7, 8, 9, 10 and 11.

739 Interview 11.

740 Interview 14.

PART D - ANALYSIS

1 Introduction

The objective of the empirical part was to determine whether the ICA terms defuse the incentives of strategic creditor actions in distress scenarios, and, if they are successful in doing that, how the ICAs are designed to overcome these problems. The fact that ICAs can provide solutions to these impediments to contracting about insolvency means that privatised insolvency procedures are both theoretically and practically possible. This led to the follow-up question whether the ICA terms enable achieving a value-maximising group-wide solution for the creditors and whether the parties need to resort to the statutory procedures to achieve this. Surely, the parties would rather opt for well-tested statutory procedures if they already provide the solutions to corporate distress scenarios. I argued in Part B, the parties should have sufficient incentives to enter into contracts for control in complex financing arrangements and to extend such contracting to the economic enterprise (debtor group) and also to the other creditors of the debtor group.

In this Part D, I will examine each of the three propositions set out at the end of Part B, Section 6(b) in the light of the empirical findings and what this means from a more general perspective concerning strategic creditor actions and reaching an optimal solution to corporate distress. I will refer to the key propositions in this Part D as Proposition A, Proposition B and Proposition C. Before analysing the key propositions, however, I will analyse the scope of the ICAs and the parties' incentives in concluding an ICA in light of the empirical findings.

2 Incentives to use ICAs

(a) Capital markets require standardisation

In competitive capital markets, the costs of restructuring are limited to the lesser of formal bankruptcy costs and the transaction costs of an informal reorganisation through the capital markets.[741] This connection requires, in practice, a high-enough level of market standardisation. Despite being very case-specific and dependent on the underlying capital structure of the LBO arrangement, the general solutions of the ICAs evidenced broad standardisation.

The interviews suggested that standardisation of ICAs was as a requirement set by the debt and capital markets for ensuring effective syndication and the transfer of loan interests. This, in turn, is capable of lowering the expected costs of informal reorganisation, which means that the argument of Haugen and Senbet that financial contracts seek lower costs of reorganisation through better use of the credit and capital markets is supported by the empirical analysis.[742] Even though the variance in the contract terms in the ICA sample was high, the themes and solutions to the material questions in the ICAs were consistent. The more effective, standardised and predictable the SFA and the ICA regime, the more likely it is that the market participants can rely on the enforcement clauses and on the ability to transfer loan participations to specialist investors within the SFA and ICA regime through the capital and credit markets.

On a general level, standardisation means that the parties view the material problems and solutions in a similar way. Assuming the market participants are rational,

741 See Part B, Section 5(b) and Haugen and Senbet (n 58) 387.

742 See Part B, Section 5(b).

standardisation of the solutions means that they expect such solutions to be generally effective and useful.

(b) Reducing financial agency costs by contracts for control

In addition to the requirements of the capital markets, the literature emphasises the incentives for shareholder-managers to try to alleviate the financial agency costs[743] that become more challenging the larger and the more complicated the capital structure gets. I proposed in Part B that owners and managers would be incentivised to offer their creditors contracts for control that regulate distress scenarios because the creditors are mindful of these financial agency costs and understand that the shareholder-managers are likely to try to negotiate in an *ex post* distress scenario.[744] The creditors anticipate this.[745] Offering such rights leads to a better ability to monitor the debtor, to take appropriate steps in financial distress scenario and to coordinate the creditor group at the appropriate time. It was therefore expected that we see private equity funds agreeing, for example, to monitoring and bonding clauses and clauses concentrating creditor control in the hands of a limited group of creditors or a particular creditor.[746]

In addition, the creditors expect that the private equity funds will seek to differentiate their financing sources and partition their assets in such a way as to achieve optimal economic benefits. To deal with this objective, it is logical for the creditors to demand extension of the scope of contracts for control beyond the debtor-creditor

743 See Part B, Sections 4(b) and 5(a)-(b).

744 Part B, Sections 5(a)-(b).

745 ibid.

746 See for the rationale to do this: Part B, Section 4(a)2.

relationship to cover all financial creditors and the entire debtor group.[747] Such extension of the creditor control to all or most financial creditors and the debtor group means that, even with a fragmented creditor base, the controlling creditor classes can internalise enough benefits, despite spending resources on the arrangement, by being able to control both the horizontal and the vertical aspects of the debtor group's indebtedness.

The empirical analysis showed that the ICAs always covered the debtor group, governed all aspects of inter-creditor relationships and supported the argument that the creditors will require an extension of the horizontal creditor control seen in the debt documents to the vertical aspect, ie between the creditor groups. The empirical analysis supported the pervasiveness of the use of ICAs in the leveraged markets and confirmed that funds have the incentives to offer an ICA to the creditors, overcoming any perceived difficulties in contracting *ex ante* about insolvency. The findings suggest that Armour and Deakin's argument that the debtor is likely to have incentives to offer the creditors a procedure maximising the net benefits of debt finance, which would solve the coordination problem, holds.[748]

The sample ICAs thus provided strong support for the notion that private equity funds and debtors have incentives to offer the creditor-base such contracts for control and that the creditors have incentives to require the use of such agreements. The analysis also showed that ICAs contain clauses that give contingent control rights to financial creditor groups in a structured manner.

Also, the extension of ICAs to cover entire debtor groups and financial creditor categories shows that the creditors seek to deal contractually with the economic

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747 See Part B, Section 5(d)2. The priority regime is created in these cases by means of contractual and structural subordination and priorities to security interests.

748 Armour and Deakin (n 64) 26-27. See Part B, Section 5(b).

rationale of the borrowers to structure the enterprise in a manner that the assets are located in an entity in which the relative costs of carrying a particular activity are the lowest.

However, despite the clear findings of the thesis, some market developments, such as the extensive use of covenant-lite loans, raise questions about the relationship between lowering the cost of credit by offering the creditors contracts for control. Covenant-lite loans are likely to have a higher interest rate while reducing the level of control granted to the creditors. Even though this is an issue within the scope of the financing documents, it is an important one. First, the fund may consider that there is so much available liquidity that the difference in the interest expense is negligible. Secondly, it may be the case that the covenant-lite document allows easier distribution of funds to its owners, before repayment of the indebtedness, which may make the use of covenant-lite loans economically more beneficial. However, there is also a possibility that the fund explicitly acquires leverage for the restructuring negotiations against the higher margin on the loan. This suggests that the claim that granting control rights to the creditors for the purposes of lowering the cost of capital is not a straight-forward one. The question about trade-off between control rights and cost of capital would appear to require further empirical research.

Despite this qualification and the fact that the analysis in this thesis is limited to a particular type of an acquisition and financing structure employed by private equity funds, these solutions provided by ICAs contrast with the argument that contractual solutions to dealing with financial distress are rare. Rather, they are the market standard in some parts of corporate finance.

3 Proposition A: dealing with hold-out creditor risk

(a) Capital structure and debt priorities

1. Introduction

Proposition A tested whether specific ICA clauses were sufficient to deal with the hold-out creditor risk, eliminating incentives for value-destroying actions. The first observable implication of this propositions was that the ICAs include comprehensive regulation on debt priorities, amendments to the capital structure and new facilities. This type of regulation was found in all sample ICAs, which all included several debt categories that were prioritised according to a fixed regime set out in the ICA. This extended to control of amendments to the terms of the debt categories and accession of new creditors into these categories. The categorisation relied on turnover subordination and structural subordination. In addition, the analysis of capital structures and creditor priorities revealed more subtle aspects of the ICAs relevant to the research question, for example, concerning the mechanism how the ICAs deal with creditor heterogeneity, future indebtedness and the on-going capital needs of the debtors.

