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Private Equity in Distress and the Incentives of Collateralised Loan Obligations

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Abstract: This article explores the problem that *both modern* private equity (PE) firms, *and* collateralised loan obligation (CLO) lenders to PE portfolio companies, have incentives to avoid a formal restructuring of PE portfolio companies in financial distress. The author is concerned that this may lead to negative social costs for suppliers, employees, customers and even government agencies... She explores how and why the problem arises, and the ways in which corporate and corporate insolvency law might be able to respond to it. Some suggestions are made, but it is accepted that any solution involves a sensitive balance that needs to be approached with considerable care.
Key words: restructuring; insolvency; private equity; CLO; covenant-lite.

1. *Introduction*

This article is about a new problem: the problem that *both* modern private equity (PE) firms, *and* senior lenders to PE portfolio companies, have incentives to avoid a formal restructuring of PE portfolio companies in financial distress.[1] As a result, corporate leverage may not decrease; may not decrease sufficiently; or may even increase in financial distress. Shareholders have always had the incentive to avoid a

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[1] Formal restructuring is used in this article to refer to a restructuring that is implemented via a legal procedure as opposed to a restructuring agreed by contract outside such a procedure – or even no restructuring at all.

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formal restructuring transaction, but their scope to do so has historically been limited by senior lenders who had the incentive to promote one in appropriate circumstances.[2] The core claim in the article is that the incentives of senior lenders to PE portfolio companies have changed, and that this is a particular problem for suppliers, customers, employees, and government agencies. A significant and growing number of large corporates in the UK are owned by PE firms, and so this is potentially a widespread problem.[3] The goal of the article is to ask what, if anything, UK corporate or corporate insolvency and restructuring law can and should do about it.

In a PE leveraged buyout (LBO) deal, the PE firm establishes a new company that borrows a substantial amount of debt finance. This new company is ordinarily a finance holding company for a short chain of companies that acquire a target company, often in an auction process. The acquisition is financed by the debt and by equity invested in one of the PE firm's funds by the PE investors.[4] Each PE fund will own more than one target company so that, after acquisition, the companies are generally referred to as 'PE portfolio companies'.[5] The acquisitions are 'leveraged' because debt finance is significant when compared to the equity finance component. In a PE LBO deal, the significant acquisition finance is typically prioritised into several classes so that, in the event of bankruptcy, some lenders will have claims ranking ahead of others.[6]

A leveraged company is more likely to face difficulties in stressed financial conditions than a less leveraged company. This is because it must 'service' – pay interest on – its substantial debt burden, and because the company may struggle to refinance the debt at maturity if conditions have worsened in debt markets. A company that is struggling to service its debt or to refinance is said to be in financial distress. Financial distress arises when there is a sound underlying business, but the company cannot pay its creditors in full. If a highly leveraged company can deleverage by reducing its financial liabilities, the business may be able to trade successfully, and the company may no longer be in financial distress.

[2] Anat R Admati, Peter M Demarzo, Martin F Hellwig, and Paul Pfleiderer, 'The Leverage Ratchet Effect' (2018) 73(1) The Journal of Finance 145.

[3] Kaye Wiggins, Harriet Agnew, and Daniel Thomas, 'Private Equity and the Raid on Corporate Britain' *Financial Times* (London, 12 July 2021).

[4] Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (3rd ed, CUP 2020) 816–22. Readers seeking an introduction to private equity more generally may find it helpful to consult pages 807–45.

[5] ibid 826.

[6] Cheol Park, 'Monitoring and Structure of Debt Contracts' (2006) 55(5) The Journal of Finance 2157.

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On the other hand, if this cannot be done, financial distress may lead to economic distress. Economic distress is caused by factors related to the company's business.[7] Douglas Baird illustrates the relationship between financial and economic distress with the example of a restaurant that is struggling to pay its creditors. The cash-strapped business 'cuts corners on food and service', with the result that customers desert the business so financial distress morphs into economic distress.[8] Thus, if the company's problem is its leverage, it must deleverage as quickly as possible so that it can start to reinvest, and financial distress does not lead to economic distress. If this cannot be achieved, the business may deteriorate so that ultimately the firm may not be capable of being saved – with consequences for all the company's stakeholders.

Modern finance theory posits that senior lenders to an overleveraged company have the incentive to support a restructuring transaction in financial distress.[9] This is because the senior lenders' claim is likely to be significantly impaired if financial distress leads to economic distress, while their claim will be protected if junior claims (equity and debt ranking after the senior claim in the distributional order of priority in insolvency) are written down or written off, and the borrower returns to profitability. Clearly, though, the shareholders do not share this incentive as a restructuring transaction risks the loss of their equity investment. At the same time, shareholders receive much of the upside of a risky investment but bear little of the downside risk. As a result, they have incentives to pursue risky strategies that threaten the senior lenders' return.[10] Specifically, they may seek to raise more debt to address cash flow difficulties, while resisting the restructuring transaction.[11] Management may be similarly incentivised to support the shareholders as they fear that a restructuring transaction will threaten their jobs.[12]

Lenders have historically used covenants in debt contracts to address this misalignment of incentives. Two types of covenants are particularly

[7] Douglas G Baird, 'Bankruptcy's Uncontested Axioms' (1998) 108(3) Yale Law Journal 573, 581.

[8] ibid.

[9] Park (n 6) 2158–9.

[10] Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305, 334.

[11] Admati et al (n 2) 147.

[12] For a description of the basic problem, and the nuances associated with it, see Lynn M LoPucki and William C Whitford, 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 141 University of Pennsylvania Law Review 669, 685.

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important. The first type of covenants is restrictive covenants. To address the risk that borrowers will respond to distress by raising more debt, lenders insist on covenants restricting the company's ability to raise new money, and negative pledge clauses that prevent the company from raising secured debt ranking above the existing lenders' claim.[13] The restriction on raising priority debt is important because the company is unlikely to be able to raise new money if part of the cashflows from the new investment will otherwise be absorbed by the existing debtholders – the so-called debt overhang problem.[14] It is, therefore, likely to be essential to offer the providers of new money a priority position in the company's capital structure, and the covenants reduce the company's ability to do this. The second type of covenant is financial covenants. Maintenance financial covenants contain set ratios and thresholds for the company's performance using 'observable financial metrics'. One of the most important maintenance financial covenants is the leverage covenant, which measures the ratio of debt to EBITDA (earnings before tax, depreciation, and amortisation).[15] This reduces the firm's ability to increase leverage when the covenant indicates that a deleveraging transaction should be pursued. Breach of covenant will be an event of default, entitling the lender to demand repayment of the loan. In general, however, lenders will not want to exercise this right because, unless the debtor has the cash on hand to repay the loan or is able to refinance it, demanding repayment may very well lead to an unplanned bankruptcy, and a value-destructive transaction, such as a break-up of the business and sale of the assets. Instead, the covenant is used to force the borrower to the table to negotiate,[16] so that the senior lenders can insist on a deleveraging transaction in appropriate cases.

Crucially, for the purposes of this article, monitoring of covenant compliance and negotiation of a restructuring transaction by senior financial creditors may be socially beneficial. This is because the firm's other stakeholders such as suppliers, customers, employees, and even government agencies can free-ride on senior financial creditors' control

[13] Alan Schwartz, 'A Theory of Loan Priorities' (1989) 18 The Journal of Legal Studies 209, 216–8.

[14] First described by Stewart C Myers, 'Determinants of Corporate Borrowing' 1977 5(2) Journal of Financial Economics 147.

[15] The description 'observable financial metrics' is drawn from Matthew T Billett, Redouane Elkamhi, Latchezar Popov and Raunaq S Pungaliya, 'Bank Skin in the Game and Loan Contract Design: Evidence from Covenant-Lite Loans' (2016) 51 Journal of Financial and Quantitative Analysis 839, 841.

[16] Raghuran Rajan and Andrew Winton, 'Covenants and Collateral as Incentives to Monitor' (1995) 50(4) The Journal of Finance 1113.

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function.[17] This brings us to the core claim in the article: that securitisation vehicles known as collateralised loan obligations (CLOs) have become significant holders of debt in leveraged loan deals to the PE industry and that CLOs lack incentives to drive a restructuring transaction. We have already seen that LBO finance may be prioritised into several facilities. An increasingly popular form of LBO facility is the so-called Term Loan B (TLB). The TLB typically ranks behind a relatively small revolving credit facility (the RCF),[18] and ahead of junior debt and/or equity. It also typically contains fewer restrictive covenants than traditional LBO term loans, and incurrence covenants rather than financial maintenance covenants. Incurrence covenants demand compliance with financial metrics only when the borrower trips a specific financial ratio, typically a maximum ratio of debt to equity, and only if the borrower is undertaking a specific action such as raising further debt.[19] TLBs that have these features are known as cov-loose and cov-lite loans.

It would be consistent with the claim in this article for CLOs to be contented holders of cov-lite and cov-loose TLBs precisely because they do not seek the covenant mechanism to force the borrower to the table. PE firms favour cov-lite and cov-loose TLBs because they provide operational flexibility, including in distress,[20] and CLOs have become the major holders of TLBs.[21] As a result, suppliers, customers, employees, and government agencies may no longer be able to rely on the senior creditor control function to drive a restructuring transaction in appropriate cases. In the worst case, they may find that the PE firm has increased leverage in financial distress, when a deleveraging transaction would have protected enterprise value, so that they rank behind even more debt in an economically distressed company that can no longer be saved. There are also wider consequences for society if companies, weighed down by too much debt, limp on, scraping by in meeting interest payments and

[17] Ibid 1114.

