

Loan Products/
High Yield
Special Report

Different countries, different structures: the effect of jurisdiction & subordination on loan and high yield bond ratings

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■ EXECUTIVE SUMMARY

This report expands on two recent studies by Fitch IBCA. The Loan Products report¹ concluded that the level of notching² above the entity rating for secured loans would vary depending on the jurisdiction in which the secured assets were based. The High Yield Covenants report³ concluded that high yield covenant packages needed to be reviewed in the greater context of the governing insolvency regime and the corresponding terms and extent of contractual and structural subordination.

The purpose of this report is to expand on the earlier studies and consider the impact that different structures can have on the ratings of secured loans and high yield bonds. We will also assess whether the degree of impact that the structure has on the ratings varies between different jurisdictions.

In this study, we use three simplified capital structures that include both high yield bonds and leveraged loans. These structures are not comprehensive but rather represent three different structural approaches. The key consideration in determining the impact of the structure is its effect on the relative position of the secured loan and the high yield bond. We then analyse the effect of these structures occurring under the differing insolvency regimes that exist in the UK, France and Germany.

Summary Findings

- Loan ratings vary with both structure and jurisdiction.
- Loan ratings are adversely affected where the structure improves the position of the high yield bondholder at the expense of the secured creditor. This is most likely to occur with contractual subordination in countries where the legislation does not give the secured creditor exclusive rights over its secured assets.
- The notching policy of bond issues is mainly a function of structural considerations. Effective structural subordination has the highest notching impact on high yield bonds while the effect of contractual subordination on bond ratings is less marked.
- The governing jurisdiction is taken into consideration, but the prime driver for bond ratings is the structure.

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¹ 'Regimes, recoveries and loan ratings; the importance of insolvency legislation' Fitch IBCA October 1999 available at www.fitchibca.com

² This refers to the increase or decrease in the rating from the entity rating that is assigned to a particular debt instrument based on its structural characteristics.

³ 'High Yield Covenants – Preserver of Value?' Fitch IBCA October 1999 available at www.fitchibca.com

■ **RATING METHODOLOGY**

A debt instrument rating consists of two elements. The first is the entity or default rating, which is derived through traditional credit analysis⁴.

The second stage is to notch up or down the debt instrument rating to reflect its relative position in the capital structure. Loan ratings are notched up to reflect a greater level of recoveries in a default scenario. The key structural characteristics considered are the collateral, the capital structure and the covenant package. A further consideration is the jurisdiction in which the borrower’s assets are based and its insolvency regime. A recent study by Fitch IBCA showed that the insolvency legislation in different countries affected the level of notching above the entity rating available to secured loans.

High yield bonds in the classic European structure (see Cases 1 & 2), on the other hand, can in principle be rated up to 2 notches below the entity rating to reflect the lower level of recoveries in a default scenario. Here, the notching policy takes into account the ranking of the high yield bond issue relative to other obligations, the structural position of bondholders vis-à-vis other lenders, the level of indebtedness and the amount of secured debt and other senior debt ranking ahead of the high yield bonds. Furthermore, as our studies have shown, structural considerations, covenant protection and insolvency legislation need to be carefully considered when rating European transactions as they can, in the aggregate, have a material impact on the recovery rate of high yield bonds.

This study expands on Fitch IBCA’s current rating methodologies and assesses the impact that the interaction of the insolvency legislation and the structure of the transaction may have on both loan and high yield ratings in the UK, France and Germany.

■ **STRUCTURAL SUBORDINATION**

Structural subordination in its simplest form is where high yield bonds are issued by a company higher in the group structure than the company issuing the secured loan. To keep matters simple, in this study we consider two basic forms of structural subordination. However, it is important to bear in mind that transaction structures have become increasingly complex and individualised which makes it difficult to draw conclusions from generalisations. There are nevertheless certain features which impact the legal rights of senior lenders and high yield investors and consequently, the value of their investment, in an insolvency or workout situation.

⁴ See Fitch IBCA ‘Corporate Rating Methodology’ available on www.fitchibca.com

In the case of effective structural subordination (Case 1), the high yield bond proceeds are downstreamed by way of share capital from the issuing entity (“Holding Company”) to the intermediate holding company which is typically the borrowing entity for secured loans. In the case of supported structural subordination (Case 2), the bond proceeds are lent-on to the intermediate holding company by way of an intercompany facility⁵. The issuance of upstream or cross-stream guarantees creates an obligation by the guarantors to repay the debt issued at the holding level.