The analysis of the first part of Proposition A, ie dealing with debt priorities and capital structures, resulted in three theoretically important findings. The first is the requirement of sufficient, controllable adherence to contractual solutions instead of the requirement of full adherence. The second finding connects to the ability of the ICAs to operate as long-term contracts for control accommodating changes to the capital structure. The third finding connects to the second finding, by showing how capital structure flexibility and the controlling creditors' ability to restructure the debtor, achieving a lighter debt capital structure, enables the parties to reduce, in some cases,

the debt overhang problem.

2. Excluding and controlling non-acceding indebtedness

The sample ICAs were consistent in including only financial creditors within their scope. Non-financial creditors such as trade creditors were not covered Thus, the ICAs did not provide a comprehensive regime covering all of the indebtedness of the debtor group. Because non-financial indebtedness was excluded from the scope of the ICAs and controlled through 'permitted indebtedness' and financial covenants,[749] the creditors take a practical, calculated view on the level of acceptable third-party debt by limiting its amount to a level that is unlikely to prohibit the use of ICA control rights in a distress scenario.[750] Also, the interviewees emphasised that the non-ICA debt will have to be manageable so that the ICA creditors have a *de facto* control over the other indebtedness.

Secondly, the ICAs invariably require any new financial indebtedness to be included in one of the existing debt categories, to be made materially on similar terms as the other ICA indebtedness, and to be included within the scope of the ICA. There were some exceptions to this requirement. For example, the debtor group was entitled to incur incremental indebtedness that is new group financing that could, on the parent's choice, be acceded in the ICA regime or excluded from its scope. Similarly to the

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749 The level of indebtedness to some trade and operative creditors cannot be controlled directly, but eg by restricting the level and nature of indebtedness through restrictions in the loan agreements.

750 The empirical analysis did not address whether the level of acceding ICA debt is sufficient for this purpose. However, because institutional creditors can be assumed to act rationally, we can expect that they set the threshold on a level sufficient for the success of a possible restructuring or liquidation. However, some aspects of the ICAs, such as the contents of permitted indebtedness, are a recent development in the markets in the UK and their scope depends on market conditions. See for a general analysis of the interplay between law and market dynamics: Paterson, *Reflections on English Law Schemes of Arrangement in Distress and Proposals for Reform Paterson (March 3, 2017)* (n 405) 6, 17-18 and 21.

excluded non-financial indebtedness, the level of such debt was regulated in practice by the senior creditors' determination of the acceptable level of third-party debt that did not disrupt creditor control in a possible distress scenario. However, the ICA sample and the interviews suggested these thresholds were in all cases subject to heavy negotiation between the private equity fund and the banks.

These mechanisms regulating acceding and non-acceding indebtedness bore resemblance to the privatised insolvency procedure modelled by Schwarcz – the bankruptcy waiver model – in which only a sufficient part of the creditor base accedes to the arrangement.[751] Unlike in Schwarcz's model, ICAs do not obviously take a stand whether their solutions have material adverse consequences on third parties. This is understandable, as the contract intentionally leaves out certain third parties and non-acceding and non-adjusting creditors. However, Schwarcz's model will be of relevance in subsequent analyses of private insolvency regimes because the natural next question after the recognition that private procedures are possible is what effects they have on society more generally.

The content analysis and the interviews show that creditors expect or are able to determine the level of hold-out value that would be disruptive or prohibitive for ICA control and enforcement. This is a matter for the commercial deal that varies case-by-case and can be controlled by the SFA permitted financing and incremental 'financing baskets' and thresholds. The same applies to commercial indebtedness, as it is subject to covenant protection and thresholds. These terms and the level of their case-specific thresholds were considered by the interviewees as increasing the negotiating leverage of the private equity fund in a distress scenario. Although, these levels were not subject of the empirical research, they are instructive of the manner the creditor

751 See Part B, Section 3(d)1.

collective ensures an adequate level of participation in the ICA process and the effectiveness of the protective measures.

3. Flexibility of the capital structure

The second finding relevant to Proposition A was that the contracts were able to accommodate a changing capital structure of the debtor group, making ICAs long-term contracts for control.

In recent years, private equity funds have been increasingly promoting their own ICAs to the creditors at an early stage, which suggests that they benefit from capital structure flexibility in their contracts while recognising the needs of the creditors to control the strategic creditor actions. The analysis showed that the ICAs included comprehensive regulation on debt priorities, amendments to the capital structure and new facilities. In fixing the priorities and the capital structure, the sample ICAs also evidenced that they operate, not only as a fixed capital structure mechanism, but rather as an extensive contractual distress resolution mechanism, adjusting to the changing capital structure and financing requirements of debtors. Although the creditor categories and their rights were fixed in all of the ICAs, the debtor group was able to vary its capital structure within this framework according to its business, growth and refinancing needs. The fact that ICAs were all long-term contracts evidenced the ability of the parties to overcome the difficulties in agreeing *ex ante* and accommodate changing capital structures.

These findings have implications for the LoPucki-Schwartz discussion on the existence of privatised insolvency solutions and their difficulties in dealing with the

changing capital structure of the debtor group.[752] Paying a 'bribe' in connection with the changes in the capital structure, as proposed by Schwartz,[753] was unnecessary under the terms of the ICA sample. The framework already permitted changes and refinancing, but within the debt categories and constraints of the ICA.[754] Pricing of the new debt was largely irrelevant from the creditor control perspective.

Based on this model, the argument of LoPucki that Schwartz' bankruptcy contract model is deficient eg due to the changing creditor-base does not hold at least under the particular case of LBO ICAs, if the arrangement focuses on financial restructuring.[755] Such a contract can in practice accommodate the changing creditor base. This finding is premised on my argument in the previous section that a market-based threshold of adherence to the contract, instead of full adherence to the contract, is sufficient to make ICAs effective for creditor control purposes.

However, it is important to note that the discussion between LoPucki and Schwartz concerns a more general case in which a company has several different types of creditors in addition to financial creditors, such as trade creditors, operative creditors and other contractual partners. Their analysis focuses on a broader set of issues that come up regularly in corporate distress situations.[756] This means that the specific findings of this thesis concerning LBOs ICAs do not as such provide a solution to the more general problem of creditor heterogeneity and changing capital structures of firms discussed by LoPucki that Schwartz.

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752 Part B, Section 3(d)1.

753 Schwartz, 'A Contract Theory Approach to Business Bankruptcy' (n 66)1827-28.

754 The commercial discussion, ie the debt terms and the interest etc., are of course always subject to negotiation. However, for example the yield of the new financing was in a number of sample ICAs restricted contractually.

755 Part B, Section 3(d)1.

756 ibid.

4. The debt overhang problem

The debt overhang problem means that an economically-viable but financially-distressed debtor is liquidated prematurely.[757] In an ICA scenario, this occurs where there is an existing standstill period and the instructing group and the private equity fund have deemed the restructuring feasible, but the senior creditors are unwilling to provide new funding to enable the restructuring for economic reasons. The debt overhang problem occurs if financing by a new creditor would enable reaching a higher going concern value for the existing creditors but leave the new creditor subordinated to the old creditors, thus receiving nothing.[758]

The primary way how ICAs reduce the debt overhang problem is through the enforcement and distressed disposals clauses. Restructuring measures under ICAs lead invariably to reduction of the indebtedness of the sold debtor group (or individual companies), which makes obtaining new financing for the business possible. However, as discussed earlier, ICAs do not provide a comprehensive solution to the problem, because they do not eg mandate debt-to-equity swaps or write-off of the existing indebtedness in the new debtor group that often requires resorting to the statutory mechanisms. Rather, the ICA mechanism assists the parties in achieving such outcome with the help of eg the statutory mechanisms.