[18] An RCF can be drawn down, repaid, and drawn down again until its maturity date, and is typically used to fund working capital – see Sarah Paterson and Rafal Zakrzewski (eds), *McKnight, Paterson and Zakrzewski on the Law of International* Finance (2nd ed, OUP 2017) para 3.1.1.

[19] Falk Bräuning, Victoria Ivashina and Alik Ozdagli, 'High-Yield Debt Covenants and Their Real Effects' Working Paper 29888 National Bureau of Economic Research March 2022, 13–4.

[20] ibid; Lisa Lee, 'Private Equity Leans on Loans for LBOs as Agility Beats Costs' *Bloomberg News*, 26 September 2017.

[21] Frederick Tung, 'Do Lenders Still Monitor? Leveraged Lending and the Search for Covenants' (2022) 47 Journal of Corporation Law 153, 177.

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other commitments on their debt but without being able to make any investment. This is the so-called zombie firm phenomenon in which debt stifles investment and employment growth.[22]

The article is organised as follows. Section 2 explores why PE firms have heightened incentives to avoid a formal restructuring transaction compared with non-PE companies. Section 3 develops the argument that CLOs also share this incentive and explores how and why PE firms may not reduce leverage; may not reduce leverage sufficiently; or may even increase leverage in financially distressed portfolio companies as a result. Section 4 analyses how serious the revealed problem is, and section 5 asks what we can do about it. Section 6 briefly concludes.

2. *Management and PE Firm Incentives in Distress*

A. *Management Incentives in Distress*

In a recent article, Vincent Buccola focuses on why the incentives of PE firms may lead to 'socially excessive delays' to restructurings of PE portfolio companies.[23] This article will suggest that this is only part of the story but, nonetheless, it is an important part of the story. It bears some consideration here.

Buccola begins by distinguishing the incentives of those who sit on the boards of PE portfolio companies from those who sit on the boards of US public listed companies.[24] He describes the typical board member of a US-listed public company as 'at the tail end of a distinguished career' and with a minimal economic stake in the business.[25] Drawing on work by Ronald Gilson and Jeffery Gordon, he highlights reputational risk as more important for these directors than the potential financial gains of lining up with the shareholders.[26] He contrasts this with the directors of portfolio company boards who 'are deeply knowledgeable about the business and committed to shareholder interests'.[27] Drawing on Gilson

[22] Müge Adalet McGowan, Dan Andrews and Valentine Millot, 'The Walking Dead? Zombie Firms and Productivity Performance in OECD Countries' (2018) 33(96) Economic Policy 685.

[23] Vincent S J Buccola, 'Sponsor Control: A New Paradigm for Corporate Reorganization' (2023) 90 University of Chicago Law Review 1, 6.

[24] ibid 22.

[25] ibid 21–2.

[26] Ronald J Gilson and Jeffrey N Gordon, 'Board 3.0: An Introduction' (2019) 74 Bus Law 351, 357.

[27] Buccola (n 23) 22.

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and Gordon once again, he points out the substantial financial commitment that these managers have at stake, not only as a result of their investment in the specific portfolio company, but also in terms of their career with the PE firm.

All these points are well-made, although the comments about the directors of publicly listed companies do not map precisely from the US to the UK. Indeed, it is the last point that is the most convincing. In separate work, Jared Ellias, Ehud Kamar, and Kobi Kastiel have investigated the appointment of 'independent directors' to the boards of PE portfolio companies that have filed for bankruptcy, where litigation is threatened against the PE firm.[28] Their thesis is that although these directors appear independent, in reality, they 'receive their appointment from a small community of repeat private equity sponsors'.[29] Essentially, the directors are motivated to please the PE firm because the directors' ability to obtain future appointments is dependent upon them. In earlier work, this author has suggested that, although managers may be incentivised to support shareholder interests in the early stages of financial distress, there is a tipping point at which they can see that a formal restructuring is inevitable. At this point, the managers have an incentive to line up with the senior creditors in order to ensure that they retain their jobs and, ideally, that they are offered an equity stake in the deleveraged business.[30] It may very well be, however, that PE firms have begun to mobilise their power to find new roles for portfolio managers to secure continued loyalty to the PE firm's interests, even when that tipping point might otherwise have been reached. This takes us to the incentives of the PE firm itself.

B. *PE Firm Incentives in Distress*

We have already referred to the fact that shareholders (and junior creditors) are generally incentivised to avoid a formal restructuring transaction. Recall that this is because their claim ranks last in the distributional order of priority, and so is vulnerable to being wiped out in any scenario in which creditor claims are not paid in full. This finds formal expression in US Chapter 11, which provides a so-called absolute priority

[28] Jared A. Ellias, Ehud Kamar, and Kobi Kastiel, 'The Rise of Bankruptcy Directors' (2022) 95 Southern California Law Review 1083.

[29] ibid.

[30] Sarah Paterson, 'The Paradox of Alignment: Agency Problems and Debt Restructuring' (2016) 17 EBOR 497.

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rule: no junior claim can be paid until a senior claim has been paid in full.[31] Creditors are divided into classes for the purposes of voting on a Chapter 11 plan of reorganisation, and the absolute priority rule does not apply if the statutory majority supports the proposed reorganisation plan in every class. However, it is the default rule against which all bargaining takes place. The UK has not embedded the absolute priority rule into its new Part 26A restructuring plan procedure, whilst there are reasons to think that Part 26A will emerge as the most popular legal tool to facilitate a formal restructuring of a large corporate over the next decade.[32] Nonetheless, the court will ordinarily require justification for leaving the shareholders with an investment where creditors ranking higher in the distributional order of priority suffer a haircut,[33] so that the PE firm must still navigate risk to their equity in any restructuring plan with care. And Vincent Buccola draws out that it is not just the equity stake that is at risk, but also the potential for the PE firm to earn the fees associated with a PE investment.[34] Better, then, to avoid the formal restructuring transaction altogether.

A crucial objective of PE as an asset class is to align the interests of the PE firm, the directors of the PE portfolio company, and the PE investors as closely as possible.[35] In previous work, the author has highlighted why, in distress, the PE firm is likely to be focussed on maintaining its equity value in the portfolio company.[36] The short point is that the fund that the PE firm raises is typically time-limited, and the PE firm must return to investors to raise a new fund relatively regularly.[37]Scholarship has demonstrated that the decision to invest in a PE firm is based in part on an assessment of the personal talents of the individuals who run the firm, and that investors carefully screen funds for indicators of expected performance.[38] Past performance is likely to be a significant factor. Of course, PE firms also need to return regularly to the debt markets. Yet, debt markets are more dependent on the market cycle and

[31] 11 USC § 1129(b).

[32] Companies Act 2006, Part 26A, section 901A–901L.

[33] For just one example, see *Great Annual Savings Limited* [2023] EWHC 1141 (Ch), [2023] Bus L R 1163, [133]–[136].

[34] Buccola (n 23) 27.

[35] Simon Witney, *Corporate Governance and Responsible Investment in Private Equity* (CUP 2021) 54–8.

[36] Sarah Paterson, 'The Rise of Covenant-lite Lending and Implications for the UK's Corporate Insolvency Law Toolbox' (2019) 39(3) Oxford Journal of Legal Studies 654.

[37] Witney (n 35) 28.

[38] Ludovic Phalippou, 'Investing in Private Equity Funds: A Survey' 18 April 2007 6–7 available at: https://ssrn.com/abstract=980243 accessed 21 February 2024.

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considerably less personalised. For the moment, we should simply note that PE firms have strong incentives to please their investors, who are likely to be highly motivated by an assessment of the talent of the specific individuals.[39]

Finally, no assessment of PE firm incentives in distress is complete without considering the lively secondary market that now exists for corporate debt. If a loan becomes distressed, specialist distressed debt investors may come to the market to buy up loan participations at a discount from current debt holders. These investors may be pursuing a so-called loan-to-own strategy. Loan-to-own (LTO) lenders are activist investors who seek to buy into the debt with the intention of controlling the restructuring process, and driving a debt-for-equity transaction in which they can take over control of the debtor.[40] If an LTO investor buys into the debt, they may rapidly seek to influence governance of the portfolio company, and the PE firm is at increased risk of losing their investment. At the same time, other investors may buy in on a passive strategy, seeking to benefit from an improvement in the trading price of the debt or, conversely, explicitly to wield holdout power, demanding higher returns to support a restructuring transaction.[41] And investors who hold credit default swap protection may have different incentives again.[42] If a restructuring is in prospect and the debt starts to trade at a discount the overall negotiating environment becomes highly unpredictable. Once again, the PE firm has every incentive to avoid this situation.

Overall, large PE firms are incentivised to avoid a restructuring transaction and have the wherewithal to align portfolio company managers with their goals. None of this would matter, of course, if senior creditors continued to monitor covenant compliance and to bring the debtor to the table to insist on a restructuring where necessary. Scholars have identified that the rise of cov-lite and cov-loose TLBs has undermined this

[39] Ibid.

[40] Edith S Hotchkiss and Robert M Mooradian, 'Vulture Investors and the Market for Control of Distressed Firms' (1997) 43 Journal of Financial Economics 401, 402; Douglas G Baird and Robert K Rasmussen, 'Antibankruptcy' (2010) 119(4) Yale L J 648, 661–6.

[41] Ibid.

[42] Frank Partnoy and David A Skeel Jr., 'The Promise and Perils of Credit Derivatives' (2007) 75 University of Cincinnati Law Review 1019, 1035; Daniel Hemel, 'Empty Creditors and Debt Exchanges' (2010) 27 Yale Journal on Regulation 159, 160; Henry T C Hu and Bernard Black, 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions' (2008) 156 University of Pennsylvania Law Review 625, 731; Baird and Rasmussen (n 40) 681.

