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European Liability Management: Understanding Ranking and Subordination Risks in European High Yield Bonds and Leveraged Loans

The Bottom Line:™

- European high yield bonds and leveraged loans often leave a company ample room to subordinate existing bondholders and lenders.
- This ever-present priming potential makes it important for investors to have a solid understanding of ranking and subordination risks common in European bonds and loans.
- We review the fundamentals of payment subordination, lien subordination, and structural subordination and discuss common vulnerabilities in European bond and loan documentation that can increase subordination risk.
- We also discuss the importance of intercreditor agreements in European leveraged financings and review typical intercreditor agreement components.

Overview

As we regularly highlight, covenant packages in European leveraged loans and high yield bonds typically provide borrowers and lenders with a wide array of options when it comes to liability management transactions, often including ample potential for so-called uptier, dropdown, and/or double-dip transactions that can disadvantage a company's existing lenders or bondholders.

This ever-present priming potential makes it important for investors to have a solid understanding of ranking and subordination risks common in European bonds and loans. We review the fundamentals of these topics below.

Payment Subordination

As the name implies, payment ranking relates to a debt holder's right to payment. Holders of debt that is contractually "subordinated in right of payment" sit behind other creditors when it comes to repayment and will not be repaid in an enforcement scenario until "senior" debt – i.e., debt (whether secured or unsecured) that is *not* contractually subordinated in right of payment to other debt – has been repaid in full.

The chart below, which is representative of a common capital structure seen in European leveraged finance, shows debt with different payment ranking.

- *Senior Notes:* Issued by a holding company ("**Holdco**"), the senior notes ("**Senior Notes**") are guaranteed on a subordinated basis by Holdco's direct subsidiary (the "**Company**") and certain of the Company's subsidiaries (the "**Subsidiary Guarantors**").
- *Senior Secured Notes:* The Company is the issuer of senior secured notes ("**SSNs**"), which are guaranteed on a senior basis by the Subsidiary Guarantors.

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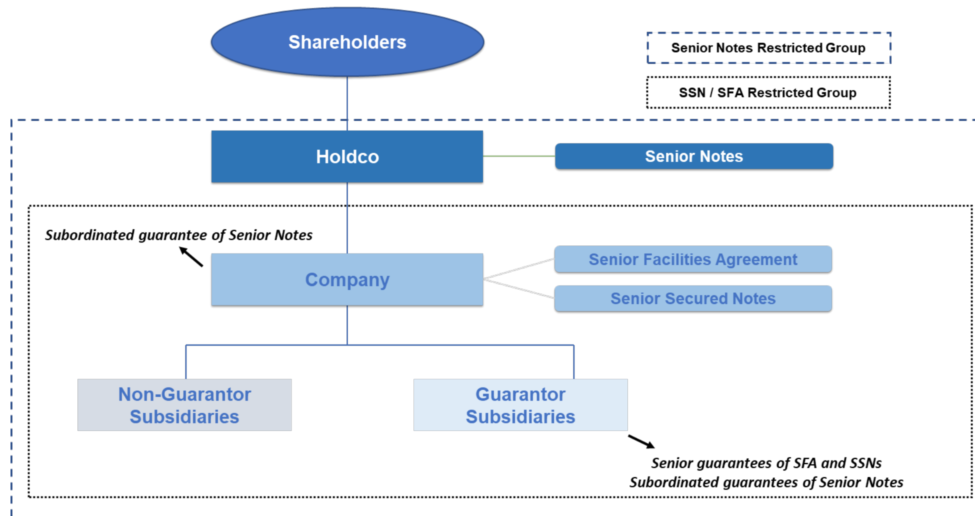
- *Senior Facilities Agreement*: The Company is also the borrower under a senior facilities agreement (the "**SFA**"), which is guaranteed on a senior basis by the Subsidiary Guarantors.



The SFA and SSNs are **senior** debt of the Company, and the guarantees of the SFA and SSNs are senior debt of the Subsidiary Guarantors – meaning that, in each case, they are not subordinated in right of payment to any other debt of the Company or Subsidiary Guarantors, as applicable. Similarly, the Senior Notes are **senior** debt of Holdco (i.e., they are not subordinated in right of payment to other Holdco debt).