ICAs also reduce the debt overhang problem through the flexibility of the ICA capital structure by enabling the debtor to incur additional or incremental financing not covered by the ICA – especially in restructuring and sale situations. Although this prohibits such debt from being covered by the transaction security, the debtor group

757 Ayotte and Skeel (n 74) 1573-74

758 ibid 1570-72.

may still hold additional assets capable of being pledged to the new creditor, especially if the underlying arrangement benefitted only from a limited security package. Alternatively, the private equity fund itself, not being covered by the ICA, may be able to provide security for the new debt. A new creditor may also be able to enjoy, as the provider of much-needed liquidity, an enhanced bargaining position of the private equity fund in the negotiations.

As the biggest beneficiary of the rescue would most likely be the private equity fund, it is unsurprising that such funds are (albeit not only for that reason) keen to increase the incremental debt thresholds. This may also be valuable to the fund at the restructuring table because the senior creditors are likely to be more willing to provide new rescue liquidity if they risk losing to a new provider of debt capital. Therefore, the ICA may reduce in specific cases the debt-overhang problem.

Although, this may overcome the deadlock in refinancing negotiations, clearly this solution is in contrast to the creditors' need to secure sufficient adherence to the ICA to enable an optimal, controlled solution to the financial distress. However, the analysis of the optimal thresholds for reducing the debt overhang problem while keeping ICAs still efficient depends on case-specific circumstances and requires further empirical research. Therefore, although this solution enables incurrence of new debt used to keep the firm going concern or seek other alternatives, it does not reduce the existing indebtedness, which means that the option does not, as such, eliminate the debt overhang problem.

(b) Defusing the hold-out creditor risk

1. The fundamental requirements

The 'run-to-the-bank' risk or prisoner's dilemma was identified as perhaps one of the most pressing reasons for the existence of mandatory insolvency laws. The parties' inability to coordinate, at least in the modern era of fragmented financing sources, creditors and financing instruments, their actions *ex ante* or *ex post*, was seen as an insurmountable obstacle to private contracting. In practice, it is difficult to find an optimal environment to study the implications of private contracting because it necessarily operates within a legal system that include statutory corporate insolvency law. Therefore, the statement that a private mechanism operates in the 'shadow of insolvency' cannot be proven empirically in a normal situation. What we can do is to evaluate whether a private mechanism necessarily requires resorting to a statutory regime.

In light of how ICAs deal with the prisoner's dilemma, the analysis suggests three solutions. First, the requirement to deal with the entire debtor group's creditor base should be loosened to cover only an amount of debt sufficient to enable control of the 'run-to-the-bank' scenario. This matter was discussed in the previous section. Secondly, control of an individual creditor group is not sufficient in LBOs but requires either a categorical restriction for payments and enforcement in all subordinated debt facilities or the use of an ICA controlled by the majority senior creditors, achieving collectivised decision-making. Such an agreement is feasible at least when it provides strict creditor priority and voting rules that can be relied on both during the life of the financing facilities and in distress. Thirdly, either the contract or the law will have to contain elements eliminating the incentives of the parties avoiding

the restrictions and standstill provisions.

2. Creditor control and hold-out value

All the sample ICAs contained extensive clauses granting control rights to the most senior group of creditors acting together as one and the control changed in prescribed situations to the more junior creditor groups if the senior majority creditors did not act. The control rights extended to all aspects of a distress scenario enabling control over modifications and payment and enforcement blockages. The rules concerning individual facilities, ie on the horizontal level, are included in the debt documents and were regulated through covenants, default clauses and syndicate democracy clauses, but the overall control of creditor actions both on a horizontal and vertical level (the entire group and all debt categories) is included in the ICAs.

The sample ICAs left the thresholds of allowed payments to the SFA, despite the fairly lengthy provisions in the ICAs. All sample documents that included more than one category of external financial indebtedness blocked all allowed payments on most default events, creating either an absolute restriction or a payment standstill period. All enforcement measures in the sample ICAs were subject to detailed regulation in relation to all creditor categories and all enforcement rights triggered by covenant breaches under the subordinated facilities and in the junior and intra-group loans were subject to categorical enforcement restrictions. Therefore, both the payment and enforcement restrictions effectively created a moratorium. At the ICA-level, the waivers and consents were controlled by the instructing group.

From the legal point of view, control of the hold-out creditors was premised on effective and strict enforcement of the ICA rules, the effectiveness of the security agent representation clauses, no-action clauses, and the effectiveness of contractual

clauses that limited creditor actions in insolvency and in relation to transaction security. Any remaining incentives to circumvent the priority regulation were eliminated by protective clauses, especially anti-layering, turnover obligation and equalisation clauses. However, in relation to the most important financial creditors, the hold-out risk was controlled by means of fixed standstill periods of 120-179 days, which meant that the controlling creditor group had to decide on the restructuring and enforcement actions within that time. If such a decision was made, the protections continued.

(c) Summary

When we take into consideration the ICA provisions restricting 'run-to-the-bank' behaviour and eliminating the remaining circumstances where the prisoner's dilemma risk might arise, we can conclude that the sample ICAs provided a comprehensive way of dealing with the risk in relation to all creditor groups. Based on the structural analysis of the ICAs, this holds although LBO capital structures are heterogeneous and fragmented. The solution is based on market-based evaluation of a case-by-case negotiated threshold of sufficient adherence to the contract, which means that adherence of all of the creditors is not required for the effectiveness of the solution. The economic analysis of the required level of acceding debt carried out at the financing stage can take into account the risk of the non-acceding creditors. Therefore, the argument ICAs can to deal with the hold-out risk within the acceding creditor groups, holds true. This means that the difficulties faced with contracting *ex ante* about the hold-out creditor risk can be overcome in some transactions and capital structures.

However, hold-out behaviour by a large-enough trade creditor may be problematic for the ICA arrangement and can lead to the inability to control the hold-out creditor risk. Furthermore, the fact that ICAs deal only with financial indebtedness

leaving eg operative and trade creditors outside the regime means that they do not create a comprehensive insolvency system capable of restricting hold-out actions by the non-acceding creditors.

Also, even if the creditors can control the acceptable level on non-acceding debt and a qualified majority of the most senior creditor group can stop hold-out creditor behaviour does not mean that the creditors can execute an optimal solution to the financial distress. I will next set out the findings concerning the strategic creditor actions prohibiting reaching such a solution.

4 Proposition B: creditor coordination and optimal arrangement

(a) Introduction

Proposition B focused on the ability of the ICA regime, on the one hand, to overcome the risk of a creditor opposing an economically feasible plan and trying to extract private benefits by facilitating better creditor coordination, and, on the other hand, to enable the creditors to liquidate or restructure a distressed debtor group in a manner maximising creditor recoveries. This appears possible only if the ICA terms include majority creditor group control on a debtor group level. Under such a regime the controlling majority creditors can choose the optimal enforcement choice, binding all creditor classes. This provides a solution to the 'free-rider' problem.