Case 1 – Effective Structural Subordination

The effect of this structure is to make the high yield bondholders remote from both the operating assets and the cashflow of the business (see diagram 1). Their only asset is the equity in the intermediate holding company. As a result, the high yield bondholders are reliant on the intermediate holding company being able to pass money up through dividends to service the high yield bonds. This puts them in an equivalent position to equity holders.

The “limitation on dividends and other payment restrictions” covenant, found in standard high yield covenant packages is designed to protect bondholders from restrictions in documentation that would disrupt the upstreaming of dividends from subsidiaries to the issuer. However, this covenant can prove worthless to bondholders if there are onerous restrictions on upstreaming dividends in the loan agreements that are exempted from this covenant. Typically, the loan documents will restrict dividends in the early stages of the transaction and will also allow secured creditors to switch off such payments for a period of time in certain circumstances, such as an event of default. This underscores the importance of reviewing high yield covenants in conjunction with other senior debt agreements and the overall transaction structure to assess their true value to high yield investors.

Additionally, if the borrower enters insolvency proceedings, then the high yield bondholders are in the position of equity holders in the intermediate holding company. Hence, they will receive distributions after all the creditors, including the unsecured creditors, of the intermediate holding company. This indeed places the high yield bondholders in a very weak position which needs to be reflected in the bond rating.

⁵ Also referred to as Multiborrower Facility or Intra-Group Notes. Although different terms are used, the key is that they create an obligation on the part of the participating group companies to repay the bondholders, subject to certain terms and conditions.

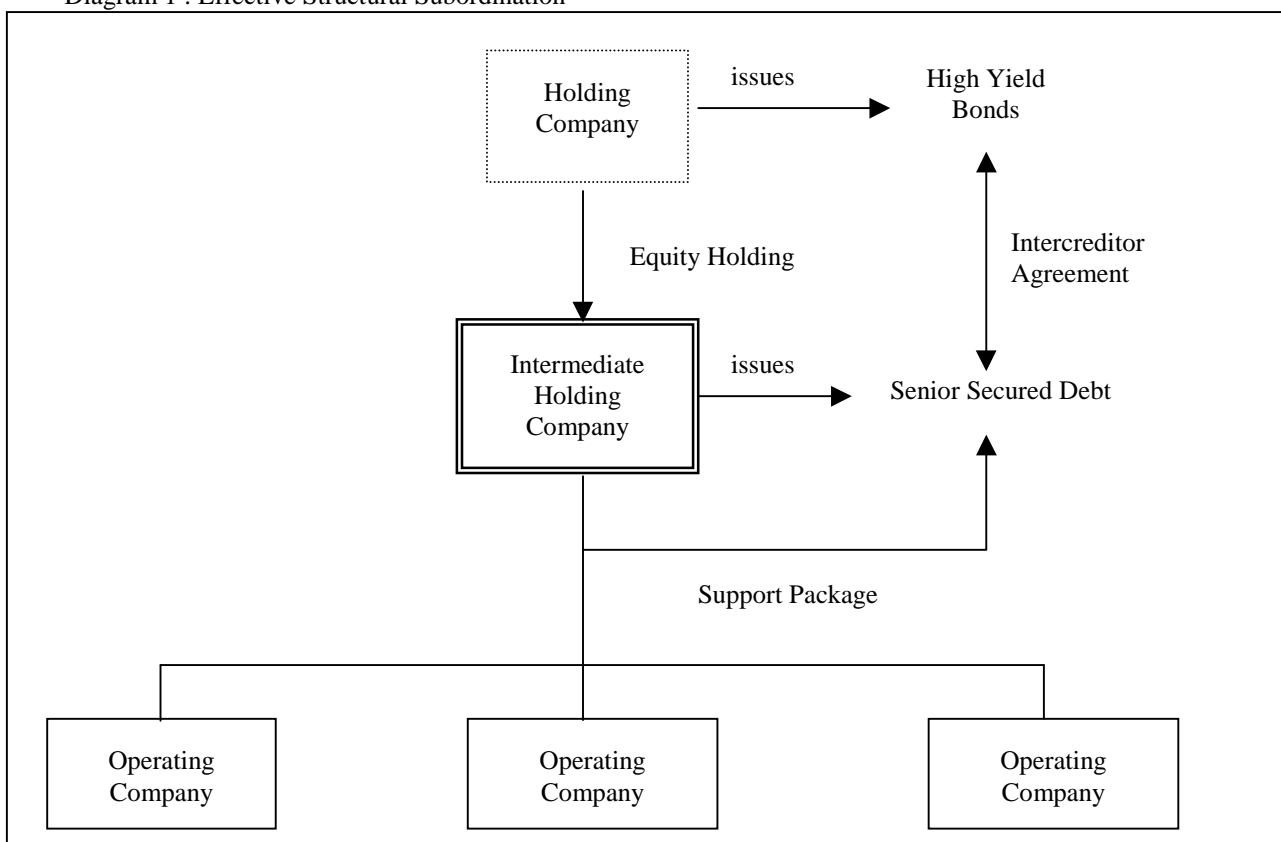
This type of structure has accounted for about three-quarters of European high yield transactions, and is prevalent in telecom issues. European examples of this type of structure include Colt, Orange, Viatel, Euronet, Jazztel and TM Group.

