Investing in Distressed Debt in Europe

The TMA Handbook for Practitioners
Second Edition

Consulting Editors
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Legal structuring of direct lending deals: England & Wales[1]

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1. Introduction

As the market prepares for challenges ahead, it seems inevitable that direct lending will continue to gain ground as an asset class. Direct lenders, which are predominantly private credit funds, have typically been afforded broad investment mandates enabling them to provide traditionally senior secured debt and other flexible financing structures (including junior debt and debt-like preferred equity). This means direct lenders are uniquely positioned to be a source of financing to performing, stressed and distressed companies – both private and public – across the upper, mid and lower markets in the years ahead.

Private credit funds' deep pockets following record levels of fund raising in recent years, their aforementioned flexible mandate and their close relationships with financial sponsors due to direct lenders' 'take-and-hold' positions will make them key players in shaping the future restructuring landscape.

2. Entering into a direct lending transaction in England and Wales

Generally, private credit funds can provide secured or unsecured direct lending financings to a borrower incorporated in England without a banking licence or similar approval unless the loan is made to a consumer. However, certain borrowers may themselves be regulated, thereby impacting the nature or scope of the security package that they can offer to direct lenders.

2.1 Structuring direct lending deals

According to the *Private Credit Insights Report 2021* prepared by Proskauer,[2] in the European market, unitranche deals accounted for 93% of all direct lending

1 References in this chapter to 'England' and 'English law' should be read as references to England and Wales.
2 www.proskauer.com/release/proskauer-releases-10th-annual-private-credit-insights-report.

deals. Unitranche facilities are single tranche term loans with a blended senior/junior interest rate provided within a single credit agreement. Such facilities are predominantly provided by direct lenders.

In a typical unitranche financing, a direct lender will pair up with a commercial bank which provides the borrower with a revolving credit facility (RCF) and potentially certain other working capital/treasury products including hedging. Direct lenders do not typically provide working capital facilities. The RCF is documented in the same credit agreement as the unitranche facility; however, the RCF will rank ahead of the unitranche facility on a 'super senior basis' in relation to the application of proceeds of enforcement of transaction security.

Direct lending deals have also been structured (albeit less frequently and experiencing a gradual decline) as a 'first out, last out' (FOLO), where a commercial bank provides the revolving credit facility and a portion of term (amortising or bullet) debt on a super priority basis and a direct lender provides the remainder of the term debt. Compared to an unitranche and super senior revolving credit facility deal, on a FOLO deal, commercial banks typically benefit from better intercreditor rights and potentially enhanced rights in the credit agreement (given that they have more skin in the game).

As mentioned above, unitranche deals are documented in a single credit agreement. However, the unitranche lenders may enter into an agreement among lenders (AAL) which is designed to replicate in a single document a two-document structure, such as a first-lien, second-lien transaction, where some of the lenders take first-lien risk and others take second-lien risk. AALs are more common in the US market than in the European market, especially as borrowers demand to be party to such arrangements.

2.2 Corporate authorisation

An English company may borrow money, provide downstream, upstream and cross-stream guarantees and give security in respect of its financial obligations or the financial obligations of companies in its group. However, this is subject to compliance with the rules on corporate capacity and authorisation, corporate benefit and financial assistance.

(a) Corporate capacity and authorisation

The company must have the power to enter into the relevant direct lending transaction (ie, borrow money, give guarantees and/or security); and its directors must similarly be authorised to exercise such power. In this regard, the relevant company's constitution documents,[3] together with the minutes of the

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3 In most cases, this will be its articles of association, but could also include its memorandum of association where it was incorporated under the Companies Act 1985 and has not elected to disapply the memorandum.

board meeting authorising the borrowing or provision of guarantees and/or security, should be checked by the direct lender's legal counsel.

(b) Corporate benefit

Pursuant to Section 172 of the Companies Act 2006, the directors of an English company are under a duty to promote the success of the company for the benefit of its members as a whole, having regard to specified factors.[4] When taking a guarantee or security, it is advisable to ensure that the board minutes state exactly what the commercial benefit was to the guarantor or security provider company. This is also important if there are solvency issues (see section 3 below for further detail).

It is more difficult to identify corporate benefit when giving an upstream or cross-stream guarantee (ie, a guarantee provided by a company in respect of its parent or sister company's debt or obligations). As a result of the corporate benefit requirement, such upstream or cross-stream guarantees are usually approved by a unanimous shareholder resolution of the company authorising or subsequently ratifying the giving of the guarantee.

The giving of a guarantee and security for a debt can constitute a transaction at an undervalue if:

- there is no corporate benefit to the guarantor/security provider; or
- the value of that benefit is insufficient (see sections 3.1 and 3.3 below for further detail).