(b) Dealing with the 'free-rider' problem

1. The general requirements

The question of optimal enforcement and distressed disposals process is inherently connected to resolving the non-cooperative game[759] that arises during the standstill period or the negotiating period in a financial distress scenario. In a non-cooperative game involving a liquidation or reorganisation decision of a distressed company the parties are incentivised to act, if they are rational, in an economically optimal matter only if the other actors act in a similar manner. There are two alternatives: either the parties' interests will have to be aligned, which is an unreasonable assumption due to the fragmented creditor-base and the multitude of the objectives and situations faced by the creditors, or there will have to be a credible threat to make them comply.

For example, a claim by a subordinated creditor to oppose a distress disposal and sale under an ICA would not be credible because the senior majority creditors control the process at the time and the only party entitled to carry out the decisions is the security agent. The subordinated creditor's claim can, however, be credible, for example, if it holds a substantial amount of non-ICA claims against the debtor group, is a major supplier, or if it is the only party capable of providing liquidity to the group during distress.

The ICA standstill provisions also created a bargaining space for the creditors, the debtors and the private equity fund to negotiate on an optimal restructuring or liquidation procedure, foregoing their incentive to extract personal benefits by deviating from the best-expected outcome. More specifically, the empirical

759 See Part B, Section 3(c).

analysis resulted in a two-part solution to the hold-up problem: a strict enforcement and decision regime concerning liquidation and restructuring measures; and a regime enabling comprehensive release of liabilities and security of the debtor group in connection with enforcement and sale.

2. Liquidation and restructuring decisions

The control of the non-co-operative game in a distressed LBO is built on the priority, control and enforcement solutions provided by the ICAs. In the ICAs, the creditor group in control, called the instructing group, was entitled to decide on the enforcement instructions that determined the moment and manner of effecting enforcement measures and distressed disposals, ie the restructuring measures. The instructing group consisted of the majority senior creditors and, after the end of the standstill periods and in the absence of enforcement actions, of the next-ranking majority creditors. Enforcement instructions by the lower-ranking creditors, however, always needed to result in full discharge of the higher-ranking liabilities. There were no systematic deviations from these solutions.

The solution to the non-cooperative game relied, therefore, on collectivisation, which meant that a qualified majority of the controlling creditor group was in control of all material decisions in the vertical aspect, ie between all stakeholders. Other creditor groups were disenfranchised. The internal decision-making within creditor groups relied on the debt documents. Therefore, the ICA regime resulted on a general level in a similar voting system as, for example, a scheme of arrangement, albeit with different voting thresholds and with a comprehensive moratorium on all creditor actions.

3. Specific solutions against 'free-rider' behaviour

Group-wide enforcement and restructuring measures require comprehensive rights to release the debtor group of all its liabilities and security interests, something that is very difficult to achieve using just the statutory measures. This eliminates hold-up behaviour on many levels and enables an optimal sale of the debtor group. The resolution of the non-co-operative game relied on the same solutions: highest-ranking creditor majority control and enforcement, defusing the incentives of the other creditors to deviate from the regime, and ensuring all claims, liabilities and security interests were released at the time of enforcement or sale.

The distressed disposals clauses that regulate the release of liabilities, guarantees and security, as well as the disposal of the debtor group's assets, were consistent throughout the sample. In a majority of transactions, the parties had enhanced the requirements of enforcement by including enforcement principles that enabled the use of non-cash consideration and credit-bidding, subject to procedural constraints. All the documents enabled debtor group-wide enforcement and disposals, including options to resort to the statutory mechanisms.

The most important deviation of the above was the inability to carry out a debt-to-equity conversion into a new debtor entity without majority senior creditor approval.[760] However, a contractual solution leading to mandatory conversion by means of a majority decision appears to be something that could be adopted in the markets. Until the market standards change, it will be necessary to resort, for example, in such cases to a combined scheme of arrangement and an administration.[761]

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760 Such a write-off is not enabled by the SFAs or the ICAs.

761 See Part B, Section 3(e)2. As the interviewees pointed out, however, there were scenarios where statutory procedures would be needed, such as if a sufficiently large senior creditor

Release of liabilities, guarantees and security were subject to observance of the value protection rules. These clauses were extensive and required, in most cases, use of fairness opinions, competitive bidding and auctions setting out rigorous procedures for the enforcement and restructuring. Only the security agent was entitled to carry out enforcement and distressed disposals under the sample ICAs. Individual creditor's actions were restricted. This solution enabled the group to carry out a comprehensive group-wide enforcement and restructuring process without necessarily resorting to the statutory procedures. It also evidenced a delicate balancing of the risks related to senior creditor moral hazard[762] and the broad enforcement and liquidation rights given to the security agent and the instructing group.

The use of provisions regulating release of security and claims and linking them to the proper valuation procedures is logical. Valuation of a distressed business cannot be carried out *ex ante*, but it is an essential matter affecting any restructuring solution. Therefore, setting up a framework for the proper determination of distress valuation increased the reliability of the *ex post* bargaining process.

It should be noted that the above solutions to the 'free-rider' problem do not as such lead to a better outcome for the stakeholders, but they only create a framework for the parties to reach such a solution. ICAs do not determine whether the parties should choose one alternative over another. However, the empirical part suggested that we can find ways and strategies how the markets and the contracts approach this question. The answer is connected to the nature of the incomplete

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group opposed a debt-to-equity conversion or to deal with a large non-ICA creditor such as a lessor of property leased by the debtor group.

762 See discussion in Part B, Section 5(e). However, even though ICAs include extensive clauses for ensuring that the enforcement and sales processes are carried out prudently and according to the professional market standard and under ICA value protection provisions, ICAs do not remove the risk of senior creditor moral hazard, but merely aim to contain it.

contracting problem and why the basic assumption underlying the problem, ie that the parties cannot contract on all contingencies relating to distress *ex ante*, does not hold in all cases. This analysis leads to the final part of the research question, whether use of ICAs necessarily require resorting to mandatory insolvency law.

(c) Framework for bargaining on an optimal arrangement

1. Incomplete contracting and the ICAs

The ICA procedure maintains the benefits of *ex ante* contracting while enabling the controlling creditors to determine the most feasible action based on better *ex post* information. This means that it supports the discussion by Skeel and Triantis concerning the benefits of being bound by *ex ante* contracting while trying to benefit from better knowledge of case-specific fact *ex post.*[763] Reconciling these two views requires an understanding of how ICAs can give insights into solutions to the incomplete contracting problem.[764] Casey has argued that 'bankruptcy's proper purposes is to solve a specific contracting failure'.[765] He notes that:[766]

> 'For a business firm, financial distress involves too many parties with strategic bargaining incentives and too many contingencies for the firm and its creditors to define a set of rules for every scenario. When distress arises, a firm's various relationships are therefore governed by incomplete contracts'.

The fundamental problem is, therefore, the inability to deal with 'too many contingencies' inherent in distress. Much of the literature challenging privatised

763 Skeel and Triantis (n 32).

764 See Part B, Section 3(d)2.

765 Casey (n 3) 4.

766 ibid.

insolvency procedures is either built on this argument or implicitly relies on it, for example, through claims that *ex ante* contracting cannot accommodate the complex insolvency scenario, liquidity needs or the varying incentives of the creditors *ex post*.

The incomplete contracting argument is not supported by the ICA analysis or the interviews. The parties do not expect any contract to cover all contingencies in the context of insolvency, but to provide the parties with a map, a predictable framework and maximum optionality, for the negotiations. From this perspective, the formulation of the incomplete contracting argument appears to be, in some contexts, such as in LBOs that utilise bank and institutional debt, too strict to take into consideration how the bargaining process or resolution of insolvency works in practice.