Impact of effective structural subordination on ratings

Structural subordination of this type ensures that the secured creditors are much closer to the operating cashflow and assets of the business than the high yield bondholders. This places the secured creditors in a position of greater strength and control over both the source of interest and principal and, in the event of an

source of repayment is the dividends being upstreamed from the operating subsidiaries, as the holding company typically has no cash-generating assets on its own. The bondholders are equityholders in the intermediate company and do not have access to the same operating assets as senior secured creditors. Consequently, none of the three insolvency regimes covered in this study mitigate the key risks that high yield investors in such a structure are exposed to and therefore their impact on the bond ratings is limited. Hence, the rating differential between the secured loan and the high yield bond in the same financing package can be quite wide to reflect the various recovery prospects.

Diagram 1 : Effective Structural Subordination



insolvency, asset realisations. The key impact of this structure is on the loan ratings since it significantly improves the relative position of the secured creditors compared to the high yield bondholders. This results in higher likelihood of notching for the secured loan rating and a greater rating differential between the loan and high yield bond.

On the high yield bond ratings, the structurally weak position of bondholders is the main reason for lowering the issue rating by up to 2 notches. In Case 1, the only

In terms of the impact on loan ratings, the existence of structural subordination is of particular importance in jurisdictions where high yield bondholders could have an impact on the level of recoveries to secured creditors. This occurs in countries, such as France and to some extent Germany, where different groups of creditors, such as employees, trade creditors and other junior creditors, are involved in either restructuring or insolvency proceedings.

This is not the case in the UK, where the secured creditor can exercise complete control over a

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restructuring or insolvency procedure through its rights to appoint a receiver under the floating charge⁶. Once a receiver is appointed by the secured creditor, he only acts for and reports to the secured creditor and there is no role for any other third party, including the court and unsecured lenders. Hence, while structural subordination does support the relative position of the secured creditor, it is not the source of the secured creditor's control. This comes from the floating charge, as receivership is a contractual remedy for a breach of the loan documents. However, in terms of the relative position of the secured creditor and high yield bondholder, this structure in the UK places the secured creditor in a virtually unassailable position to the detriment of the high yield bondholders.

Germany has a new insolvency regime which took effect in January 1999 and therefore its laws are largely untested. However, the regime includes some debtor-friendly features which are modelled after Chapter 11 in the U.S. One key difference with the UK regime is that in Germany the court together with creditors control the insolvency procedures. In theory, the court involvement should give the junior creditors a voice in the proceedings. In practice, it remains unclear if this translates into any tangible benefit for junior creditors as often other considerations, such as employment and social implications take priority and hinder restructurings or liquidations which in certain cases would be more beneficial to creditors.

The German legislation gives the secured creditors the right to 'separate satisfaction' on any secured assets. This allows them, in theory, to enforce on these assets without any court involvement. However, a borrower will often petition the court to seek its protection. In the event that the court is involved, it may make an order preventing enforcement on these assets. If this occurs, then the court will also require the borrower to pay a 'rental' for the use of the secured assets whilst it is in insolvency. These rights over the secured assets come from the legislation rather than from the structure of the transaction and limit the impact that other creditors can have on the secured creditors. Nevertheless, the structure does support the strong position of the secured creditor at the expense of high yield investors.