However, the Senior Notes guarantees are contractually **subordinated in right of payment** to senior debt of the Company and the Subsidiary Guarantors. This means payments under the Senior Notes guarantees can't be made until the SSNs, SFA, and any other senior debt of the Company and the Subsidiary Guarantors have been repaid in full – and, as such, the guarantees provide only cold comfort to holders of Senior Notes issued by a holding company with no material assets of its own.

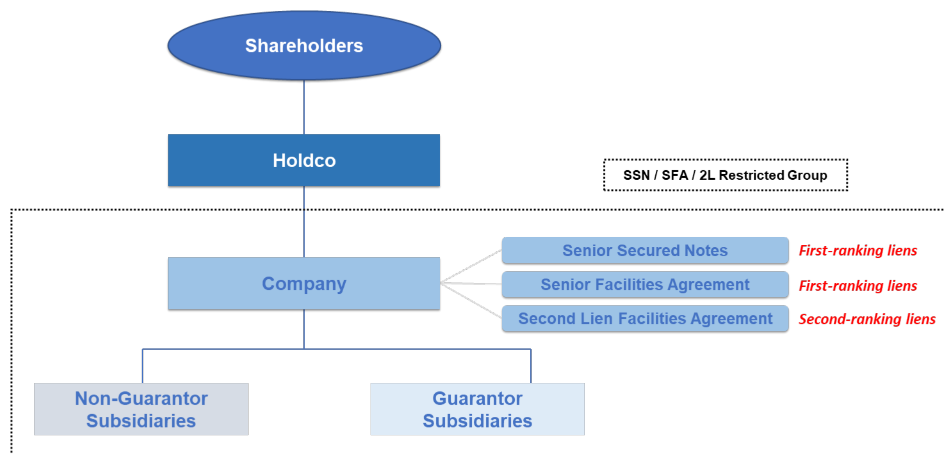
Payment subordination is set out explicitly in the document governing the subordinated debt – putting the "contract" in "contractual subordination." In this case, the Senior Notes indenture would specify that the guarantees of the Senior Notes are subordinated in right of payment to senior debt of the Company and Subsidiary Guarantors. Additionally, European leveraged financings typically have a separate intercreditor agreement (an "**ICA**") with creditors of debt secured by some or all of the same collateral package (and, in rare cases, creditors holding a material amount of unsecured debt). Among other things, the ICA will address payment ranking and specify a payment "waterfall" (i.e., order of payment) for the relevant debt. See our Covenant Primer: Ranking, Priority, and Application of Proceeds under a European Intercreditor Agreement for more detail.

Lien Subordination

Lien (or security interest) ranking concerns the relative priority of secured debt claims and the enforcement proceeds "waterfall" (i.e., the order in which proceeds from enforcement of collateral are distributed to secured creditors). Note that

lien ranking is separate and distinct from payment ranking, and debt that is pari passu (i.e., equal) in right of payment can have different lien ranking, as shown in the illustrative capital structure below. This structure includes:

- *Senior Secured Notes:* The Company is the issuer of senior secured notes ("**SSNs**"), which are secured on certain of the Company's assets (the "**Collateral**") on a first-ranking basis.
- *Senior Facilities Agreement*: The Company is also the borrower under a senior facilities agreement (the "**SFA**"), which includes a term loan and a revolving credit facility. The SFA is also secured on the Collateral on a first-ranking basis.
- *Second Lien Facilities Agreement*: The Company is also the borrower under a second lien facilities agreement (the "**2L Agreement**"), which is secured on the Collateral on a second-ranking basis.