2. Creation of a bargaining framework

ICAs create a moratorium during which the stakeholders that are either in control or have another point of leverage on the debtor group can negotiate the best rescue or liquidation option within a fixed framework. The sample ICAs created a protected bargaining framework respecting the priority structure of the indebtedness and enabling, through complex provisions, the instructing group and the security agent to affect any desired restructuring arrangement. The solution is never tied to a particular manner of carrying out the transaction and it can be liquidation, administration, a scheme of arrangement or some combination, and, in limited cases, administrative receivership, receivership, or a sale effected by the security agent.

3. Negotiation leverage

It was clear under most provisions in the ICAs and in the interviews that the decision-making mechanisms of the ICA were not the sole determinants of stakeholder control

or as to how the arrangement will unfold. However, this did not mean that the ICAs would have suffered from the incomplete contracting problem. In fact, all statutory procedures have the same problem. All depends on the parties' negotiation leverage.

The starting point, even with the controlling senior creditor group, is the SFA, which determines the allowed additional financing that the debtor group can incur after the execution of the SFA and the ICA. Secondly, something that was pronounced in the interviews, a party able to provide liquidity to a distressed firm has an enhanced position. Although the UK does not have US Chapter 11-type of debtor-in-possession financing rules, an ability to provide liquidity to the firm may tilt the agreed power balance of the ICA. As some interviewees put it, the reasons, solutions and specifics of a corporate distress scenario are so diverse that it is impossible to regulate all matters.

Therefore, the relative negotiation leverage always depends on each specific distress situation, but the negotiations themselves are always premised on the priorities, control and institutional setting laid down in the ICA. If any of the controlling creditors were to resort to the ICA, they would have a credible threat for opposing the arrangement. The ICA, the underlying statutory procedures and the commercial and financial leverage possessed by each of the parties determine their bargaining power. This means, for example, if the private equity fund sees residual value in the business either after satisfaction of the prioritised creditors' claims or possessed some form of negotiating leverage, it may be able to negotiate an enforcement and distressed disposal where the existing external indebtedness is at least partially written off, possibly left in a shell company. This may help the fund retain an equity portion in the surviving new corporate group along with the 'in-the-money indebtedness'.

Such bargaining occurs in a non-co-operative game environment.[767] The

[767] See Part B, Section 3(c).

ICA terms constitute a credible threat as long as the terms are respected should there be a legal dispute over them. English law provides a robust and reliable basis for the validity of the ICA provisions, debt subordination, turnover trust, inter-creditor obligations, strong protection of security interests, security agent actions, and general respect for the specific contract terms. This means that the ICA reduces the number of factors affecting the resolution of a distress scenario and ensures the most common threats are eliminated by contractual provisions.

The fact that they are external debtor- or creditor-specific circumstances does not mean that a contract becomes unworkable or is incomplete; just the opposite. Most parties understand when drafting and relying on the ICA that the it is a map and a framework and that the bargaining always involves a number of matters that emerge in later stages. The parties expect this and know that this will happen, and the terms reflect this. Creation of such a reliable framework for distress scenarios, rather than covering all contingencies, appears to be the core of bankruptcy contracting.

(d) Summary

With the exception of the debt-conversion situation, all sample ICAs resolved the 'free-rider' risk by collectivisation by allocating the decision-making to the most senior-ranking creditor majority, disenfranchisement of the other creditor classes, and comprehensive releases of claims, security and guarantees on liquidation or restructuring. The ICA solutions were premised on a case-by-case analysis of the acceptable level of non-acceding indebtedness and on ensuring that third parties do not have security interests over material assets of the debtor group.[768] However, the fact

[768] Although, the scope of the use of security was not part of the research, all of the ICAs relied on comprehensive transaction security to block third parties' priority claims.

that the standstill periods were fixed meant that, if the arrangement was considerably delayed, the subordinated creditors were able to exert leverage in the restructuring negotiations.

Underlying the extensive regulation of strategic creditor actions in the ICAs is a fixed bargaining framework between the relevant parties, based on their ICA control rights and external negotiating leverage. This enables the parties to solve the distress scenario in a more predictable manner *ex post*, with the information available at that time. The parties' objective of reducing the traits of the non-cooperative game (making it more co-operative) by agreeing *ex ante* to a procedure reducing the number of variables in the eventual game of distress and bargaining fits the empirical analysis of the ICAs. Knowing all *ex post* factors beforehand is an unreasonable requirement for the effectiveness of any solution to financial distress. A claim that the stakeholders cannot *ex ante* agree on the best possible outcome is not instructive for corporate insolvency theory. Therefore, the incomplete contracting claim should not be used, at least in some contexts and in relation to some classes of debt, as a basis for claims restricting insolvency contracting.

Rather, ICAs provide a framework in which the number and nature of the factors encountered in non-cooperative bargaining scenarios *ex post* are reduced to a level that enables the creditors and the private equity fund to reach a value-maximising solution in the situation at hand. Such negotiation may not always lead to a Pareto optimal outcome or even to Pareto improvements, but it gives the parties a true option to reach such a solution and help preserve most value for all.[769] Interestingly, the solution is the same one that Casey sees as the basis for a statutory corporate insolvency

[769] See Part B, Section 3(c).

procedure.[770]

The findings suggest that Haugen and Senbet's view that including contractual terms that deal with strategic creditor action should be costless, and these terms should 'prevent free riders from impeding informal reorganisation of the capital structure' holds.[771] With the LBO ICAs, the leveraged markets have created an effective mechanism in order to ensure that financial creditors are able to decide whether to cease supporting a business or if sufficient going concern value is to be found, binding the relevant creditor base.[772] However, the fact that in some scenarios, such as in debt-to-equity conversions, the parties are likely to resort to the statutory procedures means that the ICA procedure may not be able to achieve the objective of maximisation of creditor recoveries without resorting to the statutory procedures.

5 Proposition C: are the statutory procedures necessary?

(a) The parties' option to choose a procedure

Proposition C deals with the question whether the ICA procedures necessitate the creditors resorting to statutory procedures. If resorting to statutory procedures is not necessary, we would expect the controlling creditors or other stakeholders that have sufficient bargaining leverage to be able to choose the most feasible procedure and point of entry for the liquidation or restructuring also outside the formal insolvency procedures.

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770 Casey (n 3) 52.

771 Haugen and Senbet (n 59) 29. See Part B, Section 5(b).

772 See for the underlying analysis: Paterson, 'Rethinking Corporate Bankruptcy Theory in the Twenty-First Century' (n 353) 723.

According to the content analysis, the ICAs do not necessarily require the use of the statutory procedures to be effective. However, they include substantive regulation ensuring that, if the security agent elects to resort wholly or partially to the statutory procedures, the rights, priority and control regulation under the ICAs are fully respected. As a number of the interviewees stated, even if the controlling creditor group were to opt for a statutory procedure, the procedure is still premised and works under the ICA regime that is accepted and applied in the statutory procedure.

Why would sophisticated parties then contract on corporate financial distress rather than rely on the statutory law procedures? One logical answer is that they would choose the contractual alternative if it is cost-effective. The ICA analysis provided support to this argument and to the argument that failure of contracting does not hold at least in some parts of the corporate finance markets. As discussed in the previous section, the empirical analysis supported the argument that stakeholders seek to achieve in LBO ICAs an optimal game-theoretical scenario that takes into consideration that the parties will have different leverage at different times and that the actual scenario that materialises may be complex. This leads to the possibility to choose between the contractual and statutory procedures.

