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Galapagos: English Court Fully Upholds Validity of 2019 Restructuring, on Proper Construction of "Distressed Disposal" Provisions in Intercreditor Agreement

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At a Glance

The English Court ruled in favour of the Galapagos group on Friday, 28 July, in a dispute as to whether the c.€1 billion restructuring of the Galapagos group in 2019 was validly effected in accordance with the terms of an English law intercreditor agreement (ICA).

This case marks the first test of "Distressed Disposal" provisions in English law ICAs since *Stabilus* (2012)[1] (previously the most significant case in this area).

Signal, a holder of the group's €250m high yield notes (HYNs) — the liabilities under which were fully released via the restructuring by the security agent by exercising its rights under the "Distressed Disposal" provisions in the ICA — has brought proceedings opposing the validity of the restructuring across multiple jurisdictions for several years, including in Germany, Luxembourg and the U.S.

In granting the declarations sought by the Galapagos group, the court held that, under the relevant Distressed Disposal provision:

- the requirement that the proceeds of the sale/disposal must be in cash or substantially in cash was satisfied in circumstances in which the purchase consideration was partly paid by way of a consensual, contractual set-off of funds

(i.e., the proceeds of the enforcement being reinvested by senior creditors that supported the transaction lending that money back to the post-restructured group);
- the requirement that creditors' claims/security must be unconditionally released concurrently with a Distressed Disposal was satisfied in circumstances in which the newco purchaser issued new debt securities to the group's existing creditors — in other words, the court held that the holders of debt securities *are* able to participate in the financing of the restructured group under the terms of the market-standard ICA;
- accordingly, the restructuring was validly effected under the Distressed Disposal provision;
- it was therefore unnecessary to determine the group's "fall-back" case, that a term should be implied into the Distressed Disposal provision such that its conditions should not apply if the HYNs were "out-of-the-money"; but
- in any case, the HYNs *were* as a matter of fact "out-of-the-money" at the time of the Distressed Disposal.

This decision offers significant guidance as to the proper interpretation of Distressed Disposal provisions in ICAs. It also offers comfort to debtor groups and their senior creditors that using such provisions "works", validly releasing junior creditors' claims as part of a restructuring.

In particular, from a wider market perspective, the decision in this landmark case underlines the effectiveness of the distressed disposal mechanics that are typical within English law intercreditor agreements in most European leveraged financing transactions as the basis for delivering out-of-court restructuring transactions outside bankruptcy processes.

Kirkland represented the Galapagos group in its restructuring and have represented the group in the subsequent litigation across the various jurisdictions, including in the English proceedings.

Background

The Galapagos group restructured in October 2019. In summary, the following steps were taken with the consent and support of the overwhelming majority of the group's senior creditors:

- directors of the parent company applied to the English Court for an administration order after events of default occurred under the group's senior secured notes (SSNs)

when the group failed to pay interest and to deliver audited financial statements;

- a sales process was commenced for the purpose of selling key secured assets;
- the SSN holders accelerated repayment and issued enforcement instructions to the security agent;
- the security agent enforced the security and agreed to sell the key secured assets — including shares in Galapagos Bidco — to the highest bidder, with a "backstop" bid of c.€425 million from the group's existing sponsor;
- pursuant to the waterfall in the ICA, the senior lenders and SSN holders were repaid;
- the security agent exercised its contractual power under the Distressed Disposal provisions of the ICA to release the remaining claims — namely, those arising under the HYNs, the most subordinated tranche of the group's financial indebtedness;
  - in essence, the Distressed Disposal provision required that — unless >50% of the HYN holders approved the disposal (which they did not) — each of the following conditions must be satisfied for a Distressed Disposal (if the guarantees/security in respect of the HYNs were to be released):

    (A) the proceeds of the sale/disposal must be in cash or substantially in cash;

    (B) concurrently, creditors' claims against relevant group members and relevant security must be unconditionally released and discharged; **and**

    (C) the sale/disposal must either be made pursuant to a public auction or a financial advisers' opinion be obtained — it was common ground that this condition was satisfied;

- accordingly, the purchaser — a newco controlled by the group's existing sponsor — acquired the group (through an investment of new money) free of the liabilities under the HYNs; and
- the new group (Mangrove) entered into new financing arrangements on the same day with a number of its existing senior creditors and sponsor.