The SSNs, SFA, and 2L Agreement are all senior debt of the Company and the Subsidiary Guarantors. However, as the chart indicates, the ranking of the liens securing the debt instruments in this structure varies, with the 2L Agreement ranking lower than the SSNs and the SFA. Further, proceeds from enforcement of the Collateral would be distributed as follows:

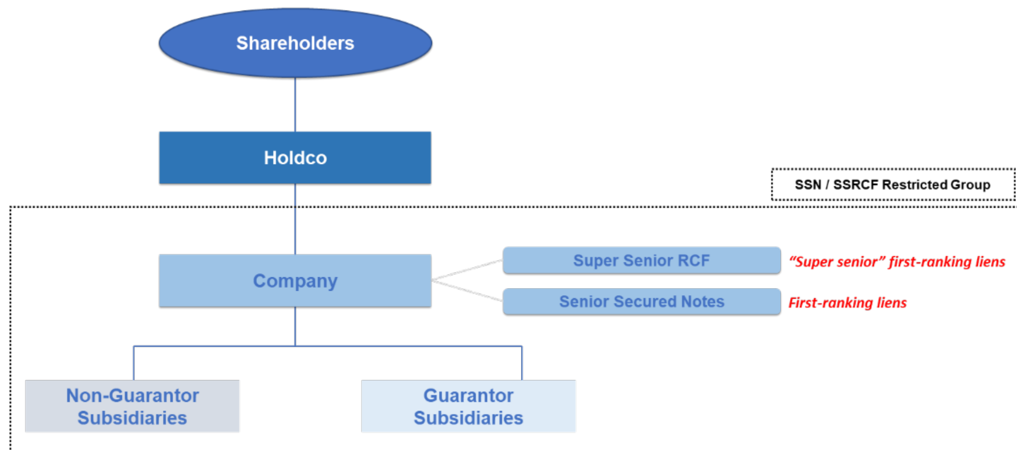
- *First,* to repay (pro rata) the SSNs and the SFA (including the term loan and revolving credit facility), and
- *Second, (if any proceeds remain)* to repay the 2L Agreement.[1]

The following example shows another typical European capital structure that includes debt instruments with different lien priorities. This structure includes:

- *Senior Secured Notes:* The Company is the issuer of senior secured notes ("**SSNs**"), which are secured on certain of the Company's assets (the "**Collateral**") on a first-ranking basis.
- *Super Senior RCF*: The Company is also the borrower under a super senior revolving credit facility ("**SSRCF**"). The SSRCF is also secured on the Collateral on a first-ranking basis, but it is "super senior" – i.e., it comes first – with respect to enforcement proceeds.

[1] If Collateral enforcement proceeds are not sufficient to fully repay some or all of this debt, then holders of any remaining unpaid debt will be treated as unsecured creditors with respect to the remaining amount.

It is common for European high yield bonds to permit super senior debt from day-one, but rare for European loans to do so. Loans that do contemplate a super senior revolving credit facility typically require the term loans under the agreement to be discharged before the revolver can be elevated to super senior status.



As noted above, the SSNs and the SSRCF are both secured by first-ranking liens on the Collateral, meaning they have equal lien ranking. However, the intercreditor agreement will specify that enforcement proceeds from the sale of the Collateral must be applied first to repay the SSRCF and then to repay other first lien debt – making the liens securing the SSRCF "super senior" by contract.[2] Accordingly, proceeds from enforcement of the Collateral would be distributed as follows:

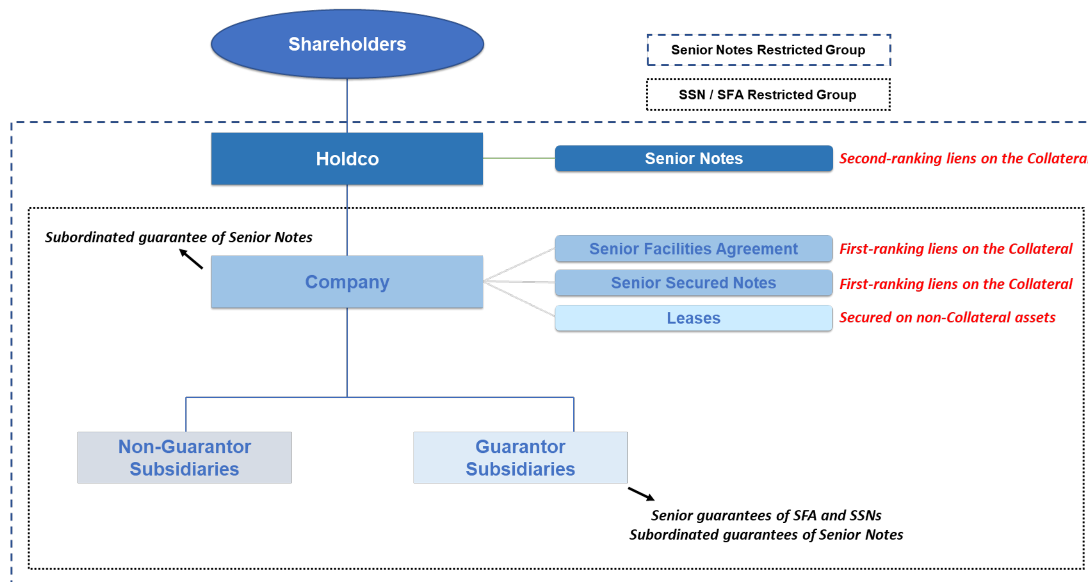
- *First,* to repay the SSRCF, and
- *Second, (if any proceeds remain)* to repay the SSNs.