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mechanism.[43] Yet few have focussed on the fundamental incentives of CLO lenders. This is where we now turn.

3. *CLO Incentives in Distress and PE Firm Reactions*

A. *CLO Incentives in Distress*

Until relatively recently banks were the dominant providers of leveraged loan finance to large corporates in the UK. Banking was largely relational – a bank lent money to its borrower client and held the loan until maturity. The bank maintained a significant back-office operation, monitoring the bank's lending relationships and raising red flags when out-of-the-ordinary information was received, and a relationship manager was assigned to each borrower. This meant that, if a trigger warning such as a breach of financial covenant was raised, the bank was well-placed to come to the table to see whether steps needed to be taken. Banks did not mark their loans to market, and there was no developed secondary market for loan debt. If the bank concluded that the trigger warning was, in fact, a false alarm, or at least not particularly concerning, it could reach minor accommodations with its borrower client, charge a fee for its trouble to cover its internal costs, and go back to the business of monitoring the relationship. Although the discussions may have been a worrying interlude for the borrower, and the payment of amendment and waiver fees regrettable, it is perfectly possible that everything would be back on track in a relatively short period of time.[44]

This landscape has changed dramatically with the expansion in alternative lenders as providers of leveraged loan finance. One crucial new player is the CLO which, as we have already noted, has become the major holder of leveraged loans.[45] As described in the introduction, CLOs are a form of securitisation: bankruptcy remote special purpose vehicles that issue notes against the purchase of tranches of corporate loans. In earlier work, this author has focussed on the problems of costly monitoring for CLOs as they are largely passive investors and do not have a substantial back-office operation of the type that a commercial bank would have.[46]

[43] Buccola (n 23) 17–8; Paterson, 'The Rise of Covenant-lite Lending' (n 36).

[44] For a more detailed discussion of banks and their incentives at the relevant time, see Sarah Paterson, *Corporate Reorganization Law and Forces of Change* (OUP 2020) 86–91 and 100–2.

[45] Tung (n 21) 177.

[46] Paterson, 'The Rise of Covenant-lite Lending' (n 36) 663.

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In that work, the author also referred to the desirability of standardisation of terms for loans that are designed to be purchased by CLOs in the secondary market.[47] Both reducing monitoring costs and the pressures for standardisation in the secondary markets hold explanatory power for the emergence of cov-loose and cov-lite loans. Yet, a further insight is emerging in the literature about CLOs that is highly relevant for our analysis of incentives in distress.

CLOs are set up and managed by an asset management firm (the CLO manager). A typical CLO buys tranches of leveraged loans and uses payments under the loans as security to issue new instruments to investors. Maria Loumioti and Florin Vasvari find that the average CLO portfolio consists of 200–250 tranches issued by borrowers in 20–25 industries.[48] The CLO instruments are themselves divided into junior notes and senior notes, with the junior notes providing the loss absorbency for the senior investors that enables the senior notes to carry an investment grade rating. Nonetheless, the senior notes remain vulnerable to the situation in which the CLO loan portfolio suffers losses, but the junior investors continue to be paid out. To protect against this, CLOs are subject to overcollateralisation tests (OC tests). The purpose of these OC tests is to ensure that, where losses occur, payments are made to the senior, and not the junior, investors until the CLO has caught up. Failure of an OC test therefore has serious consequences for the junior investors, but it also has serious consequences for the CLO manager. Notably, on failure of an OC test, CLO managers do not receive their performance-linked compensation.[49]

CLOs are required to meet two OC tests each month: the senior OC test and the junior OC test. Loumioti and Vasvari explain that these tests (which are highly standardised across the industry) are calculated by measuring the sum of five components: (a) the principal balance of the performing loans; (b) the cash generated by loan trading held by the CLO; (c) the fair value or the recovery value of defaulted loans, whichever is lower; (d) the fair value of excess CCC-rated loans;[50] and (e) the purchase price of deep-discount loans.[51] The important point to note

[47] ibid 662–3.

[48] Maria Loumioti and Florin P Vasvari, 'Portfolio Performance Manipulation in Collateralized Loan Obligations' (2019) 67 Journal of Accounting and Economics 438, 440.

[49] ibid 442.

[50] CLOs are typically subject to limits on how many loans rated CCC or below that they are allowed to hold. Excess CCC-rated loans are loans that are more than that limit – see ibid 439 fn 2.

[51] ibid 438–9.

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is that the par value of performing loans is included in the calculation, but if a loan has defaulted, or is rated CCC and is above the maximum CCC-rated loan balance that the CLO is allowed to hold, then loans are valued at fair value or, in certain cases for defaulted loans, at their recovery value. Loumioti and Vasvari go on to explain that recovery values are provided by credit rating agencies; and fair values are based on loan market prices from data providers such as Intext, Loan Pricing Corporation, or Markit if the loans trade, or on bids sought from independent broker-dealers, if they do not.[52]

An emerging body of literature has begun to investigate the incentive effects of these OC tests for CLO managers.[53] This work has focussed on the risk that CLO managers have incentives to overstate loan fair values; trade with affiliate CLOs; or retain low-performing loans and sell high-quality ones if the CLO is at risk of failing an OC test, even if this has longer-term adverse effects on portfolio value.[54] The important point for our analysis is that the CLO manager has incentives to avoid defaults (which will cause loans to be valued at fair or recovery value) and to avoid breaching the CCC maximum hold covenant. Defaulted loans are those that do not pay principal or interest; are D-rated; or are made to borrowers in respect of which any bankruptcy, insolvency, or receivership proceeding has been initiated. In Gategroup, Zacaroli J found that the UK formal Part 26A restructuring plan procedure was an insolvency proceeding.[55] Thus, the CLO manager has every incentive to avoid Part 26A. Of course, if there is an early warning trigger in the loan, nothing as significant as a Part 26A restructuring plan may follow. Once the parties are at the negotiating table after a default, however, the world of possibilities becomes unpredictable. Similarly, there is always the risk that, once negotiations start, they attract the attention of the rating agencies who then move to downgrade the loan. Overall, the incentives of the CLO manager are to have as many performing loans for as long as possible, and only to risk reclassification of a loan in the portfolio as a defaulted loan or CCC-rated loan once that becomes unavoidable.

[52] Ibid 441.

[53] ibid; Shohini Kundu, 'The Externalities of Fire Sales: Evidence from Collateralized Loan Obligations' https://ssrn.com/abstract=3735645 accessed 25 February 2024.

[54] Loumioti and Vasvari (n 48) 440.

[55] *Gategroup Guarantee Ltd* [2021] EWHC 304 (Ch), [2021] BCC 549. For a view that goes even further, and suggests that Part 26 schemes of arrangement are also insolvency proceedings, see Riz Mokal, 'What is an Insolvency Proceeding? *Gategroup* Lands in a Gated Community' (2022) 31(3) International Insolvency Review 418.

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Furthermore, if restructuring talks do begin it is not at all straightforward for the CLO to participate in them. As we saw in the introduction, it may be very difficult for a leveraged company to raise new finance because of the debt overhang problem. However, once the firm has deleveraged in a restructuring transaction, it may be able to raise new debt. Thus, it has become increasingly common for UK restructuring plans to make some provision for so-called exit finance, which provides the company with new money, and participating lenders with valuable, additional rights.[56] However, tax exemption rules prevent CLOs from direct lending so that they may not be able to participate in exit financing.[57] CLOs also face difficulties in participating in a debt-for-equity swap,[58] and will be reluctant, for reasons already explored, to participate in any restructuring that may result in a downgrade to CCC or below. It is possible that CLOs will have negotiated specific permissions for bankruptcy or restructuring exchanges, and some have made exceptions to their investment guidelines to allow direct lending in connection with a restructuring (which may also enable the CLO to navigate the tax exemptions).[59] Nonetheless, it is not straightforward for most CLOs to participate, and the relevant exemptions will be subject to relatively low caps so that, once again, they have an incentive to retain the performing loan for as long as possible. All of this means that somewhat counter-intuitively, the CLO manger's incentives may be aligned with those of the PE firm in avoiding a formal restructuring transaction. The question then arises: if a formal restructuring is avoided, what alternatives are available to the PE firm and its portfolio company?

B. *Alternatives to a Formal Restructuring*

The first, and potentially most damaging option, is for the portfolio company simply to divert as much cash as it can from its operations to meet its debt service obligations. In this event, the only hope is that trading improves and liquidity pressures ease so that, provided the portfolio company can hobble through a difficult period, eventually

[56] See, for example, *Re AGPS Bondco Plc* [2023] EWHC 916 (Ch); [2023] 4 WLUK 196 at [80]–[83].

[57] O'Melveny, 'CLO Issues in Workouts and Debt Restructurings' 2 July 2020 available at: https://www.omm.com/resources/alerts-and-publications/alerts/clo-issues-in-workouts-and-debt-restructurings/ accessed 11 April 2022.

[58] Mike Harman and Victoria Ivashina, 'When a Pandemic Collides with a Leveraged Global Economy' in Voxeu.com 29 April, 2020 cited in Mike Harmon and Claudia Robles-Garcia, 'Restructuring Corporate Debt – A Different Kind of Cycle' 1 December 2020 available at: https://ssrn.com/abstract=3740657.

[59] ibid.