The situation is different in countries such as France. In this jurisdiction security, other than equity, is frequently

not taken due to its potentially limited value or validity⁷. The court is involved in the majority of restructurings as well as all insolvency proceedings. All groups of creditors are involved to a limited extent in any restructuring or insolvency proceeding, but the control is in the hands of the court-appointed supervisor.

Under this type of insolvency regime, any way in which secured creditors can improve their position relative to other creditors may impact the recovery level. Hence, the existence of structural subordination in France does assist in the rating of loans. On the other hand, the fact that the court leads the process does allow for a potentially greater role for high yield bondholders. However, given the already weak position of the bondholders and their uncertain treatment by the court-driven proceedings, the bond ratings are still likely to be fully notched down in France.

Case 2 - Supported Structural Subordination

In this structure the high yield bond is still issued by a company higher in the group structure than the company issuing the secured loan (see diagram 2). The key difference is that there is some additional support for the high yield bondholder. It is no longer in the position of only having access to cashflow through dividends from the intermediate holding company. In 1999, we saw a wide range of supported subordination structures which became increasingly more complex and deal-specific. To keep matters simple, in this study we consider the following two basic support features:

- *Intercompany Loan*

Here, the proceeds of the high yield bond issue are downstreamed to the intermediate holding company by means of an intercompany loan. This allows the high yield bondholder to rank as a creditor in an insolvency of the intermediate holding company rather than merely having equity. The holding company can receive interest payments from the intermediate company to enable it to service the high yield bonds.

- *Upstream Guarantees*

The intermediate holding company, and potentially some or all of the operating companies offer upstream guarantees for the high yield bond. These guarantees can 'shortcut' the group structure in terms of ensuring

⁶ This charge or lien is not attached to any particular assets, unlike the fixed charge, but covers all current and future assets of the company, such as receivables, inventory and goodwill.

⁷ As outlined in our previous study, the court, which is typically involved in restructurings or insolvencies, determines the length of the 'Suspect Period'. This can be set up to 18 months prior to insolvency and any actions taken by the company in this period, including the granting of security, can be set aside.

the holding company has sufficient cashflows to service the high yield bonds. However, there are legal uncertainties and restrictions in a number of European countries as to the extent and the validity of such corporate guarantees. Indeed for the three countries covered in this study, guarantees are only of real value in the UK where they are more common.

As with the structure shown in diagram 1, this structure is more common in European leveraged transactions than in US deals. It has been primarily used in European LBO transactions in response to high yield investor concerns regarding their weak position under effective structural subordination (case 1). Recent examples include Kappa, Leica, HMV Media, ZSC Specialty Chemicals, and Premier International Foods.