Contractual vs. Effective Lien Subordination

In Europe, lien ranking is often set out contractually, with priority for shared collateral typically addressed in the intercreditor agreement and sometimes also specified in the relevant security documents. However, lien subordination also can occur without a contract, by virtue of certain debt being secured by assets that do not secure other debt. This is known as "effective subordination."

Imagine that the company in the sample structure chart below has lease obligations that are secured on assets that are not part of the Collateral securing the company's other debt. Proceeds from enforcement of the assets that secure the leases would go towards repayment of the leases; they would not be available to repay the Company's obligations under the SFA, SSNs, or Senior Notes (or any other debt that is not secured on those assets). Accordingly, the SFA, SSNs, and Senior Notes would be effectively subordinated to the leases up to the value of the assets that secure the lease obligations.

[2] Despite the different priority with respect to enforcement proceeds, the equal lien ranking of the two instruments likely would be considered relevant to determining creditor classes in an insolvency procedure as well as the Instructing Group under the terms of the intercreditor agreement.



Effective subordination is a significant point to consider in European financings, where bond and loan collateral packages often are limited to "soft" assets (such as share pledges, bank accounts, and intragroup receivables) and do not include "hard" assets (such as machinery, equipment, other tangible assets) or other valuable collateral, such as intellectual property. This is typically due to practical and legal considerations in the relevant European jurisdictions, where local laws and regulations may prohibit some entities from providing credit support, or the cost of providing security may be deemed disproportionate to the benefit to the lenders.

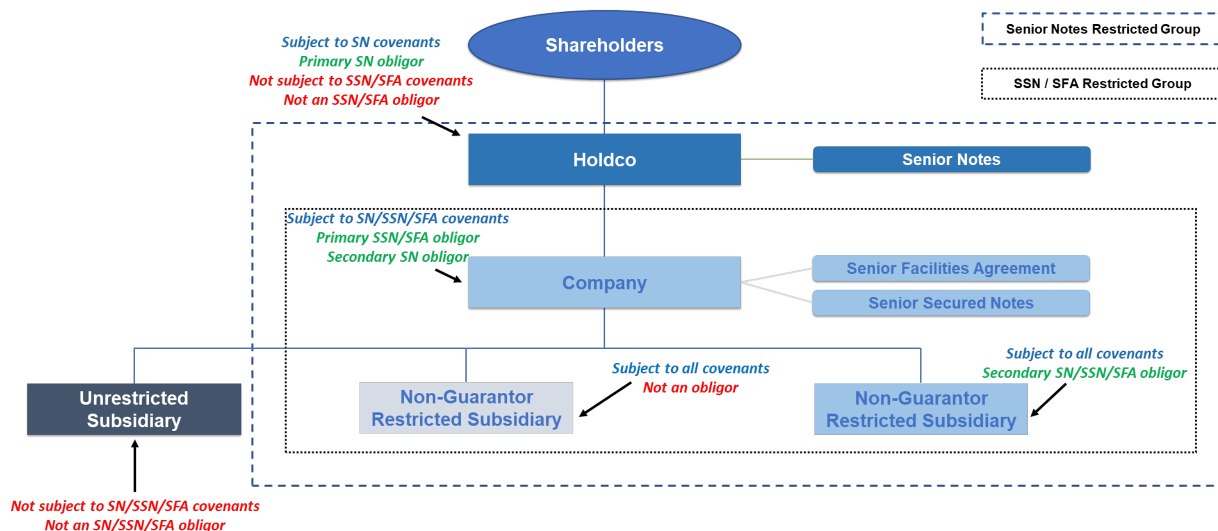
In particular, some European jurisdictions impose meaningful constraints on the granting of upstream and cross-stream guarantees and credit support, with requirements in relation to corporate benefit and prohibitions on financial assistance (i.e., guaranteeing debt and/or providing security for third-party debt to finance the purchase of a company's shares or shares of its parents) featuring prominently. For more on this topic, please see our reports European Agreed Security Principles and Guarantor Coverage Tests, Plain English Translations: Limitations on Guarantees Provided by Spanish Companies, and Plain English Translations: Limitations on Guarantees Provided by French Companies.