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everything will turn out satisfactorily for everyone. In their work, Jared Ellias and Robert Stark recount how Colt Holdings Limited sought to delay a restructuring in this way.[60] They note that although Colt did eventually go into Chapter 11, and did emerge, it 'left bankruptcy without improving its competitive position'.[61] This is the zombie company phenomenon we identified in the introduction. We also identified that suppliers, customers, employees, and government agencies may also suffer more significant losses because of the delay of a restructuring transaction than they would have suffered if the firm had restructured at an earlier stage. In a worst-case scenario, we saw that financial distress can lead to unresolvable economic distress. The most celebrated example of this in recent times is arguably Toys R Us which had 'crushing debt',[62] so that it struggled to invest in its business[63] and was eventually liquidated. Overall, the 'do nothing' scenario is potentially the most damaging of all and yet it may also be the CLO manager's preferred strategy, if it avoids a downgrade and a loan continues to be classified as performing.

Of course, the firm may be facing a maturity date and may not be able to refinance all its debt or may only be able to refinance at punitively high rates. The loan may also be on 'covenant tight' terms and contain covenants that have been or are forecast to be breached. In this scenario, the CLO manager may favour the least interventionist strategy possible, likely to be an 'amend and extend' transaction that pushes the maturity date of the TLB out, and gives management of the portfolio company more time, as it is rather euphemistically put in the market, 'to grow back into its capital structure'. Where relevant, covenants breaches will be waived. These types of transaction can add to liquidity pressure because the borrower is likely to have to pay fees and an increased interest rate to implement the transaction.[64] While the rates may be less than the rates in the market to refinance, they can still be punishing for a financially distressed borrower. Once again, however, these are attractive

[60] Jared A Ellias and Robert J Stark, 'Bankruptcy Hardball' (2020) 108 California Law Review 745, 768.

[61] ibid 771.

[62] Denise Dahlhoff and Mark A. Cohen, 'What Went Wrong: The Demise of Toys R Us' 14 March 2018 https://knowledge.wharton.upenn.edu/podcast/knowledge-at-wharton-podcast/the-demise-of-toys-r-us/ accessed 31 July 2023.

[63] Nathan Bomey, '5 Reasons Toys R Us Failed to Survive Bankruptcy' *USA Today* https://eu.usatoday.com/story/money/2018/03/18/toys-r-us-bankruptcy-liquidation/436176002/ accessed 31 July 2023.

[64] Howard Morris, 'Will Creditors Amend and Extend or Enforce With(out) Remorse?' 27 July 2022 https://www.mofo.com/resources/insights/220727-will-creditors-amend-and-extend-or-enforce accessed 3 January 2024.

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transactions for CLO managers.[65] Not only do CLO managers benefit from avoiding OC triggers, and continuing to collect performance fees, but they may also be attracted by the higher interest rate that will be paid on the loan until the CLO reaches the end of the reinvestment phase, during which loans can be switched in and out of the portfolio.[66]

Finally, and particularly if the loan is cov-lite or cov-loose, there is a veritable smorgasbord of strategies that PE firms and their portfolio companies can pursue to try to reduce cash debt service requirements, deleverage, and/or increase liquidity, without resorting to a formal restructuring. One of the more aggressive strategies currently pursued in the US is the so-called 'uptier' transaction in which a certain group of participating lenders, constituting a majority under the loan agreement, agree to provide a new loan that will either have a senior secured position or senior payment priority to the existing loans. The borrower agrees to use part of the new loan to buy back existing debt from these participating lenders, relying on provisions in the loan agreement that entitle the borrower to buy back debt in the open market. The participating lenders amend the loan agreement to facilitate the incurrence and priority position of the new loans.[67] Another US strategy is the so-called 'dropdown' exchange in which the company places certain assets into an unrestricted subsidiary, or redesignates a restricted subsidiary as unrestricted, and then uses the assets as security for new financing, offering participating lenders the chance to exchange their current debt for this structurally senior debt.[68] Both transactions have attracted a great deal of attention, primarily for the way in which they pitch one set of creditors against others, even if those creditors ranked pari passu before the transaction. Hence, the strategies have been described as 'creditor on creditor violence',[69] and much of the literature analysing the phenomenon has focussed on the non-pro rata nature of the transactions, benefiting some lenders and not others.[70]

[65] Nathan Tipping, 'Why CLO Managers are Agreeing to Extend and Amend' Risk.net 27 January 2023 https://www.risk.net/investing/7955892/why-clo-managers-are-agreeing-to-extend-and-amend accessed 31 July 2023.

[66] ibid.

[67] The most celebrated example of this is the Serta Simmons transaction – see Vincent S J Buccola and Greg Nini, 'The Loan Market Response to Dropdown and Uptier Transactions' https://ssrn.com/abstract=4143928 accessed 25 February 2024, *forthcoming* J Leg Stud.

[68] The most celebrated example of this is *J Crew* – ibid.

[69] Rodrigo Olivares-Caminal, Randall Guynn, Alan Kornberg, Eric McLaughlin, Sarah Paterson and Dalvinder Singh, *Debt Restructuring* (3rd ed, OUP 2022) 94.

[70] See, for example, Kenneth Ayotte and Christina Scully, 'J Crew, Nine West, and the Complexities of Financial Distress' (2021) 131 Yale Law Journal Forum 363; Diane Lourdes Dick, 'Hostile Restructurings' (2021) 96 *Washington Law Review* 1333.

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These transactions have not made their way from the US to the UK yet and may be more difficult to implement under the terms of UK loan agreements.[71] There is also some evidence that the contractual permissions that are essential for these transactions may disappear over time in the US, while the transactions have been the subject of significant US litigation.[72] Although there has been no decisive court case outlawing the principal steps needed to complete the transactions, it cannot be ruled out that future judgments will make the position more difficult.[73] At the same time, there is a question mark over how a UK court would react to a transaction of this type. In the Redwood case, Rimer J decided that a majority of lenders could amend a loan agreement to bind a minority, even though the minority argued that the amendments did not benefit them.[74] However, in the Assénagon case, minority bondholders successfully challenged a so-called exit consent transaction, in which debt holders invited to tender their bonds in exchange for new bonds also passed a majority vote to amend the terms of the legacy debt in a way that was extremely unfavourable for the non-participating minority.[75] Questions have been raised as to whether an uptiering transaction could be challenged in the UK on similar grounds.[76] And finally, the transactions are dependent on the precise terms of the loan agreement and come in all shapes and sizes so that in reality many different types of transaction along these lines may be structured and implemented, using variations of these techniques, and using them alone or in combination.

The important point, for the purpose of this article, is that this type of transaction aims to avoid a formal restructuring. If the transaction reduces cash debt service requirements and deleverages the capital structure, then it may be possible to avoid a formal restructuring completely

[71] Antony Kay, Elaine Baynham, James Turner, and Fani Chlampoutaki, 'Calm After the Storm? UK Lending Market Eyes Stability Amid Challenging Headwinds' 26 September 2023 IFLR https://www.iflr.com/article/2c8p73b1ace5jf8p80zk0/expert-analysis/special-focus/calm-after-the-storm-uk-lending-markets-eye-stability-amid-challenging-headwinds accessed 3 January 2024.

[72] Buccola and Nini (n 67) (finding some evidence of moves in recent US loan agreements to limit borrower's flexibility to pursue dropdown transactions in which valuable intellectual property rights are moved to unrestricted subsidiaries, and some evidence of provisions that seek to block the debtor's flexibility to carry out uptiering transactions).

[73] ibid.

[74] *Redwood Master Fund Ltd v TD Bank Europe Ltd* [2002] EWHC 2703 (Ch), [2002] 12 WLUK 288.

[75] *Assénagon Asset Management SA v Irish Bank Resolution Corpn Ltd* [2012] EWHC 2090 (Ch), [2013] 1 All E R 495.

[76] Peter Burgess, 'US Distressed Debt Techniques and Minority Protection in English Law' (2022) 10 Journal of International Banking and Finance Law 667.

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in a way that will be in the interests of all stakeholders, and successfully return the company to profitability. This may not, however, be the result. For example, cash interest may be converted into so-called payment in kind (PIK) interest. This will help liquidity but will also cause debt to build up more aggressively as the PIK interest is capitalised. Similarly, if a debt buyback occurs at a discount it will help to deleverage the capital structure, but the size of the discount that can be negotiated will determine how significantly the capital structure is deleveraged – and the discount may not be great, or it may not be achievable at all so that it may be necessary to repurchase at par. Once again, the transaction may do little more than kick the can down the road. A similar concern arises with another recent PE innovation: the establishment of continuation funds to acquire one or more portfolio companies from funds whose term has expired.[77] A detailed review of the advantages and disadvantages of continuation funds falls far outside the scope of this article. However, it is worth noting the concern that an underperforming asset may be transferred to a continuation fund as an alternative to a restructuring.[78] And the CLO manager may prefer any of these options to a formal restructuring, if a downgrade can be avoided so that a loan can be classified as performing that would otherwise be classified as defaulted if the debtor started restructuring discussions. The central concern of this article for the consequences of delaying a thorough-going restructuring for other stakeholders, and for the allocation of assets in the economy, is very much in the frame.

4. *Are These Incentives Really a Problem?*

In this section, we focus on whether the analysis thus far is too gloomy. We will unpack this question by considering it from several angles: arguments that the new incentives create a more efficient environment in distress; the split control or delegated monitoring argument; and a more detailed focus on the structure of the CLO itself, and on other non-CLO senior lenders. We start with Frederick Tung's argument that the new world of leveraged debt creates a more efficient environment in distress.

[77] For a recent examination of continuation funds see Kobi Kastiel and Yaron Nili, 'The Rise of Private Equity Continuation Funds' ECGI Working Paper Series in Law No 733/2023, *forthcoming* 172 University of Pennsylvania Law Review.