As noted, the central issue in these proceedings was whether the restructuring was validly effected in accordance with the ICA, which revolved around satisfaction of conditions (A) and (B) above.

The new group sought a court order to state that such conditions were satisfied; Signal, a holder of c.€73 million of the HYNs, sought a court order to state that the conditions had not been satisfied and therefore the releases were of no effect.

The following proceedings are separate but related to this challenge.

- *New York claim*: Signal brought a claim in New York against Galapagos Bidco and various parties, alleging a conspiracy to defraud the HYN holders; those proceedings have been stayed (since July 2020) pending determination of these English proceedings.
- *Insolvency proceedings in respect of former parent*: Galapagos S.A., the old group's interim holding company, is in English liquidation proceedings. It is purportedly also in German insolvency proceedings, commenced by certain HYN holders. The validity of these proceedings has been subject to a protracted challenge. The Court of Justice of the European Union ruled that the German court had no jurisdiction to open insolvency proceedings, given there was a pre-existing administration application in England and the effect of the European Insolvency Regulation. However, the German courts have nevertheless allowed the German insolvency to continue after Brexit, though the English Court has refused to recognise the German insolvency proceedings.
- *Claw-back action within German insolvency proceedings*: the purported German insolvency officeholder sought a "claw-back action" to reverse the share sale and the deed of release under which the HYN liabilities were released. Those proceedings have recently been dismissed.

Judgment

There were essentially three core issues, on which the court ruled as follows — granting most of the declarations sought by the group.

Issue	*Summary*	*Judgment*
1. **Cash consideration** — Condition (A)	Whether the sale of secured assets pursuant to the restructuring was made for consideration "in cash (or substantially in cash)" for the purposes of the ICA Signal asserted that this condition was not satisfied because the purchase price for the key secured assets was paid,	The fact that a majority of the holders of the SSNs chose to reinvest their share of that sum in the new notes did not mean that the issue of the new notes were themselves to be treated as consideration for the disposal. There was no reason in principle why the SSN

		in part (c.65%), by way of set-off.[2] Galapagos Bidco did not dispute that the actual payment was partially effected by way of set-off, but it did not accept that this meant that the proceeds of the sale were not in cash or substantially in cash.	holders should not be entitled to do whatever they liked with the money they received through the waterfall under the ICA, including subscribing for new debt securities. The mere fact that a substantial part of the consideration for the Distressed Disposal was applied by way of set-off did not mean that the proceeds were not "in cash (or substantially in cash)" for the purposes of condition (A). It was the promise to pay in cash which generated the proceeds of the sale/disposal; there was nothing to restrict any holder of the SSNs from re-lending those proceeds by directing that the cash which it would otherwise receive under the distribution waterfall should instead be applied as a set-off against the subscription price for the new notes. "In short there is no reason in principle why the proceeds in the present case cannot be treated as being "in cash" if what occurs has the

		legal effect of discharging by set-off the obligation which arose under the promise to pay." "The operation of a legal set-off should be regarded for the purposes of condition (A) as having precisely the same effect" as payment "in cash", provided both sums are both liquidated and certain. "The real purpose of condition (A) is to ensure that the proceeds of the Distressed Disposal are identified and valued in cash." Accordingly, condition (A) was satisfied.
2. **Validity of release of claims / security** – Condition (B)	Whether as part of the restructuring all the claims of the existing creditors against the Galapagos Group were "unconditionally released and discharged" and "not assumed by the purchaser or one of its Affiliates", and whether all security under the Security Documents was "simultaneously and unconditionally released" for the purposes of the ICA	There was nothing in this condition to prevent existing creditors from agreeing to lend money to the new group. On proper construction, the claims under the new debt instruments were held by the re-subscribing noteholders / lenders in a different capacity and under different debt documents with different terms. Their existing creditor rights did not give rise to any

This condition effectively required the security agent to sell the relevant shares on a debt-free basis — i.e., creditors' claims must be released, together with security in respect of those claims. A sale for nominal consideration (but subject to existing indebtedness) is therefore not permitted.[3]

Signal asserted this condition was not satisfied because the substance of the transaction left a significant number of existing creditors as creditors of the new Mangrove group.

claims by them as creditors within the meaning of condition (B).

It was an "unjustified leap in logic" to argue that existing creditors could no longer be creditors of the new group under alternative financing arrangements following the Distressed Disposal — even where the re-lending was made in a prearranged manner in conjunction with the sale.