In the context of a European high yield bond or loan with a relatively limited collateral package, the pool of non-collateral assets can be substantial and valuable. This makes it particularly important to consider the capacity to secure debt on non-collateral assets, as bondholders or lenders will be effectively subordinated to that debt to the extent of the value of the non-collateral assets.

Structural Subordination

Structural subordination occurs when non-guarantor subsidiaries of an issuer or borrower incur debt. Unlike subsidiary guarantors, who are secondary obligors of their parent's debt (i.e., liable for the debt if the parent fails to pay), non-guarantor subsidiaries have no obligation to make payments under their parent's debt. Additionally, in an insolvency scenario, non-guarantor subsidiaries cannot upstream money or assets to their parent until they have repaid their own debt and other liabilities – i.e., non-guarantor debt in the capital structure must be paid before value can flow to the parent, as equity holder of the non-guarantor subsidiaries. Accordingly, parent debt is said to be "structurally" subordinated to the debt at non-guarantor subsidiaries (which sit below the parent in the capital structure).

As the chart below indicates, there can be two types of non-guarantor subsidiaries: non-guarantor Restricted Subsidiaries, who are subject to bond and/or loan covenants but have no direct payment obligation on the debt, and Unrestricted Subsidiaries, who are not subject to the covenants and have no direct payment obligation on the debt.



Common Subordination Risks in European Bond and Loan Documentation

European high yield bonds and leveraged loans often leave a company ample room to prime, or subordinate, existing bondholders or lenders. We discuss key vulnerabilities below.

Super senior debt and uptiering transactions

Many European high yield bonds permit certain liens on the collateral to have super senior priority – often limited to liens securing the Credit Facilities basket and hedging obligations carveout, though occasionally the permission is broader.[3]

In addition to day-one capacity, it's typically possible to increase super senior capacity under a high yield bond with simple majority consent, as a change to the size of an existing basket would not be included in the limited list of fundamental matters requiring supermajority consent. British retailer Matalan did just that, upsizing its Credit Facilities debt basket (which was already permitted to be secured by super senior liens on the collateral) from £60 million to £100 million with simple majority consent. Note that the intercreditor agreement in a structure with existing super senior debt is unlikely to impose constraints on this type of increase, as it typically would not specify a cap for the various classes of liabilities.

Even holders of bonds that do not include super senior capacity on the issue date could find themselves subordinated to super senior debt with just simple majority consent, particularly when the existing intercreditor agreement includes a so-called "hollow tranche" in anticipation of future super senior debt (which is increasingly common). As we note in our report Liability Management: The Distinct Lack of Anti-Subordination Protection in European High Yield, it's rare for the list of super majority matters in a European high yield bond to include changes to lien priority or application of collateral proceeds, facilitating the introduction of new priming debt.

Aviation services company Swissport took advantage of this when it sought consent to amend its high yield bond indenture (which did not originally permit super senior debt) to add a new €380 million debt basket and permission to secure that basket on the bond collateral on a super senior basis. Because the list of matters requiring super majority consent made no mention of amendments to priority or ranking, the company's senior secured notes could be primed by €380 million of new super senior debt with simple majority consent from bondholders.

[3] As noted above, permission for super senior liens is very rare under European loans. Where present, it is typically allowed only after the term loans under the senior facilities agreement have been repaid in full.