[78] ibid 17.

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A. *Avoiding False Positives*

Frederick Tung has argued that cov-lite and cov-loose loans may be more efficient than loans with financial maintenance covenants because they avoid 'false positive' triggers.[79] In other words, in a world of financial maintenance covenants and 'covenant-tight' loans, banks may come to the table, evaluate the situation, and conclude that there is, in fact, little to be concerned about. In the meantime, management is distracted from running the business; news may leak out of discussions, affecting the business; negotiations to arrive at the conclusion that all is in fact well may be costly; and banks are likely to extract a price for their trouble. The cov-loose and cov-lite loan, on the other hand, makes it considerably less likely that the parties will engage in re-evaluation unless there is really something to be concerned about.

We can apply this insight more generally to the incentives of CLOs to avoid a restructuring, and it does indeed reveal the slippery nature of the problem at the heart of this article. It is undoubtedly the case that there will be situations in which avoiding a costly renegotiation is more efficient and benefits the wider group of stakeholders with which this article is concerned. We know that there are high direct and indirect costs associated with restructuring negotiations.[80] It seems unlikely that every situation in which a costly restructuring is avoided because of CLO incentives will be detrimental. This does not, however, conclusively solve the problem with which we are concerned. The question is whether there will be a more significant number of cases in which restructuring is delayed in a way that is socially costly. The argument in this article is that we have reason to suspect that this will be so.

B. *Split Control Rights or Delegated Monitoring*

Tung also suggests that concern for the lack of financial maintenance covenant triggers may be overblown because of what he calls (borrowing from Berlin et al.)[81] 'split control rights',[82] or what we might call,

[79] Tung (n 21) 159.

[80] Direct costs are the costs of the restructuring transaction, such as legal and investment bank fees. Indirect costs represent losses to the business because of the restructuring transaction such as the loss of customers or competitively priced sources of supply.

[81] Mitchell Berlin, Greg Nini and Edison G Yu, 'Concentration of Control Rights in Leveraged Loan Syndicates' 137 (2020) Journal of Financial Economics 249.

[82] Tung (n 21) 182.

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borrowing from Diamond, delegated monitoring.[83] Recall that the TLB typically ranks behind an RCF. The RCF provides a working capital line for the borrower and is likely to be provided by conventional financial creditors, including banks. It also typically does have a leverage covenant. The argument runs that the RCF lenders therefore undertake monitoring and covenant enforcement on behalf of all lenders. If this is right, then the monitoring function of sophisticated senior financial creditors remains intact and other stakeholders can free-ride on their efforts as before.

The problem today is that the leverage covenant in the RCF operates in a rather novel way. The covenant is constructed as a ratio of consolidated net debt (or senior debt) to EBITDA.[84] However, it is a 'springing' rather than a maintenance covenant. This means that it is only tested if the drawn amount under the RCF exceeds a threshold amount of aggregate revolving commitments on the last day of the quarter specified in the debt contract. If the covenant is breached, then the borrower normally has a right to cure the breach by contributing further equity that will be added to EBITDA for the purposes of the leverage test. We have already argued that if the PE firm's incentive is to inject fresh equity, then many of the concerns in this article for stalling a restructuring transaction fall away. In UK and European deals, however, there may be ways to deem a cure without making an equity contribution, and in most other deals there are ways for the PE firm to avoid covenant testing, or to ensure compliance. For example, because the test is designed as a 'snapshot', the borrower may be able to pay down borrowings before the test date and redraw them immediately after the test date. They may also be able to size the revolver to make it less likely that the relevant threshold will be crossed. More flexible definitions of EBITDA may make compliance easier, and it may be possible to use letters of credit that are excluded from the calculation of drawn amounts under the revolver. Norton, Le Cren, and Nolan conclude that it is, 'inaccurate to describe the revolver springing leverage covenant as a financial maintenance test'. Indeed, they arrive at the conclusion that it is a 'late-term liquidity test'.[85] Thus, it does not appear to address the concern that restructuring will be delayed in a socially inefficient manner.

[83] Douglas W Diamond, 'Financial Intermediation and Delegated Monitoring' (1984) 56 Review of Economic Studies 393.

[84] Jeff Norton, Danelle Le Cren and Eamon Nolan, 'The Revolver Springing Leverage Test Unpicked' (2016) International Financial Law Review https://www.iflr.com/article/2a63ej1tpk40uxq7nbhfk/the-revolver-springing-leverage-test-unpicked accessed 4 March 2024.

[85] ibid.

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This insight is reinforced when we consider that even if the springing covenant is breached and not cured, only the revolving lenders have default rights. The TLB lenders only acquire default rights if the revolving lenders accelerate because of the breach. The difficulty here is that, as Cheol Park has identified, for the revolving lenders to be incentivised to act, their claim must be large enough to pose a serious risk of impairment in any bankruptcy.[86] If their claim is risk free then they have no incentive to act. Where the revolver is a slim slice compared with the overall debt burden of the firm in today's highly leveraged capital structures, the situation may have to get very serious indeed for the revolving lenders to consider their claim at risk.

C. *The Incentives of Senior CLO and Other Investors*

This brings us to the question of whether the CLO landscape that we have drawn here might be expected to change. While the CLO manager and, indeed, junior CLO investors share the incentives of the PE firm to avoid a restructuring transaction, the senior CLO investors do not have the same incentives. Indeed, the OC test may give rise to a classic agency problem in CLOs for senior noteholders, in which CLO managers are incentivised to take action to maintain loans as performing loans which is in the interests of junior noteholders but may not be in senior noteholders' interests.[87] This raises the question of whether we can expect senior CLO investors, over time, to take steps to align their interests with the interests of CLO managers when a CLO portfolio loan is stressed. However, the portfolio nature of modern investment makes it very difficult to unravel the incentive effects for senior CLO investors: an investor in the senior tranche in one deal may be in the junior tranche in the next. It may be the case that in the long run the structure of CLOs, and therefore the incentive effects, shift dramatically. As we know, however, the problem with the long run is that it can be a very long time indeed.

The problems posed by complex portfolios and complex capital structures also apply when we consider the incentives of other, non-CLO senior investors. First, these investors may only be a minority in the TLB, so that they are unable to drive the nature of the overall bargain. Second, they may hold junior debt in other parts of their portfolio, so

[86] Park (n 6) 2159.

[87] Loumioti and Vasvari (n 48); Shohini Kundu, 'The Anatomy of Corporate Securitizations and Contract Design' (2023) 81 Journal of Corporate Finance 1.

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that their overall incentives are difficult to determine. And finally, they may seek to manage their exposure by limiting the number of deals they enter alongside CLOs. Vitaly Bord and João Santos find fascinating evidence of this, suggesting that non-CLO syndicate participants buy a smaller share in securitised loans whenever the lead bank retains less 'skin in the game' relative to loans it does not securitise.[88] Even more importantly, they find that such investors buy smaller shares of the loans the bank sells to CLOs when compared with the share they buy in loans that it does not securitise.[89] Bord and Santos interpret this as evidence that institutional investors anticipate that loans acquired by CLOs will 'perform worse' so that they invest less in these loans.[90] For our purposes, it may mean that other, non-CLO investors protect themselves against CLO incentives by careful portfolio management, rather than renegotiation of terms.

5. *Addressing the Problem*

We remain concerned, then, that both PE Sponsors and CLO managers have incentives to avoid formal restructuring and that, as a result, directors of overleveraged portfolio companies may not pursue a deleveraging transaction; or may not pursue a sufficiently deep deleveraging transaction; or may even increase leverage in financial distress. Our concern is not with the consequences of this for other financial creditors, but for other stakeholders such as suppliers, customers, employees and even government agencies. We are also concerned that it will contribute to the zombie company problem, affecting investment and employment. In short, our concern is with social cost. The question that emerges is whether corporate or corporate insolvency and restructuring law does or should do anything to fill the gap that CLO incentives have left – and several options present themselves.

A. *Creditor-Led Restructuring*

One answer to the problem raised in this article is for large trade suppliers or government agencies to take matters into their own hands and

[88] Vitaly M Bord and João A C Santos, 'Does Securitization of Corporate Loans Lead to Riskier Lending?' (2015) 47(2–3) Journal of Money, Credit and Banking 415, 442.

[89] ibid.

[90] ibid.

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propose a restructuring. However, multiple problems arise. First, neither trade suppliers nor government agencies may be as effective at monitoring the health of a company as senior financial creditors, who are specifically trained to monitor financial condition and creditworthiness. Second, there are a host of legal problems, not least that a creditor cannot propose a scheme of arrangement or Part 26A restructuring plan without the support of the company.[91] And finally, even without these legal problems, both trade suppliers and government agencies suffer resource issues, lacking the specialist restructuring experts that large UK banks would traditionally have employed. It is unlikely that the stakeholders with which this article is concerned will be able to take matters into their own hands in the face of changing senior financial creditor incentives. We might, therefore, seek to rebalance the incentive effects revealed in this article instead.