Along with the ability to resort to the statutory procedures, ICAs are also, in practice, supplemented with several other procedures and agreements, such as additional standstill agreements, disclosure procedures and protocols and creditor committees, which help to implement the ICA framework. This kind of a contractual and negotiation framework for the resolution of distress benefits from better *ex post* information, which is one aspect affecting the parties leverage and in finding a solution. This objective can, at least in connection with LBO arrangements, accommodate the varying incentives of the creditors and the debtor's specific circumstances. Therefore,

it may not be correct to talk about ICAs as an independent privatised insolvency mechanism.

Rather, although ICAs can work without necessarily resorting to the statutory procedures, a more proper formulation is that they enable group-wide solutions to most distress scenarios by dealing with the strategic creditor actions, giving the stakeholders an option to choose an *ex post* feasible statutory or contractual solution to distress. ICA-type contractual mechanisms work in practice in tandem with the statutory procedures, not excluding one another.

(b) Qualifications for the effectiveness of the procedure

However, the findings are qualified in a number of respects. On a general level, the use of an ICA-type contractual mechanisms for agreeing on priority, control and enforcement before and after financial distress is subject to a number of practical and legal issues material to the operation of the ICAs.

First, the effectiveness of the contractual remedies and rights used in ICAs are likely to be connected to the level of legal enforcement in a particular jurisdiction. For example, Lerner and Schoar find that the valuations tend to be higher in high enforcement countries, by which they mean common law countries.[773] In low enforcement countries, private equity firms are likely to resort more to equity and board control whereas, in high enforcement countries, they are likely to rely more on contractual protections.[774]

Secondly, the ICA solution appears possible only if there is a single event

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773 Josh Lerner and Antoinette Schoar, 'Does Legal Enforcement Affect Financial Transactions? The contractual Channel in Private Equity' [2005] The Quarterly Journal of Economics 223.

774 ibid 242.

enabling financial structuring of the debtor group. This can be, for example, an LBO acquisition in which the financial creditors accede to the contractual package simultaneously. Once this is achieved, the ICA regime allows flexible amendments to the capital structure, controlled by the parent or the private equity fund. It is likely that the ICA regime works only or predominantly in jurisdictions that have a strong respect for party autonomy, established rules of interpretation, and low likelihood of using implied terms or invalidation of the parties' contract by the courts. Furthermore, the rules on debt subordination in a jurisdiction should be clear and reliable; this is key to structuring an LBO transaction.

Thirdly, it is likely that the ICA procedure cannot be used in its English law form in jurisdictions where, for example, bankruptcy waivers are heavily restricted. However, even in the US where bankruptcy waivers are restricted ICAs are used and address certain matters that the parties can agree on irrespective of the statute.[775] Connected to that, it appears that for ICAs to be effective, mandatory national laws should not restrict the ability to release all security and indebtedness of the debtors, when the enforcement or restructuring is carried out.[776]

Fourthly, based on the empirical research, the regulation and case law concerning creditor oppression has an impact on the effectiveness of ICAs because the banks expect commercial certainty from the instructing group's decisions. However, a reliable view on the effects of these rules for the use of ICAs would require comparative legal analysis.

Fifthly, in practice, all of the LBO ICAs rely on a comprehensive or extensive security package and recognition of a possible single point of enforcement

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775 Morrison (n 11).

776 For example, long stays relating to enforcement of security may operate in a similar way and restrict the effectiveness of ICAs.

deemed optimal by the controlling creditor group. It is likely that these arrangements do not work as well in jurisdictions that have a tendency to stay creditors' enforcement procedures.

Sixthly, the ICA structures and the underlying loan facilities assume that a sufficiently large percentage of the creditors is bound by the ICA. Therefore, the arrangement may not be optimal if the nature of the business means that there is a very large percentage of trade creditors or, for example, substantial lease liabilities, unless they are subject to an ancillary arrangement. Interestingly, the structure of the debtor group would not appear to have a major impact on the usability of the ICA mechanism. Creditors are generally free to choose the optimal point of enforcement, which means that the mechanism may be used in most types of group structures.

Although these characteristics appear to restrict the use of ICAs, they should not be interpreted as strict qualifications for their use. ICAs are used in other important corporate finance structures such as securitisations, project finance and real estate financing. ICAs have also been increasing their significance in the US even though Chapter 11 provides a number of the solutions provided in English law ICAs. They are also in use throughout Europe, North America and Asia in domestic law arrangements.[777] The generality of the solutions in LBO ICAs also begs the question of whether the solutions adopted in ICAs are useful in other distressed financing scenarios, for example bank resolution and insolvency, which are especially prone to the prisoner's dilemma hold-out risk. Therefore, the findings are likely to have more general applicability in other areas of corporate finance.

[777] Plank and Prusko (n 11).

(c) Summary

Contracts for control such as ICAs are commonly encountered in the corporate finance markets. The empirical analysis supports the view that, the theoretical impediments to contractual solutions to financial distress were not pervasive and that the theoretical literature on the parties' ability to design financial contracts and capital structures to avoid strategic creditor actions is correct. In the corporate finance markets, such contracts are neither marginal nor rare. They are also able to address the agency costs and strategic creditor actions encountered in multi-tiered financings and group structures that are inherently difficult to solve using the statutory procedures. Also, they facilitate value-maximising enterprise-wide solutions in restructuring and enforcement scenarios. This suggests that the contractual mechanisms used in LBOs for overcoming and defusing certain strategic creditor actions by better creditor coordination may be applicable in a wider arena of corporate finance. This is the case especially with companies and transactions having an initial structuring event that enables proposing a contract for control to all of the primary financial creditors of the debtor group.

However, because they do not cover all creditors of a firm, they have their limitations and there are a number of scenarios where resorting to the statutory procedures is still necessary. Reliance on the statutory procedures is not required for the effectiveness of ICAs, but such mechanisms work as a part of the bargaining framework. This means that, although ICAs do not necessitate use of the statutory procedures, they are in practice part of the same 'toolbox' of the stakeholders as the statutory procedures.

6 Scope for future research

In this thesis, I discussed one branch of corporate finance, LBOs that use ICAs as an important part of regulating the relationship of various stakeholders. ICA-type agreements are used in several other fields of corporate finance such as project finance, securitisation and real-estate financing. If similar structures are used in these fields, we can argue that the scope of ICAs is not restricted to private equity or to LBO transactions.

On a more general level, the thesis set out one example of a contractual solution to insolvency in a particular jurisdiction, England, which is very permissive to contracting in relation to insolvency. Because contractual solutions are first and foremost connected to the governing law of the contract and to the laws of the debtor's domicile, one fruitful area of research would be a comparative analysis of either European ICAs or the US and English law ICAs. There is plenty of practical experience of the latter, which is likely to make a comparative analysis very informative. On a more theoretical level, it would be interesting to see if the game-theoretical views presented in the thesis can be applied on a more detailed level to analysis of various English and European insolvency mechanisms. This type of analysis is likely to benefit from both quantitative and qualitative research.

The empirical analysis evidenced a mechanism of ensuring a single-point of entry procedure for restructuring and liquidation enabling continuance of the business free of out-of-the-money financial obligations. This option meant that the group could be sold free and clear of all claims, with security at the desired level of the debtor group. Such mechanisms and ways of eliminating strategic creditor actions could be used in bank resolution procedures as private mechanisms for effecting a prompt

rescue of a financial institution while maintaining access to the private capital markets before the completion of the arrangement. Increase of such mechanisms should have positive effects on market expectations and on the coherence and integrity of the resolution mechanism. This approach can also have profound implications for the analysis of financial distress on the macro-level.