(c) Financial assistance

With effect from 1 October 2008, there is no prohibition on a private company from granting financial assistance for the acquisition of shares in itself or another private company.[5]

However, public companies continue to be prohibited from giving financial assistance for the purpose of the acquisition of their own shares or those of a parent company. It is also unlawful for a private company to give financial assistance for the purpose of the acquisition of shares of a public parent company (Sections 677 to 683 of the Companies Act).

2.3 Security

Any direct lender providing financing into a company will want to ensure that:

- it obtains a robust security package, with a single point of enforcement; and
- it has considered any potential future enforcement routes.

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4 The reference to the 'success of the company' is to the success of the company itself and not the group of which it is a member.

5 Note that 'financial assistance' is defined widely and includes financial assistance by way of guarantee, security, indemnity, release or waiver, loan, and any other financial assistance where the net assets of the company giving the financial assistance are reduced to a material extent (Section 677 of the Companies Act).

(a) General

The taking of English security over almost any asset class is generally straightforward. The extent of the security package depends on the commercial agreement between the parties and the type of security depends on the asset in question. In direct lending transactions, security is typically:

- a (fixed or floating) charge, which is an equitable right in the asset; and
- a mortgage, which involves transfer of title.

Under English law, security is often granted to a 'security trustee' or a 'security agent' which holds the security on behalf of the lender or group of lenders.

(b) Single point of enforcement

This is the ability of direct lenders to take control of the borrower group as an ongoing concern by carrying out a one-step enforcement over the shares and receivables security at the top of the borrower group. While in recent years, sponsors and their legal advisers have requested changes to documentation which have 'eroded' key protections to lenders, having a single point of enforcement at the outset of the deal and ensuring that it is protected throughout the life of the loan should be prioritised by direct lenders; and any changes to the finance documents that could impact this should be firmly resisted.

Having a single point of enforcement at a level above the operating companies is essential for a clean, quick and efficient transfer of the business as an ongoing concern without interfering with trade creditors and other stakeholders. In this regard, the terms of the shares and receivables security should be considered carefully together with the provisions of the intercreditor agreement if an enforcement is being sought by the direct lenders (see section 4 below for further detail).

(c) Fixed charge versus floating charge

A floating charge differs from a fixed charge in that it still creates an immediate security interest, but it does not attach to a specific individual assets until 'crystallisation' occurs. By contrast, a fixed charge which immediately encumbers the charged assets.

The classification of a charge as fixed or floating is a matter of substance depending on the essence and nature of the charge. A restriction on the chargor's ability to deal with the assets without the chargee's consent is the most essential measure for a fixed charge. If the chargor does not in fact exercise the degree of control usual for a fixed charge, the charge may instead be deemed a floating charge.

The holder of a floating charge over all or substantially all the assets of a

company can enforce that charge by appointing an administrator under a streamlined out of court administration process.

(d) Financial collateral arrangements

The EU Financial Collateral Arrangements Directive (2002/47/EC) was implemented in the United Kingdom through the Financial Collateral Arrangements (No 2) Regulations 2003, as amended. The regulations effectively cover any arrangements where collateral – in the form of cash, financial instruments (eg, shares) or credit claims – is provided by means of security or outright transfer, where the purpose is to secure or cover 'relevant financial obligations'.

The regulations:

- remove formalities that would otherwise apply to the creation, perfection and/or enforcement of 'security financial collateral arrangements';
- disapply certain insolvency law provisions, such as stays or moratoria; and
- provide that where a collateral taker has a security financial collateral arrangement, it may enforce any right of appropriation of that collateral without applying to the court for an order for foreclosure.

To this effect, the collateral under a security financial collateral arrangement must be in the possession or under the control of the collateral taker or a person acting on its behalf.[6]

2.4 Due diligence[7]

Direct lenders must be attentive to the need for comprehensive due diligence when financing a new transaction, to ensure that any regulatory approvals or specific UK regimes are observed and factored into deal processes and timelines. This section includes a high-level overview of certain matters to be considered at the due diligence stage in light of recent legal developments and trends.

(a) National Security and Investment Act

The National Security and Investment Act (NSIA) came into force on 4 January 2022 and provides the UK government with updated powers to scrutinise and intervene in investments in order to protect national security. Transactions

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6 The meaning of 'possession' and 'control' required remains unclear, and is largely fact dependent. The issue was considered under English law in *Gray v G-T-P Group Ltd* [2010] EWHC 1772 (Ch) and later in *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997. More recently, the issue was also considered by the Court of Justice of the European Union in *Private Equity Insurance Group SIA v Swedbank AS* [2016] EUECJ C-156/15. Please refer to these cases for further information.