B. *Directors' Duties*

The first way in which we might seek to rebalance the incentive effects revealed in this article is by intervening to incentivise PE firms to promote a restructuring by the stick of liability if they do not. Sections 213 and 214 of the Insolvency Act 1986 set out the UK regimes of fraudulent and wrongful trading. The threshold for a fraudulent trading claim is high, although claims can be brought against 'any person' who was knowingly party to the carrying on of the business with intent to defraud creditors of the company, so that a broad range of actors are potentially within scope.[92] A wrongful trading claim has a somewhat lower bar, although it can only be brought against directors and shadow directors. A wrongful trading claim applies where the company has gone into insolvent liquidation or administration, and it appears that at some time before the winding up or administration the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation or administration, and did not take every step with a view to minimising the potential loss to the company's creditors.[93]

Thus, wrongful trading is only engaged where there is no reasonable prospect of avoiding insolvent liquidation or administration. It is not

[91] *Re Savoy Hotel Ltd* [1981] Ch 351, [1981] 3 WLR 441; *NGI Systems & Solutions Ltd v The Good Box Co Ltd (in administration)* [2023] EWHC 274 (Ch), [2023] Bus L R 562.
[92] Insolvency Act 1986, s 213.
[93] Insolvency Act 1986, s. 214.

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out of the question that a claim could be made that, because the directors did not pursue a significant deleveraging transaction, or even increased leverage in financial distress, they arrived at this point and were guilty of wrongful trading. However, this is not an easy claim to frame. Moreover, an insolvency practitioner is appointed in both liquidation and administration and only the insolvency practitioner has standing to bring a wrongful trading claim. The liquidator or administrator is likely to seek majority creditor support to pursue the claim and may be unwilling to do so if secured creditors do not support it.[94] Overall, wrongful trading may not be a very promising claim for the types of behaviour with which this article is concerned. We might therefore need to seek out a more expansive duty to have regard to creditor interests than the wrongful trading regime provides.

The question of whether and when directors owe a duty to have regard to creditor interests has recently been the subject of extensive review by the UK Supreme Court in *Sequana*.[95] All of the UK Supreme Court justices considered that there is a coherent and principled justification for directors to have a duty to have regard to creditor interests when the company is insolvent. Directors do not owe a direct duty to creditors – their duty is still a duty to act bona fide in the interests of the company – but company interests include creditor interests.

The judgments in *Sequana* are less clear when it comes to balancing the interests of creditors and shareholders at the appropriate time. All the Supreme Court justices agreed that where insolvent liquidation or administration is inevitable, the creditors' interests are paramount. However, they offered different formulations once the duty is engaged but before insolvent liquidation or administration is inevitable.[96] All of the justices offer some version of the formulation of acting in the best interests of 'creditors as a whole' while, as this article has amply demonstrated, there may be very difficult tensions between different creditor constituencies. And the Supreme Court justices place the trigger point

[94] For a recent discussion of the incentives of insolvency practitioners to please secured creditors see Insolvency Service, 'Post-Implementation Review: Corporate Insolvency and Governance Act' 21 February 2023 https://www.legislation.gov.uk/ukia/2023/69/pdfs/ukia_20230069_en.pdf para 6.4.

[95] *BTI 2014 LLC v Sequana* [2022] UKSC 25, [2022] 3 WLR 709.

[96] ibid; Lord Reed [81] ('… the more parlous the state of the company, the more the interests of the creditors will predominate'); Lord Briggs [176] ('It may well depend upon a realistic appreciation of who, as between creditors and shareholders, then have most skin in the game'); Lady Arden [303], 'In my judgment, a sliding scale provides some assistance, but I would add that the analogy with any such scale should not be taken too literally').

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for the duty at a relatively late point in time. In the Court of Appeal, Richards LJ (as he then was) had concluded that 'the duty arises when the directors know or should know that the company is or likely to become insolvent'[97] where 'likely' means probable. Richards LJ expressly stated:

> I consider there to be a problem with formulations … such as being on the verge of insolvency, because they suggest a temporal test. If the test is that insolvency is 'imminent', or if similar words are used, it suggests that actual insolvency will be established within a very short time.[98]

The Supreme Court, however, adopted a rather different approach. Although there was disagreement as to whether the directors must or should know of the financial condition for the duty to be engaged, the four Supreme Court justices who gave judgments agreed that the relevant temporal point for creditor-regarding duties to intrude is when the company 'is insolvent or bordering on insolvency, or an insolvent liquidation or administration is probable'.[99] In other words, the concept of imminence is very firmly embedded in the Supreme Court's formulation. Although this only has the status of dicta, it is, of course, highly persuasive dicta from the highest court in the land and it seems likely that lower courts will adopt it as the relevant test going forwards. Indeed, in the first case to consider the Supreme Court judgment, Zacaroli J did just that.[100] At the same time, however, he drew a distinction between the prospects of success in a critical piece of litigation, and the prospects of insolvency, setting the bar lower for the first than the second, in a way that is not altogether easy to reconcile with the Supreme Court judgments.

Overall, then, the picture is rather murky. The duty is not a direct duty owed to creditors, but rather a duty to have regard to their interests, as well as shareholder interests, at the relevant point in time. There is considerable uncertainty as to precisely how directors are to balance creditor and shareholder interests. The Supreme Court has not really tackled the inevitable tensions between different creditor constituencies which this article has revealed. And while the UK Supreme Court would trigger the duty on the border of insolvency, rather than only on actual insolvency, it appears to have rowed back from a wider 'zone of insolvency'.

[97] *BTI 2014 LLC v Sequana* [2019] EWCA Civ 112, [2019] 2 All ER 784, [220].
[98] ibid [219].
[99] *Sequana* (n 95) [203]; [231].
[100] *Hunt v Singh* [2023] EWHC 1784 (Ch), [2023] STC 1603.

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Furthermore, the Supreme Court justices did not agree on the meaning of 'insolvency' in this context. In particular, Arden LJ appeared to favour a definition of insolvency that would be engaged at a very late stage.[101] Lord Reed and Lord Briggs, on the other hand, appeared to favour engagement of the more flexible standard of 'inability to pay debts' provided for in section 123 of the Insolvency Act 1986.[102] While the analysis in this article would have supported Richards LJ's formulation in the Court of Appeal, given that *Sequana* is likely to be followed for some time to come, the next best thing is that subsequent courts follow Lord Reed and Lord Briggs' instincts on this point, at least for the purposes of disincentivising some of the riskier strategies that shareholders may otherwise be tempted to pursue. And it appears that there is room for the lower courts to fill the liminal spaces left between the Supreme Court judgments in important, and potentially novel, ways to foreclose the most egregious forms of behaviour.

Nor are matters as clear as we would like when we turn to the standard of review. First instance authority suggests that the question is whether the directors acted in what they, and not the court, considered to be the best interests of the company having regard to the interests of creditors.[103] Only if directors failed to consider the interests of creditors at all is an objective test engaged, and even then it is a generous objective test: 'whether an intelligent and honest man, in the position of a director of the company concerned could, in the circumstances, have reasonably believed that the transaction was for the benefit of the company'.[104] The Supreme Court did not comment on the standard of review in *Sequana* and the position described here is thought still to be good law. Nonetheless, the question for the UK court is whether the director honestly believed that their act or omission was in the interests of the company. There is certainly room for the UK court to ask the director to explain why, in their reasoned judgment, the action they took was likely to result in a rescue of the firm, and why the risks of failure did not make this an inappropriate course of action. The analysis in this article would suggest that the courts should not be afraid to flex this muscle where necessary.

[101] *Sequana* (n 95) [307]–[311].

[102] ibid [88] and [120].

[103] *HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch), [2013] 9 WLUK 528 [91] (citing *Regentcrest plc v Cohen* [2001] 2 BCLC 80 [120]).

[104] ibid [92].

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Once again, an administrator or liquidator has standing to bring a claim, but the same problem with insolvency practitioner incentives rears its head again. Section 212 of the Insolvency Act 1986 provides that, procedurally, creditors can bring a claim against directors and officers for breach of fiduciary duty to the company. This means that suppliers and other creditors prejudiced by the directors' efforts to stave off a restructuring do have a mechanism through which they can advance a claim. Nonetheless, this relies on larger trade suppliers being willing to take the risk on this type of litigation where senior financial creditors are not incentivised to do so.

There is, of course, the possibility of legislative reform. In her rather colourfully titled 2019 Stop Wall Street Looting Bill, US Senator Elizabeth Warren has proposed that PE firms would be jointly and severally liable for the debts of their portfolio companies in the US.[105] This would certainly have a dramatic effect on the incentives of PE firms but is perhaps not the finely balanced intervention that we should be looking for. There is a delicate balance to be struck in intervening in a way that addresses the worst of the behaviours with which we are concerned but that does not undermine the PE model entirely. The question is whether there may be more nuanced ways to tackle the issue, expanding the view from financial creditors prejudiced by the delay to the other stakeholders with which this article is primarily concerned. In an interesting, recent article John Quinn and Philip Gavin examine the introduction of a new statutory statement of directors' duties in distress in Ireland,[106] as part of Ireland's response to the European Restructuring Directive.[107] A particularly interesting feature of the reform is the insertion of a specific duty to have regard to 'the need to take steps to avoid insolvency'.[108] This would seem to go some way to a duty to consider restructuring in an appropriate case. Moreover, Ireland has introduced an objective standard into the trigger for the newly codified duty.[109] Nonetheless, as Quinn and Gavin

[105] Stop Wall Street Looting H.R. Bill (2021) 5648, sec 101.

[106] John Quinn and Philip Gavin, 'The Creditor Duty post *Sequana*: Lessons for Legislative Reform' (2023) 23(1) Journal of Corporate Law Studies 271.

[107] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) Official Journal L 172, 26 June 2019.

[108] Quinn and Gavin (n 106) 286, citing s 224(A)(1) of the Irish Companies Act 2014 inserted by the European Union (Preventive Restructuring) Regulations 2022.

[109] Irish Companies Act 2014, s 224(A)(1) (specifying that the duty arises where the director 'believes' or 'has reasonable cause to believe' that the company is, or is likely to be, unable to pay its debts within the Irish definition of that concept).