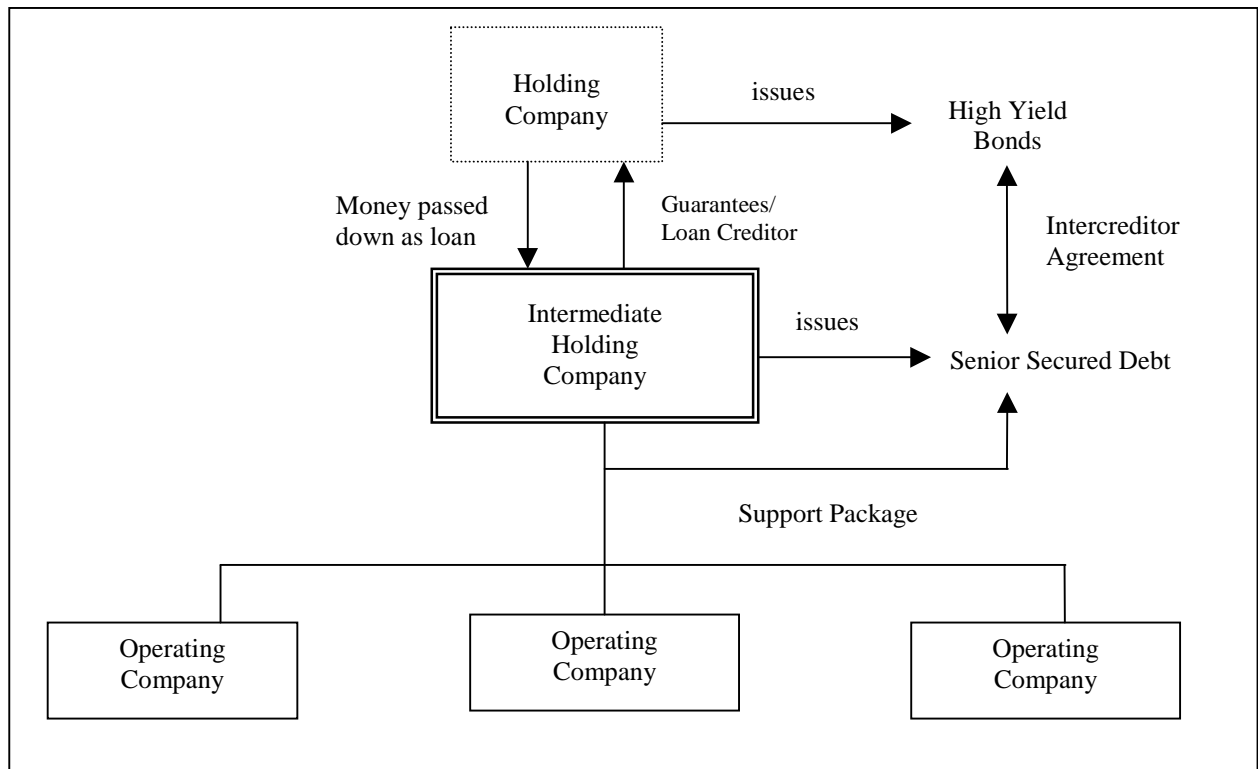
Whilst we welcome the increased focus on structural features by market participants, we believe that the legal complexity of some of the support arrangements in recent deals and their validity in the governing jurisdiction is not always properly disclosed and explained in the indentures. It is therefore highly recommended for high yield investors to seek legal clarification as the “devil is in the details”.

Impact of supported structural subordination on ratings

This structure represents an improvement in the position of the high yield bondholder compared to that shown in diagram 1. Were this improvement to be at the expense of the secured creditors, this would obviously impact the loan rating. If, however, the improvement is at the expense of other groups of creditors then this will not affect the loan rating. Nevertheless, even if the loan rating was not affected there may well be a narrowing in the rating gap between the two debt instruments.

As outlined previously, the strong position of a secured creditor in the UK is derived from its rights to appoint a receiver under its floating charge. These rights, and hence the loan rating, are not impacted by the granting of a guarantee or intercompany loan to support the high yield bond. The high yield bondholder in fact has improved its position at the expense of the unsecured creditors at the intermediate holding company. This is because the high yield investors will now rank as unsecured creditors of this company and hence any realisations at this level will be distributed between a larger group of unsecured creditors.

Diagram 2: Supported Structural Subordination



Since the use of upstream or cross-stream guarantees directly or indirectly by the operating companies does materially enhance the position of the high yield investors, this will be reflected in our notching of the bond. However, the value of such guarantees (and hence the bond rating) could diminish if there are provisions in the intercreditor agreement forcing the high yield investor to release those guarantees if the senior creditor is enforcing or if the guarantees are otherwise subordinated.

In our bond rating analysis we will also consider the validity of guarantees in a given jurisdiction. In the UK, upstream guarantees are more common, yet to be valid, there needs to be some corporate benefit to the individual guarantor companies. These considerations include current and future shareholders as well as creditors. In practice, it is often beneficial for one company to support other group companies which further assists the bond rating under this structure.

Similar to the UK, in Germany taking security over specific assets gives creditors the right to 'separate satisfaction' on these assets. The granting of a guarantee or an intercompany loan does not dilute the rights of the secured creditors in relation to the secured assets. Hence, as the likely level of recoveries from the security is not diminished, the loan rating is also unlikely to be affected by the use of this structure.

In Germany, the bond rating again tends to benefit from the enhanced position achieved through the intercompany loans. However, the use of guarantees is not yet common in Germany and they have only recently emerged in some LBO transactions. Since the insolvency regime is new and has not been tested in the courts, there remains some legal uncertainty as to the legal treatment of such guarantees. If they are considered as a "payment to a shareholder", they are forbidden under the Limited Liability Companies Act where they result in a company's net assets being insufficient to cover its liabilities. If this were proven to be the case, the Managing Director would be personally liable for the damages. So far, there are conflicting views in Germany on the likelihood of such a claim and until then the validity of such guarantees may be questionable. In such cases, the bond rating may not benefit significantly from the guarantee package put in place.