7 A detailed review of the National Security and Investment Act, the register of overseas entities regime and the considerations around financing public takeovers is beyond the scope of this chapter.

within its scope may require mandatory notification or alternatively a voluntary notification may be advisable – in each case, to the Investment Security Unit within the Department for Business, Energy and Industrial Strategy (BEIS).

Any notifications or written confirmations which may be required under the NSIA should be included as a condition precedent in the credit agreement (this will generally be aligned with the conditions included under the acquisition agreement).

In addition, from a direct lender's perspective, it is fundamental to consider whether an NSIA filing can arise where a lender (or group of lenders) gains control over any shares,[8] voting rights and/or assets that may be offered by the borrower as security following a default under the credit agreement. To this effect, any such rights must be carefully drafted to ensure that directs lenders can benefit from any exceptions/carve-outs available under the NSIA, to avoid cutting across the exercise of any rights under their security documents.

Finally, in transactions where direct lenders are getting any sort of equity uplift, such as warrants or options,[9] or where transactions are structured as convertible loan notes (ie, loan notes will convert into shares either at the parties' election or upon specific events, such as an exit), special care must be taken and direct lenders should consider the substance and practical effect of these instruments and underlying documents from which 'control' or 'influence' of an entity may trigger an NSIA filing.

(b) Cash confirmation in public-to-private (P2P) acquisitions

The UK Takeover Code provides that:

- a bidder must announce an offer only after ensuring that it can fulfil, in full, any cash consideration; and
- a cash confirmation by the bidder's financial adviser is included both in the firm offer announcement and in the offer document (General Principle 5 and Rules 2.7(d) and 24.8 of the Takeover Code).

When diligencing the financing arrangements, the financial adviser must ensure that any debt used to finance the offer is made available on a 'certain funds' basis (ie, that the circumstances in which the lenders may decline to fund are limited, as far as possible, to matters which are reasonably within the bidder's control to avoid). In addition, the financial adviser must take all

8 The BEIS guidance published on 19 July 2022 confirms that the mere creation of share security will not trigger change of control tests unless the title is transferred when creating security (when granting security over shares, it is market standard in England to create a fixed charge by means of which no title is transferred on creation).

9 According to the Private Credit Insights Report for 2021 prepared by Proskauer, in the European market 11% of deals had equity co-investments in 2021, up from 8% in 2020.

reasonable steps to assure itself that the cash for the offer will be available;[10] this will require further diligence on the ability of the lenders to meet in full their commitments to fund.

In recent years, direct lenders have increasingly taken part in P2P transactions. In the case of direct lenders (which are predominately funds), the financial adviser's due diligence will be focused on the fund structure. In this regard, it will cover matters such as:

- the undrawn commitments of the fund;
- an analysis of the fund formation documents to confirm their capacity to enter into the financing documents; and
- the process for the fund to perform its funding obligations (whether via capital calls or the use of the fund's own debt (bridge capital) facilities).

In light of these additional steps, it is fundamental that the financial adviser's due diligence on the direct lender(s) starts at the early stages of the bid process.

This is an extract from the chapter 'Legal structuring of direct lending deals: England & Wales' by Elisabeth Baltay, Alex Griffith and Rafael Serrano in *Investing in Distressed Debt in Europe: The TMA Handbook for Practitioners, Second Edition*, published by Globe Law and Business.

https://www.globelawandbusiness.com/books/investing-in-distressed-debt-in-europe-second-edition

10 See paragraph 1.3 of the document titled "Cash confirmations – duration of certain funds period" dated 28 June 2021 and drafted by the Joint Working Party of the Company Law Committees of the City of London Law Society and the Law Society of England and Wales.

Investing in Distressed Debt in Europe

The TMA Handbook for Practitioners, Second Edition

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Throughout the COVID-19 pandemic, opportunities for distressed-debt investors continued to appear in the European market despite high numbers of state-backed loans and financial injections from EU member states. Such opportunities are set to increase significantly as this financial assistance is gradually withdrawn, and especially in light of the EU Directive 2019/1023 on Preventive Restructuring (the 'Restructuring Directive'), which gives a more central role to distressed creditors who will benefit from more flexible pre-insolvency instruments with a broader scope.

This second edition, co-published with TMA Europe, provides an overview of the European distressed-debt market and covers, among other topics:

- non-performing loans;
- direct lending; and
- restructuring and workouts.

It explores these subjects from a pan-European viewpoint and includes a comprehensive analysis of how the Restructuring Directive has been implemented. Chapters have been written by leading experts in the field, supported by consulting editors Patricia Álvarez Alonso and Ignacio Buil Aldana, partners in the restructuring, insolvency and special situations team at the London office of Spanish law firm Cuatrecasas.

Whether you are a lawyer in private practice or in-house, a financial adviser or an investor, this practical guide will provide you with invaluable insight and a better understanding of the commercial and legal complexities involved in the European distressed-debt market.

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