More recently, plumbing fixture company Ideal Standard launched an uptier exchange offer and consent solicitation aimed at facilitating a sale of the struggling company. The company offered to exchange existing senior secured notes for new notes that would be subject to mandatory redemption at up to 82% upon a Change of Control and encouraged holders to exchange by pairing the offer with a consent solicitation that would give the new notes higher ranking lien priority with respect to the bond collateral (as well as stripping the covenants of the existing bonds) – all of which required only simple majority bondholder consent.

In positive news for lenders, European leveraged loans are much less permissive when it comes to uptiering transactions that slot in a new, higher priority debt tranche ahead of existing term loans with less than unanimous lender consent.[4] However, that risk is technically present, particularly in more recent loans. See our reports Following in Serta's Footsteps: Could a European Borrower Replicate a Non-Pro Rata Uptier Exchange? and Newer Vintage European Loans Facilitate Serta-Style Priming Debt Exchanges.

Structurally senior debt of non-guarantor Restricted Subsidiaries

Like collateral, guarantor coverage and/or value for European bonds and loans can be significantly limited due to legal restrictions on guarantees in a number of European jurisdictions, meaning that a surprisingly large proportion of the restricted group could be non-guarantors. This can be true even when a guarantor coverage requirement applies. As we explained in a report on European Agreed Security Principles and Guarantor Coverage Tests, when calculating the percentage of total EBITDA represented by the guarantors for purposes of the coverage test, the company is often permitted to exclude from the denominator the EBITDA of entities in named “Excluded Jurisdictions” and entities that cannot provide a guarantee because of legal or other restrictions. Conversely, the company is often permitted to include the entire EBITDA of guarantors whose guarantees are limited in value. In other words, an 80% guarantor coverage test could provide far less credit support than the figure suggests. For more detail, see our reports Understanding European Guarantor Coverage Calculations and Plain English Translations: Limitations on Guarantees Provided by French Companies.

Additionally, European high yield bonds and loans in the current market typically permit non-guarantor Restricted Subsidiaries to incur a substantial amount of debt under the Debt covenant. While non-guarantor caps, or sub-limits, on Ratio debt remain common in high yield bonds, 86% of sponsor deals and more than half of non-sponsor deals in 2023 permitted non-guarantors to incur the full amount of debt permitted under the Credit Facilities basket, in addition to other material baskets under the Debt covenant. The story is similar with respect to European leveraged loans, where non-guarantor sub-limits have become increasingly rare. Where present, caps are generous in amount yet stingy in scope, often limited to a few permitted debt baskets and leaving ample capacity for non-guarantor debt.

Taken together, this can present a material risk of structural subordination.

Drop down transactions involving Unrestricted Subsidiaries

So-called “drop down” transactions involve designating or transferring assets to an Unrestricted Subsidiary, which then – unconstrained by the loan or bond covenants – incurs debt that structurally subordinates the company’s existing debt. These transactions depend on sufficient investments capacity under the relevant loan or bond for the designation / asset transfer, which is typically generous: average day-one currency-capped investments capacity in 2023 was 1.08x opening EBITDA for European high yield bonds and 1.37x opening EBITDA for European leveraged loans.

This capacity, coupled with the common permission to release collateral and/or guarantees in connection with the designation or transfer of assets to Unrestricted Subsidiaries, can increase the risk of structural subordination by way of a drop down transaction. See our reports European Sponsor Playbook: Vulnerabilities to Aggressive Liability Management

[4] Swissport faced a higher hurdle on the loan side, as it needed unanimous consent from lenders under its senior facilities agreement to amend the intercreditor agreement (which did not have a super senior “hollow tranche”) to establish a new class of super senior liabilities. The company ultimately utilized a Scheme of Arrangement, permitting the transaction with a lower level of consent.

and Priming Debt Transactions in High Yield, European Sponsor Playbook: Release of Credit Support as Part of a Dropdown Under European Leveraged Loans, Covenant Primer: Security Releases in European High Yield, and Covenant Primer: Subsidiary Guarantee Releases in European High Yield for more detail.