The situation is different in France where all the creditors of a particular corporate are effectively considered alongside each other by the court for distribution purposes. In this case, the existence of an intercompany loan, resulting in the high yield bondholders being recognised as creditors of the intermediate holding company rather than merely as

equity providers, is likely to improve their recoveries. This increase in recoveries is at the expense not only of other unsecured creditors (through dilution) but potentially also the secured creditors who are not necessarily given full priority by the court for their security.

Given that the likely level of recoveries to secured creditors could be affected by this structure, this will be reflected in the rating of the secured loan. Conversely, the higher recovery potential for high yield investor would be equally reflected in a higher bond rating.

In the case of guarantees, we would carefully consider their validity under French law. Upstream guarantees are available, but they are not common. This is mainly because of the harsh rule on "misuse of corporate assets" which obliges the directors to carefully consider the use of guarantees. Misuse is a criminal offence and punishable by five years' imprisonment and/or a large fine. Consequently, directors usually limit guarantees to the net asset value of the guarantor which reduces the value of the guarantee and hence the available security. As a result, similar to Germany, bond ratings would not be likely to benefit as much as in the UK from the use of guarantees.

■ CONTRACTUAL SUBORDINATION

This structure is materially different from the earlier examples in diagrams 1 and 2. With contractual subordination, the high yield bond is issued by the same company in the group structure as the secured loan (see diagram 3). The subordination of the high yield bondholder is achieved through an agreement, whereby the high yield bondholders agree that the secured creditors take priority over cashflow for interest and principal payments, and in the event of insolvency the secured creditors have first priority over the assets for realisations.

This structure is typical of leveraged transactions in the US but rare in Europe. So far, to our knowledge, only Doncasters has used this structure in Europe. This rarity is explained by both the senior banks' reluctance to allow for the high yield bonds to be issued at the same legal entity and some prevailing legal uncertainties. In particular, there remains some legal doubts in the UK and in many jurisdictions in Continental Europe as to the legal enforceability of subordination agreements.

In the UK, there were 2 cases in 1993 that confirmed that certain types of contractual subordination would be upheld by the courts. "The concern (derived largely from "British Eagle") was that it was not open to parties to contract out of the statutory winding up

provisions which stipulate that all unsecured creditors rank equally on a winding-up. Indeed, there remains considerable doubt as to whether the turnover obligation assumed by the junior creditor will work in favour of the senior creditor *if* at the time the junior creditor receives payment it is in liquidation *and* the senior creditor has not registered the turnover obligation as a security interest under Section 395, Companies Act 1985.”⁸