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note, it is likely to be more challenging to bring a claim for a failure to act than where a director positively acts in a way that is detrimental to the creditors.[110] And entirely practically, the UK does not have the requirement of compliance with the European Restructuring Directive to motivate action, while there is no apparent sign of a legislative plan of action for reform of directors' duties.

Finally, there is potentially room for the directors' disqualification regime to be useful in this context.[111] Crucially, this is a state remedy, enforced by the Secretary of State for Business and Trade. Among other things, the Secretary of State can bring a claim on the basis that the director was a director of a company that has become insolvent, and that their conduct as director makes them unfit to be involved in the management of a company.[112] A director may accept a disqualification undertaking to avoid court,[113] and since 2015 the Secretary of State has had power to apply to court for a compensatory award to be made against a disqualified director (or to accept a compensation undertaking), and to identify whether specific creditors should receive the compensation, or whether it should be paid as a contribution to the assets of the company.[114] Where a PE portfolio company collapses with substantial losses for suppliers, customers, employees, and government agencies, the Secretary of State might have grounds, in the public interest, to bring disqualification proceedings. Then the risk of disqualification proceedings could act as a more powerful disincentive for directors of a PE portfolio company considering an aggressive strategy to avoid a full restructuring, than the risk of litigation from suppliers and other stakeholders.

Recently, there has been some evidence of an increasing willingness of government to pursue these actions where large, high-profile companies collapse.[115] However, days before the most significant disqualification proceedings for some time were due to start, the Secretary of State

[110] Quinn and Gavin (n 106) 287.

[111] The Company Directors Disqualification Act 1986.

[112] ibid s. 6.

[113] ibid s. 1(A), 7(2)(A) and 8(2)(A).

[114] Small Business, Enterprise and Employment Act 2015, s. 110 inserting a new s 15A, B, and C into the Company Directors Disqualification Act 1986.

[115] The Insolvency Service, 'Second Carillion director disqualified' https://www.gov.uk/government/news/second-carillion-director-disqualified; John Tribe, 'Carillion: Move to Disqualify Directors Signals UK Getting Tougher on "Corporate Wrongdoing"' University of Liverpool, 18 January 2021 https://news.liverpool.ac.uk/2021/01/18/carillion-move-to-disqualify-directors-signals-uk-authorities-getting-tougher-on-corporate-wrongdoing/ accessed 26 July 2023.

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discontinued them.[116] Only time will tell what impact this will have on the willingness of government to pursue directors in high-profile cases of collapse. Although the trial collapsed, it was only being pursued against certain non-executive directors. The executive directors had already accepted disqualification undertakings so that the case was not an unmitigated failure for the state.[117] Nonetheless, the collapse of the trial presumably came at a considerable cost to government finances, and it would not be altogether surprising if the overall result has a chilling effect on government's willingness to intervene.

Overall, we should not overstate the potential for UK directors' duties to create incentives for the directors of PE portfolio companies to pursue a restructuring transaction. Much will depend on the facts and on the specific actions that the directors took. We must admit that a well-advised director who takes care to document their decision-making process, may be able to navigate liability risks without too much fear.

C. *Lender Incentives*

One obvious, alternative option might be to motivate CLOs more actively to support restructuring efforts by regulation. European CLOs are already subject to the Securitisation Regulation.[118] However, as the full title of the Securitisation Regulation suggests, it lays down a general framework for securitisation and a specific framework for simple, transparent, and standardised securitisation, and is in no way designed to address the types of incentive effect with which this article is concerned. Nor is it obvious how regulators could interfere in the detail of the functioning of CLOs in a way that would successfully address the risks discussed in this article while not disturbing the financial sector or imposing significant costs.[119]

[116] Erskine Chambers, 'Government Abandons Disqualification Against Carillion NEDs' 13 October 2023 https://www.erskinechambers.com/government-abandons-disqualification-claim-against-carillion-neds/

[117] The Insolvency Service, 'Second Carillion Director Disqualified' 14 July 2023 https://www.gov.uk/government/news/second-carillion-director-disqualified.

[118] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 OJ L 347.

[119] For this problem more generally see, Promitheas Peridis, 'Securitisation in the era of Blockchain: Credit Funds, CLOs, Tokenisation, and the Question of Investor Protection and Financial Stability' 13 September 2023 European Banking Institute Working Paper 2023 – no 154, 40.

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One way in which we might seek to promote a more thorough-going restructuring is by disincentivising lenders from providing new priority money without the consent of the existing creditors or the court. We have already noted that significant litigation has been launched in the US challenging some of the more aggressive debt-raising transactions. In the case of Neiman Marcus this did result in a settlement, and Mitchell Mengden reports that as part of the litigation settlement:

> The lenders that consented to the recapitalization waived their rights to assert deficiency claims against the debtors.[120]

He goes on to report that those deficiency claims amount to $3 billion.[121] Clearly, the consenting creditors conceded something of value in the litigation, showing that lenders who participate in the most aggressive of the transactions may suffer losses as a result. While we concluded that litigation is unlikely to render the issues explored in this article moot, it may have some impact on lenders' willingness to provide priority money without a formal restructuring transaction. Similarly, we saw that there is considerable uncertainty about the legal position of majority lenders in the UK, that may make lenders cautious and may render it difficult to pursue some of the debt-raising strategies here. We could, of course, go further and, drawing inspiration from civil law jurisdictions, impose broader lender liability for extending credit to financially troubled borrowers.[122] Once again, however, delicate balancing is necessary here lest we disincentivise all rescue financing efforts. And we also saw that the very worst of the strategies to avoid a formal restructuring did not necessarily involve new money at all.

Alternatively, we could encourage priority debt raising in distress to occur within sight of the court, and as part of a more significant restructuring transaction. Indeed, the problem with some of the more aggressive US strategies is that no one genuinely independent has oversight of them. To this end, there have now been cases in which a debtor has introduced new money and provided priority for it through the UK Part 26A restructuring plan.[123] Unlike the US examples we have already discussed, the opportunity to participate in the new money will need to be

[120] Mitchell Mengden, 'The Development of Collateral Stripping by Distressed Borrowers' (2021) 16(1) Capital Markets Law Journal 56, 61.

[121] ibid.

[122] Eddy Wymeersch, 'Bank Liability for Improper Credit Decisions in the Civil Law' and Ulrike Schäfer, 'Lender Liability Towards Financially Troubled Borrowers in German Law' in William Blair (ed), *Banks, Liability and Risk* (3rd ed, Routledge 2001).

[123] *E D & F Man Holdings* [2022] EWHC 687 (Ch), [2022] 3 WLUK 410 [60].

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made available to all members of the dissenting class. If this is not done, the class may be fractured into those with the opportunity and those without. Nonetheless, only those who participate in the new money offering will receive the elevation of their debt.[124] This means that if CLOs are reluctant to support a restructuring transaction, including exit financing, because they cannot participate in it, the courts may be able to impose the transaction over their dissent, while continuing to provide independent oversight. Rather than wielding the sticks of directors' duties or lender liability, perhaps we should focus instead on positively incentivising the PE firm that is, after all, in the driving seat to pursue a more substantial restructuring transaction in distress. The possibility to raise exit finance through a Part 26A process provides an incentive for PE firms to start a restructuring transaction, where new money is needed to return the portfolio company to profitability, and where it is proving difficult or impossible to raise new money without a deleveraging transaction. This incentive will be even larger if the sponsor can participate in exit financing efforts, and this is where we turn to next.

D. *Incentivising PE Firms to Pursue Restructuring in Distress*

We have already briefly discussed the fact that it is very difficult for PE sponsors to retain their equity in the US because the US's restructuring chapter, Chapter 11, engages the absolute priority rule (APR). This is the rule that no junior class can recover until a more senior class has recovered in full.[125] It means, almost by definition, that if creditors are suffering a writedown, or their debt is being entirely written off, equity will make no recovery. Although the rule does not apply to a quasi-consensual plan approved by the statutory majority in each class, it provides the default rule against which all bargaining takes place, and severely weakens equity's hand. In short, it provides a powerful disincentive for PE firms to start the deleveraging conversation.

Partly because of concerns for the incentive effects which the APR creates, the UK has not adopted it in its new Part 26A restructuring plan procedure. Nonetheless, the court will (or should) require ample justification for the decision to leave a PE firm with equity in the business

[124] This arises because in the UK classes are determined based on both the existing rights of creditors and the rights they are being offered under the plan, and the new money (so-called exit financing) is treated as part of the offer under the plan – see E D & F Man Holdings (n 123) [61]–[64].

[125] 11 USC § 1129(b).

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where creditors are not being paid in full. The first case in which this arose was the Virgin Active Part 26A restructuring plan.[126] In *Virgin Active*, Snowden J (as he then was) applied both the 'gifting' and 'new value' approaches which have received some consideration in the US. Gifting permits senior creditors to gift to a more junior class part of the distribution that they would otherwise be entitled to.[127] The new value exception, on the other hand, allows shareholders to retain shares if they have contributed new capital.[128] It is worth noting that both 'exceptions' to the APR are controversial in the US and not easily relied upon in that jurisdiction.