APPENDIX 1. Interview Questions

(i) Do the market participants consider that the ICAs are drafted and intended to be used so that they enable, especially through standstill, enforcement and release provisions, dealing with the risks of strategic creditor actions - and do the terms of the actual ICAs support this view?

Questions to the interviewees:

a. Do you use ICAs when entering LBO arrangements?
b. What are your primary purposes for entering into the ICA?
c. Which party coordinates the drafting and controls the term sheet / main terms?
d. When the debtor group faces financial distress, when and how do you resort to the ICA standstill or other protections?
e. Do you consider that the ICA standstill provisions are sufficient to retain control of the scenario?
f. Do you consider the ICA enforcement, distressed disposal and release clauses sufficient and/or usable in the restructuring process?
g. Is the Instructing Group control in your opinion workable in practice?
h. Does your institution consider that the English law contractual remedies and framework is sufficient to ensure a workable LBO restructuring?
i. Do you consider that the actions and measures taken by the Instructing Group and the security agent are adequate protected and robust under English law so that the parties are not obligated to resort to mandatory insolvency law procedures or authorities?
j. Does the answer change if the debtor group is mostly non-English?

(ii) Do the market participants consider that the ICA restructuring can operate without the parties having to resort to the statutory procedures – and do the ICA terms reflect that?

Questions to the interviewees:

a. Do you consider that the restructuring procedure facilitated by / set out in the ICA is capable of operating as an independent insolvency/restructuring procedure without resorting necessarily to the statutory procedures such as administration or scheme of arrangement?
b. What are the circumstances where you consider it either necessary or feasible to resort to one or several of the statutory procedures?
c. What are the benefits (if any) in resorting to the statutory procedures?

(iii) Do the market participants consider that the actual ICA terms enable use of optimal enforcement choice by the controlling creditor group, enabling restructuring of the entire economic enterprise (ie the debtor group) and maximising the creditor recoveries?

Questions to the interviewees:

a. Do you consider that the 'group obligor' perspective of the ICA in an LBO facilitates restructuring or creates additional benefits to the parties?
b. Do you consider that the extensive group-wide enforcement options enable you to make a more optimal restructuring choice compared to purely statutory procedures?
c. Do you consider that a same type of a restructuring as enabled by the terms of the ICAs can be achieved by means of just the statutory procedures?

APPENDIX 2. Coding Framework

Capital Structure & Priorities	
Capital Structure	Provisions setting out the debt facilities and claims covered by the ICA; definitions of the debt facilities. This refers to defining different categories of the debtor group's indebtedness, their relative priorities, and how the debtor may increase, amend and refinance such indebtedness.
Transaction Security	Provisions setting out which debt facilities are secured by comprehensive security and definitions of security interests carved out so that they only cover certain assets (the latter usually in connection with holding company financings).
Anti-Layering	Provisions of the ICA regulating accession of new or replacing debt facilities ranked between the existing creditor and debt categories, with rights deviating from the existing categories.
Priorities	Provisions concerning ranking and subordination of the debt facilities and the transaction security. This is commonly a straight-forward ranking of various debt categories (1st, 2nd, 3rd), but also covers possible changes to the priorities when the security agent distributes funds according to the 'payment waterfall' clauses.
Amendments	Provisions regulating permitted amendments of the terms of the individual debt facilities, such as changes to maturity, interest rate, covenants and events of default.
Senior Liabilities	See Part C, Section 3(c) for a detailed description.
Junior Liabilities	See Part C, Section 3(c) for a detailed description.
Other financial liabilities	See Part C, Section 3(c) for a detailed description.
Parent/Vendor/Investor Liabilities	See Part C, Section 3(c) for a detailed description.
Intra-group Liabilities	See Part C, Section 3(c) for a detailed description.
Refinancing Facilities	Provisions of the ICA enabling inclusion of financing facilities that are used to refinance all or some of the original debt facilities
Incremental Facilities	Provisions enabling incurrence or new incremental or additional indebtedness, their inclusion into ICA and rights to security. The incremental facilities may or may not be included within the ICA. In the latter case, they cannot be secured with the transaction security.
Redistribution	Provisions regulating repayment of distributions received by a particular creditor and their redistribution back to debtor/security agent for proper distribution in accordance with the 'payment waterfall'.
Turnover	Provisions regulating payment of non-permitted distributions and payments received by a creditor back to the security agent for proper ICA distribution in accordance with the 'payment waterfall'.
Equalisation	Provisions regulating fixing a particular date as the correct time for determining the creditors' proportional entitlements to the final distributions
creditor Control	
Agent Control	Provisions regulating the rights of the security agent (and the exclusion of creditors' actions) to carry out measures under the ICA / various scenarios
Party Enforcing	Provisions regulating which creditor, or a group of creditors, is entitled (at defined time periods) to decide on the commencement of creditor actions.
Waivers to Transaction Documents	Provisions regulating, which creditors or parties are entitled to grant waivers and changes to transaction security.

Majorities	Provisions setting out controlling creditor majorities and thresholds for material decisions, consent and enforcement under the ICA.
Restrictions on Payments	Provisions restricting payments under the debt facilities following occurrence of events of default under the debt documents.
Senior	-
Junior	-
Other financial	-
Parent/Vendor/Investor	-
Intra-group	-
Restrictions on Enforcement	Provisions restricting enforcement measures under the debt facilities following occurrence of events of default under the debt documents.
Senior	-
Junior	-
Other financial	-
Parent/Vendor/Investor	-
Intra-group	-
Enforcement	
Enforcement of Transaction Security	Provisions regulating coordinated enforcement measures of transaction security and requirements for its efficacy in relation to other creditor groups.
Enforcement Instructions	Provisions regulating which creditors, or a creditor group may issue enforcement instructions (solely) at various times and after various events.
Manner of Enforcement	Provisions regulating which creditors, or a creditor group is entitled to decide on the manner of enforcement of transaction security.
Voting	Provisions which creditors or a creditor group decides how other parties are obligated to vote in possible statutory procedures or informal or pre-insolvency procedures.
Granting Waivers	Provisions concerning waiver of rights to require particular enforcement of transaction security or distribution.
Duties Owed to whom	Provisions regulating to which creditor groups the security agent owes its duties when enforcing transaction security
Distressed Disposals	Provisions regulating releases of security, guarantees, liabilities and shares and their appropriation and transfers of assets claims and rights.
Definition	Provisions regulating to nature of the allowed measures.
Scope	Provisions regulating the scope of the allowed measures.
Release of claims and security	Provisions regulating specific authorisations to effect the releases.
Fair Value requirement	Provisions regulating required measures for fulfilment of security agents obligations with enforcement/restructuring so that releases or security, assets, claims and rights can be carried out.
Non-Cash Consideration	Provisions regulating allowed use of non-cash consideration in enforcement and distressed disposals (eg shares).
Structural Adjustments	Provisions enabling structural adjustments (eg write-off of indebtedness and debt to equity conversions) in the debt facilities to be effected also within the ICA (vertically in group).
Protective Clauses	The provisions ensuring that the creditors' incentives for avoiding the control and enforcement restrictions are defused.