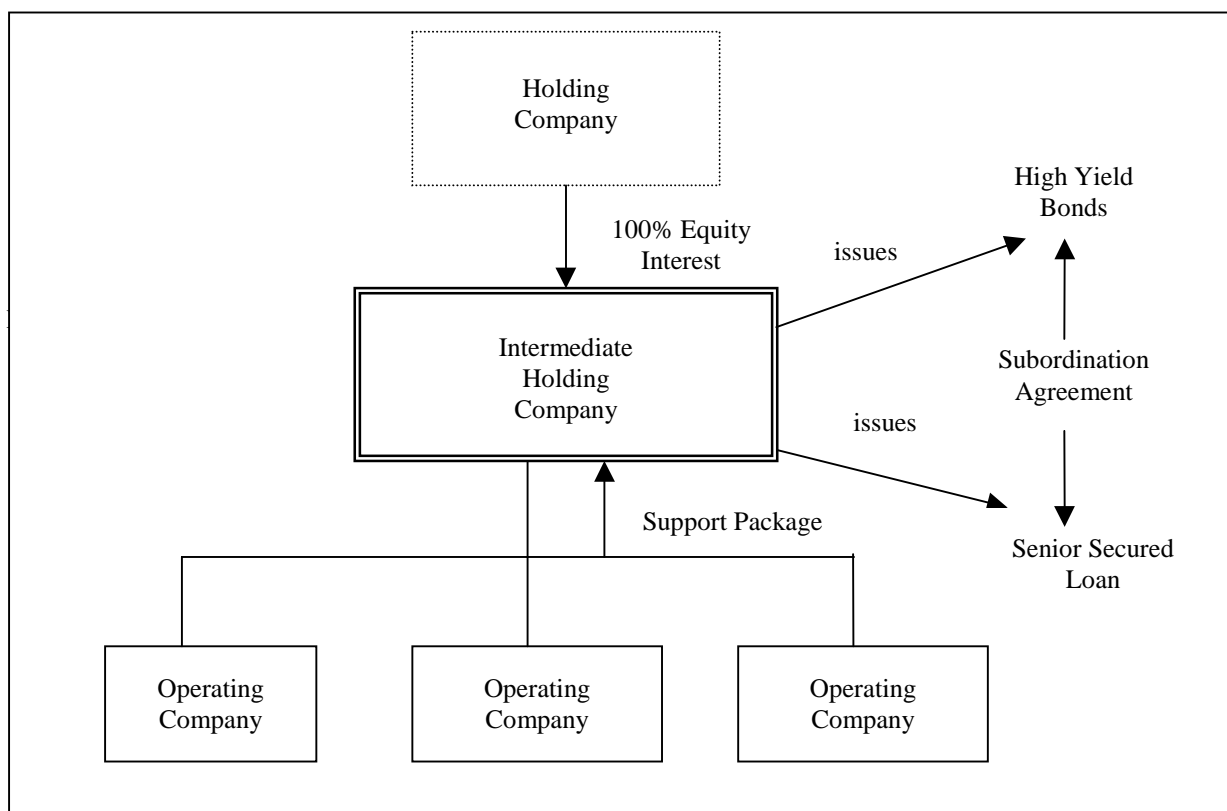
As a result, we do not believe that the use of contractual subordination will become the norm in European high yield transactions in the near future. Instead we have to satisfy ourselves with a greater number of supported structurally subordinated transactions that strive to better balance the interests of both senior and junior creditors.

a contract, often referred to as a subordination agreement.

This structure will have the greatest impact in those jurisdictions where a secured creditor does not have exclusive rights over the assets on which it is secured. In these countries, such as France, the presence of another group of creditors alongside the secured creditors is likely to have an impact on both the restructuring of the company and the distribution of realisations.

In countries, such as the UK and Germany, where a secured creditor has exclusive rights to the realisations from its secured assets, the impact will be less. This is especially the case in the UK, where it is also very difficult for anyone to challenge the validity of the

Diagram 3 : Contractual Subordination



Impact of contractual subordination on ratings

With this structure the high yield bondholder and the secured creditor are lending to the same company, with the priority of the secured creditor being determined by

security or to become involved in its realisation, even if they are lending to the same company.

Consequently, in all three jurisdictions, the rating impact will be more favorable to bondholders than secured lenders. The ultimate level of notching down of the bonds will depend on the level of secured debt as well as contractually senior unsecured debt ahead of the high yield bondholders. It is therefore common

⁸ How Stands the High Yield Investor in the European LBO Market? A Review of European High Yield in the LBO Market. Nigel T. Ward, Ashurst Morris Crisp.

that under contractual subordination the high yield bond rating is the same or 1 notch below the entity rating.

Where this structure may have an impact on secured creditors in the UK and Germany is if the company is restructured. It is worth making the point here that the strength of the secured creditor in the UK does not necessarily result in a greater tendency to invoke insolvency proceedings when a company is in difficulties. Indeed it could be argued that this underlying strength of their position actually results in secured creditors being more willing to attempt an informal restructuring of the business, on the basis that if this proves unsuccessful, they can quickly withdraw and appoint a receiver.

While the floating charge exists in its current form⁹, a secured creditor in the UK has control over appointing a receiver. However, as the high yield bondholder is lending to the same company, they are more likely to be involved in a restructuring process.

The insolvency regime in Germany has only recently been introduced. Hence, it is difficult to determine how it will work in practice, but recent experience, such as the Holzmann situation, has shown that there is at the very least a political desire to pursue an informal restructuring rather than a formal court-led process. This pressure on banks not to enforce on their security is likely to mean that high yield bondholders will be able to be involved in a restructuring process.

⁹ The UK government is currently considering amending the insolvency laws to limit the floating chargeholder's rights to appoint a receiver without a notice period.