In *Virgin Active*, Snowden J determined that the senior secured creditors were the only 'in the money' class, and that it was therefore for them to determine both whether the shareholders could retain equity and on what terms.[129] Moreover, an existing shareholder loan was to be compromised in the plan;[130] £5m of royalties owed to a company in common ownership were to be deferred;[131] the shareholders were to provide up to £25m of new funding, to rank junior to the senior secured creditors' lending, to enable the plans to be proposed;[132] affiliates of the shareholders were to provide a further post-restructuring loan of £20 million;[133] and an obligation was included for the shareholders to contribute up to £6 million of equity to enable payments to be made to landlords and certain other creditors under the plan.[134] The company argued that the terms on which the new monies were advanced were better than any that would be available from a third party in the market.[135] No market testing process was run, although the company's evidence was that it had approached 'a leading private equity firm with extensive knowledge and experience in the sector' that had not wished to proceed.[136] Furthermore, it stated that it had been approached by a number of investment funds

[126] *Virgin Active Holdings Limited* [2021] EWHC 1246 (Ch), [2022] 1 All E R (Comm) 1023.

[127] Michael Carnevale, 'Is Gifting Dead in Chapter 11 Reorganizations? Examining Absolute Priority in the Wake of the Second Circuit's No-gift Rule in re DBSD' (2012) 15 U. Pa. J. Bus. L. 225, 235.

[128] Alexandra Wilde, 'Considerations for Private Equity Firms When Utilizing Chapter 11 New Value Deals' (2012) Mich. J. Private Equity & Venture Cap. L. 197, 199.

[129] *Virgin Active* (n 126) [267]–[268].

[130] ibid [22].

[131] ibid [23].

[132] ibid [36].

[133] ibid [38].

[134] ibid.

[135] ibid [39].

[136] Ibid [45].

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with proposals to lend funds, but on a super senior basis that would not have achieved consent from the senior secured creditors.[137]

In other work, the author has highlighted the significant risk that shareholders do a deal with senior creditors in which they retain equity, provided that they drive a plan that meets the goals of those senior creditors.[138] The result is a transfer of value from the dissenting class or classes to the shareholders. This comment was cited with approval by Johnson J in the recent Great Annual Savings case, where shareholders were retaining shares while making no obvious contribution to the plan, and sanction was denied.[139] However, in *AGPS Bondco* (popularly known as *Adler*), Leech J identified that the issue which had given him the 'greatest concern' was that shareholders who had 'provided no support for the Plan and no additional funding' would receive the upside if the plan succeeded, but ultimately determined that the party 'most affected' by the shareholders' equity position had consented to it.[140] In *Fitness First*, the court took a very similar approach notwithstanding that the secured creditor was also a 75% indirect shareholder, and in the same family as the minority shareholders.[141] And in *AGPS Bondco* in the Court of Appeal, Snowden LJ was untroubled by the fact that shareholders in the parent company shared none of their upside potential from the plan with unsecured noteholders.[142]

Real caution is needed here. On the one hand, the absence of the APR can create a powerful incentive for PE firms to seek a restructuring transaction in the UK, particularly given all the perils of alternative courses of action. This article argues that creating that incentive is important in an era in which senior financial creditors may no longer have the incentives to drive a restructuring transaction when one is clearly needed, with socially costly results. Thus, the author is in favour of developing approaches that enable a PE firm to retain some or all its equity interest, where it contributes to the firm as part of a deleveraging transaction. At the same time, however, it is important that this does not become a charter for shareholders to line up with senior creditors, achieving a bilateral deal that the senior creditors are content with, but that unfairly

[137] ibid [46].

[138] Sarah Paterson, 'Judicial Discretion in Part 26A Restructuring Plan Proceedings' https://ssrn.com/abstract=4016519, 24.

[139] *Great Annual Savings Company Ltd* [2023] EWHC 1141 (Ch), [2023] Bus L R 1163 [133]–[135].

[140] *AGPS Bondco Plc* [2023] EWHC 916 (Ch); [2023] 4 WLUK 196 [324]–[326].

[141] *Fitness First Clubs Ltd* [2023] EWHC 1699 (Ch), [2023] 6 WLUK 456.

[142] *AGPS Bondco Plc* [2024] EWCA Civ 24, [2024] 1 WLUK 227 [239]–[278].

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squeezes out other creditors. The position clearly needs some time to develop in the UK, but an approach based on the monetary contribution of the PE firm, and a careful valuation of the post-restructuring equity, would seem to hold more promise and less pitfalls than a 'gifting' inspired approach.

One of the difficulties is that the Government clearly indicated, in consultations that predated the introduction of Part 26A by some considerable period but that clearly influenced it, its objective to minimise the likelihood of valuation challenges in Part 26A restructuring plans.[143] And it appears that judges may be mindful of the risk of bogging down Part 26A cases in expensive, time-consuming and value-destructive fights over valuation of the equity. And yet, if sponsors (and others) are to be allocated equity in Part 26A restructuring plans when creditors are not being paid in full, it is difficult to avoid complex valuation arguments. The justification for the result is essentially that the sponsor is not retaining existing equity but is subscribing for new equity with new money. This new money may be used: to finance the payment of the fees and expenses of the case; to fund cash recoveries provided to other creditors as part of the restructuring plan; and to provide new liquidity for the deleveraged business going forward. The question is whether this consideration is adequate to justify the allocation of equity to the PE sponsor in the plan.

One way to answer this question may be to show that others have been offered the chance to provide the equity finance, and either have declined or have not matched the PE sponsor's offer. Another option may be for a financial analyst to provide a post-new money valuation to demonstrate that the overall shape of the plan is fair. This may well engage the very type of complex valuation fight that the Government appeared to wish to avoid: disputes over the post-reorganisation enterprise value of the firm; the appropriate discount to plan equity valuation for what is effectively rescue finance; and the fees for the equity raising, which may effectively provide another layer of discount. All of this may lead to a spectacularly difficult, and perhaps rather imprecise, valuation fight. Indeed, Demiroglu, Franks, and Lewis find an average difference between court value and the post-emergence value of newly issued equity in US Chapter 11 of over 50%.[144] It is suggested, however,

[143] Department for Business, Energy & Industrial Strategy, *Government Response: Insolvency and Corporate Governance* (26th August 2018), 73–4.

[144] Cem Demiroglu, Julian Franks and Ryan Lewis, 'Do Market Prices Improve the Accuracy of Court Valuations in Chapter 11?' (2022) 77(2) The Journal of Finance 1179. They also find that the effect is reduced where there is publicly available information about the price of debt securities during the case.

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that we must provide adequate safeguards for creditors in incentivising PE firms to pursue Part 26A restructuring plans and receive an equity allocation, even if this adds layers of complexity that we may prefer to avoid. The alternatives risk making the Part 26A restructuring process the Wild West.

6. *Conclusion*

In the past, senior financial creditors had the incentive to drive a restructuring transaction where one was needed and used covenants in debt documents to monitor and enforce this outcome. Suppliers, customers, employees, and government agencies could all free-ride on these monitoring and enforcement efforts. However, CLOs are now the major providers of senior term debt to PE portfolio companies, and they are not incentivised to push for a restructuring in financial distress. As a result, directors of an overleveraged PE portfolio company may not seek to deleverage its capital structure; may not deleverage it sufficiently; or may even increase leverage. This poses serious risks for suppliers, customers, employees, and even government agencies. It may also contribute to the zombie company phenomenon in which companies limp along struggling to service their debt and meet their debt commitments, unable to invest in their business. Given the increasing importance of PE portfolio companies in the UK, we should take these problems seriously.

We investigated various arguments that this assessment is too gloomy. None of these, however, were convincing answers to the whole of the problem. Various solutions in corporate insolvency and restructuring law were therefore considered. It was suggested that UK corporate law does offer routes for creditors to challenge directors who take a particular course of action when there is reason to suspect that it will fail to save the firm, although it is not an easy path to chart. Little hope was pinned on the ability of the UK government to pursue directors of PE portfolio companies who adopt strategies with disastrous results for small suppliers, customers, employees, and even government agencies, given the recent collapse of highly significant disqualification proceedings. Equally, however, the promise of the directors' duties regime to create a substantial incentive for directors positively to pursue a restructuring, when one is needed, is weak. It is not at all easy to see how a robust regulatory framework could be developed for CLOs that would address

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the risks discussed in this article. And caution is advisable in imposing liability on lenders lest we disincentivise all rescue financing efforts.

It has been suggested, therefore, that rather than developing sticks negatively to incentivise restructuring transactions, we should develop carrots positively to incentivise them. There are encouraging signs that lenders could be incentivised to provide new money through court-supervised routes in the UK, where an independent arbiter can judge the fairness of the proposed course of action to creditors as a whole and where, crucially, the new money is provided after a reasonably substantial deleveraging transaction. And, finally, it has been suggested that the UK was right to avoid introducing the APR in its new Part 26A restructuring plan, and that this creates some incentive for PE firms to pursue a deleveraging transaction, and to contribute new equity, in a formal restructuring where they otherwise lack the incentive to do so. Nonetheless, caution is needed, lest this becomes a charter for collusion between PE firms and senior creditors.

Overall, a challenging new landscape is revealed that undermines many of our foundational assumptions about incentives in financial distress. Moreover, modern finance being what it is, the situation is likely to be dynamic, requiring constant reassessment and evaluation. Indeed, as this article is being written we are witnessing the rise of new private credit deals in which PE sponsors provide the debt financing for PE portfolio companies,[145] undoubtedly creating new webs of complex incentive effects. These incentive effects become even more complex when we consider that larger PE firms have established their own CLOs, which might buy the loans that the same PE firm originates to finance LBO transactions of portfolio companies. The short point is that it may be necessary for corporate insolvency and restructuring law to intervene where market incentives have previously done the heavy lifting, so that we need to be alert to the changing nature of these incentives. At the same time, any intervention needs to be carefully balanced, and approached with considerable care.

[145] Robin Wigglesworth, *Private Credit Returns are Great (if you Believe the Marks)* Financial Times 17 October 2023.

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