Effect of Insolvency Event	Provisions regulating payment of insolvency distributions to the security agent in accordance with the ICA ‘payment waterfall’.
Application of Proceeds	Provisions regulating the order of payment after enforcement, collection, etc. by the security agent to the creditors in their order of priority, ie the ‘payment waterfall’.
Filing of Claims	Provisions regulating possible sole right of the security agent to take actions and file claims in insolvency instead of any and/or all of the creditors.
Further Assurance and Security Agent Instructions	Provisions obligating the creditors to take any and all actions for ICA purposes required by security agent in order to ensure the enforcement, disposals, voting and other liquidation and restructuring measures can be carried out binging all of the creditors.

APPENDIX 3. Key Concepts

acceleration	The creditors, or often the facility agent, declaring a claim to be due and payable prematurely and/or cancellation of commitments.
additional facilities/liabilities/financing/debt	Additional indebtedness allowed and governed by the ICA incurred by the debtor group.
application of proceeds	Provisions regulating the order of payment after enforcement, collection, etc. by the security agent to the creditors in their order of priority, ie the 'payment waterfall'.
appropriation	Appropriation (or similar enforcement process) of the shares that are part of the transaction security.
common charged property	all transaction security. The definition is used is also the parent/HoldCo creditors (not only the company and its' subsidiaries) are secured in relation to such assets.
company	usually the main debtor, which is the primary debtor eg under the senior debt facilities.
competitive sales process	An auction or other competitive sale process with several bidders (also through a court) participating the transaction. There is usually an advisor (investment bank) arranging the transaction.
credit facility	Any loan facility, but usually the term refers to the SFA.
creditor	Any external (not the private equity house or any of the group companies) financial creditor of any of the debtor companies.
debt/finance documents	All of the external facilities and financing agreements covered by the ICA.
debtor	The primary debtor of the senior facilities but may refer to any member of the debtor group.
debtor group	the group consisting all of the debtors under the debt documents.
distress event	an event stipulated in the ICA that triggers a right to make eg distressed disposal.
distressed disposals	Transfers and appropriation or shares assets security and claims. Usually carried out free and clear of all claims, security and creditor rights.
EBITDA	Earnings before interest, taxes, dividends and amortisations.
enforcement	Any measures to enforce transaction security whether contractually, by a receiver, third party or in a statutory process.
enforcement instructions	The instructions given by the instructing group in relation to enforcement of transaction security.
enforcement notice	A notice by a particular creditor group that they will commence transaction security proceedings.
enforcement principles	A list of substantial/procedural rules applied to transaction security measures, procedure and requirements.
event of default	A breach of terms or commitments under the debt document stated to be an event of default in such a document.
facility agreement(s)	Syndicated loan agreements that provide for different tranches of loans documented in a single agreement.
fair value/value protection	Clauses requiring certain substantial/procedural measures to be taken in transaction security/distressed disposal. This is often also the requirement for release of security, claims and guarantees.
financial adviser	Means an adviser nominated often by the security agent in connection with enforcement/distressed disposals/valuation.

guarantees	Guarantees granted usually by the debtor group companies for the senior indebtedness and sometimes also for other indebtedness.
guarantor	A guarantor of financing facilities (often under eg the SFA) which may or may not be a part of ICA debtor group.
headroom	A percentage or monetary threshold a particular indebtedness can exceed without additional consents. Usually used to allow amendments to the financing covered by the ICA.
high yield facility/liabilities/debt/notes	Usually second or third-ranking external indebtedness, often issued by the parent in a form of high yield bonds or notes.
high yield (note) creditors	Creditors of the high yield facility/liabilities/debt.
holdco	Either the parent or its parent company.
incremental (senior) facilities/liabilities	Liabilities incurred under permitted facilities often under the SFA, which may or may not be covered under the ICA. If they are not covered by the ICA, they are not secured by the transaction security.
instructing group	The majority creditor group making material decision under ICA (eg enforcement and disposals). The constitution of the group will change subject to certain events set out in the ICA.
intra-group liabilities	Liabilities owed by companies within the debtor group to other debtor group companies.
junior facility/liabilities/debt	parent, vendor, investor, shareholder, intra-group and subordinated liabilities.
lender	The same as a creditor, but often referring to a creditor under the loan facilities.
liabilities	All financial liabilities against any of the debtor group members covered by the ICA, where the creditor is also subject to the ICA.
liabilities sale	A sale of debtor group liabilities in a distressed disposal.
majority/requisite/required (senior/second lien/mezzanine/high yield) creditors	Generally a percentage of a creditor group required to effect a change or take action/resolution under the ICA.
margin	Generally percentage points of interest or level a yield can exceed a certain threshold as allowed under the ICA.
mezzanine facility/liabilities/agreement	Liabilities owed to a creditor group (claims and security) subordinated to senior liabilities under a mezzanine facility agreement.
non-cash	A form of consideration made by other means than cash (eg in shares).
parent	The parent company of the main Debtor company.
parent, vendor, investor, shareholder and subordinated liabilities	Liabilities owed to these parties (respectively), always heavily subordinated to external financing.
pari passu creditors	Creditors of the pari passu liabilities.
pari passu liabilities/facilities	Senior liabilities that can be issued as loans or bonds, often in a same transaction with super senior liabilities.
payment stop notice/period	A notice by representative of priority creditor category that future payments to subordinated facility are blocked.
permitted enforcement	Permitted enforcement under the ICA, until a specific trigger date.
permitted Financing	Permitted new financing under the facility agreements.
permitted payment	Payment permitted to be made under the ICA, until a specific trigger date.

PIK	Payment in kind, ie often that the interest of the loan is capitalised.
primary liabilities	With some deviations, senior facility, refinancing, incremental, hedging, second lien and mezzanine liabilities.
priority creditor only transaction security	Security granted only to primary creditors (not parent's or HoldCo's creditors).
(qualifying) refinancing facilities/liabilities/debt	Liabilities incurred under debt facilities used to refinance all or particular original indebtedness covered by the ICA.
refinancing yield	The yield (in effect the calculated interest) of the new debt facilities used to refinance debt.
second lien facilities/liabilities	Liabilities owed to a creditor group (security) under a second lien facility agreement subordinated to senior liabilities.
security agent	An agent of the creditors under the ICA.
senior facility/liabilities/debt	Liabilities owed to the most senior creditor group.
senior headroom	Usually refers to the allowed increase of the senior facilities.
senior secured bonds	Senior Facilities issued in a form of a bond or a note.
(senior) (secured) noteholders	Holder of the relevant bonds or notes or bond/note units.
senior (subordinated/unsecured) indebtedness	Means high yield indebtedness or loans issued on the same level (parent or HoldCo).
senior yield headroom	The percentage or level that the yield of the senior facilities can be increased from the original level.
SFA	Senior facility agreement.
standstill notice/period	A period under which no payments or enforcement measures by subordinated creditor categories are allowed.
step-in event	A scenario where another creditor group is entitled to replace the controlling creditor group (LMA SS/S ICA). Usually used with senior creditor and super senior creditor financings.
subordinated liabilities	Means parent, HoldCo, investor, shareholder and vendor liabilities.
(super) (senior) discharge date	the date a particular indebtedness is fully and unconditionally repaid.
super senior facility/liabilities	Often revolving first-ranking liabilities usually granted by a bank.
tranche	In relation to financing facility, a sub-category within a particular creditor category or a part of it. There may be one or more tranches of indebtedness within a particular creditor category.
transaction security	All security granted to the debt documents (or the main facilities) and covered by the ICA.
unitranche	A loan facility where several debt categories (by same creditors) are regulated by the same document and the creditors often take portions of all of the debt categories covered.
unsecured	Used in a name of a loan facility name, which is not secured by transaction security or other security.

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