Double dip transactions

“Double dip” transactions give certain creditors two claims against a borrower or issuer. Sometimes the favored creditors have separate claims against the same guarantee and collateral package for other secured debt – essentially giving them a form of seniority by doubling the value of their claims. In other cases, the favored creditors prime others by gaining sole access to specific assets and credit support, on top of shared access to the guarantee and collateral package for other secured debt.

Synthetic fabric manufacturer Lycra initiated a double dip transaction in 2023, in which holders of new notes issued by an orphan SPV indirectly benefitted from the existing bond credit support and were intended to have sole benefit of security over certain intellectual property (but an intervening settlement meant that this second “dip” in respect of the intellectual property ultimately didn’t occur).

Lycra’s partial double dip was closely followed by two double dips in the US market, At Home and Sabre Corporation. Both involved new debt (issued by a non-guarantor Restricted Subsidiary in At Home and an Unrestricted Subsidiary in Sabre Corporation) and an intercompany loan of the new debt proceeds.

As we explained in our reports European Liability Management: Lessons Learned from Lycra's Quasi-Double Dip and The European Sponsor Playbook: Weak Unrestricted Subsidiary Conditions Facilitate the Priming Debt “Double Dip,” European bond and loan documentation in the current market can contain a number of vulnerabilities to double dip transactions (many of which we have discussed above), including excessive capacity for non-guarantor Restricted Subsidiary debt and/or for investments in Unrestricted Subsidiaries, scope for Unrestricted Subsidiaries to hold liens on restricted group assets and/or have debt that is recourse to the restricted group, and ample capacity to guarantee debt incurred by the relevant non-guarantor, Unrestricted Subsidiary, or SPV and/or to incur intercompany loans.

Debt secured by liens on non-collateral assets

The “Permitted Liens” definition in a bond or loan typically includes a long list of liens on non-collateral assets, and debt secured by these liens will be effectively senior to the bonds or loans to the extent of the value of the assets pledged. In addition to allowing certain debt baskets (or certain categories of debt, such as finance leases or receivables financings) to be secured by liens on non-collateral assets, there is typically a general Permitted Liens basket that can be used to secure debt incurred under any Debt covenant carveout or basket on non-collateral assets.

The Importance of Intercreditor Agreements in European Leveraged Financings

Unlike the US bond and loan market, where Chapter 11 under the United States Bankruptcy Code provides a uniform legal framework for bankruptcies, Europe has multiple insolvency regimes and a variety of laws relating to enforcement of collateral, meaning that contractual intercreditor agreements are essential to establish creditors’ relative ranking and rights.

Fundamentally, the purpose of a European intercreditor agreement is to ensure that the various debt in a company’s capital
structure ranks in accordance with creditors’ understanding of their priority of payment and right to collateral enforcement proceeds.

As a threshold matter, a typical European intercreditor agreement sets out the payment priority of the relevant obligations as well as lien priority. The intercreditor agreement will also specify the order in which proceeds from collateral enforcement will be applied and include “turnover” provisions requiring creditors to turn over amounts received or recovered from any member of the group to the security agent in order to comply with the intercreditor agreement

payment waterfall. See our report Covenant Primer: Ranking, Priority, and Application of Proceeds under a European Intercreditor Agreement for more detail.

Additionally, an intercreditor agreement will place limits on junior creditors' rights to enforce security and make claims on the underlying debt and guarantees, imposing "standstills" that leave senior creditors in control for an initial period after a default and payment stop provisions that prevent junior creditors from receiving cash interest and certain other payments after events of default. The agreement will also include "instructing group" provisions that determine which creditors are permitted to instruct the security agent – such as the "Majority Senior Secured Creditors" – at various points, including when and how to enforce the shared collateral.

A well-drafted intercreditor agreement can facilitate an out-of-court restructuring process that is value-protective for creditors, but only to the extent that all relevant creditors are bound by its terms. All too often, European bonds and loans do not require unsecured creditors and/or creditors of debt secured on non-collateral assets to become party to the intercreditor agreement. Accordingly, those creditors will not be subject to the intercreditor agreement's release, standstill, distressed disposal, or turnover provisions and could end up with hold-up value and a disproportionate amount of negotiating power in a distress scenario – potentially turning the principles of subordination discussed in this report on their head.

— *Covenant Review*

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