To hold otherwise would be "a wholly uncommercial consequence", because it would seriously restrict creditors' ability to obtain a recovery on their claims, by removing from the potential pool of refinancing those creditors who are most likely to have an appetite to continue to support the group with new finance. "There is little commercial sense in restricting the ability of the senior creditors to contribute finance to fund [the] survival and future development [of the underlying business],

whether by the restatement of their existing exposures on new terms, or by the advance of wholly new money."

Further, to hold otherwise would also have a very significant adverse impact on the senior creditors' rights to utilise the funds to which they were entitled under the distribution waterfall in their own interests; it would give the holders of the HYNs a very significant negotiating position extending well beyond any legitimate interest they might have in ensuring that the value of the underlying business is realised in full.

The fact that the releases formed part of a series of interlinked restructuring steps did not mean that each release was anything other than an unconditional release and discharge. The correct question was whether, at a time concurrent with the sale effecting the Distressed Disposal, creditors' claims against

		the relevant member of the group were unconditionally released and discharged. Accordingly, condition (B) was satisfied.
3. **Implied term in Distressed Disposal provision?**	(A) Whether a term should be implied into the Distressed Disposal provision of the ICA to the effect that the conditions in that provision are not required to be satisfied if the HYN holders are "out-of-the-money"[4]; and (B) if so, whether the HYN holders were so "out-of-the-money" This was a "fall-back" argument adopted by the group, in case it did not succeed on issues 1 and 2 above. The purported German insolvency officeholder argued that the English court should not decide this point at all, as it was a question of fact on issues which were also before the German court (in the claw-back action).	It was unnecessary to determine this question given the court's rulings on issues 1 and 2 above. However, it was nonetheless appropriate to make findings of fact on the "out-of-the-money" issue, for various reasons. On the potential implied term: the ICA could operate satisfactorily without implying the suggested term, and it was important to construe the ICA in a way which provides for a reasonable degree of commercial certainty and predictability. These factors (among others) pointed against the implication of the suggested term — and, more generally, against a construction of the ICA which would disapply the need to satisfy conditions (A), (B) and (C) if the HYN

holders were "out-of-the-money".

However, the court went on to consider whether, if it was wrong on the above point of construction, the HYNs were in fact "out-of-the-money". It held that:

- there was very clear evidence that, in absence of the Distressed Disposal, a formal insolvency was likely to occur;
- the strong likelihood was that there was no real prospect of a sale being agreed other than on the terms of the Distressed Disposal (or substantially those terms);
- it was unrealistic for Signal to point to things that the existing sponsor or senior creditors could have done to improve the group's prospects of survival; such actions essentially involved either advancing further funding or deferring creditors' enforcement rights, when there was no evidence these other

stakeholders would have been prepared to do so;

- for junior creditors (here, the HYN holders) to be considered "in-the-money" requires clear evidence sufficient to prove, on the balance of probabilities, that they would receive a return in the event that the restructuring does not proceed;
- in this case, the available evidence did not demonstrate that, if the proposed Distressed Disposal failed, the group would somehow have been supported for sufficient time to enable another orderly sale to proceed; and
- instead, a liquidation sale was the likely counterfactual in the absence of the planned Distressed Disposal — in which the HYN holders would have been "out-of-the-money".

Accordingly, the HYN holders were "out-of-the-money" at the time of the Distressed Disposal.

The court also held that there is no general principle of contractual construction that, if there is ambiguity in a clause which is potentially "expropriatory", then the ambiguity should be resolved against taking away property rights. Instead, the relevant question is which construction is more consistent with business common sense:

> "Where an agreement such as the ICA regulates the relationship between creditors, business common sense may well point to a construction which preserves the rights of the senior creditors as against the junior creditors, even if in so doing the junior creditors are no longer able to enforce their claims against the debtor or receive the benefit of security to which they would otherwise be entitled. … The rights of the holders of the HYNs to initiate enforcement and receive any proceeds from the operation of the payment waterfall have always been restricted by their ranking."

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1. *Saltri III Ltd v MD Mezzanine SA SICAR* (2012) ↩

2. The payment by set-off occurred because certain creditors who were entitled to receive a share of the sale proceeds under the ICA's distribution waterfall opted to lend money back to the new Mangrove group for the purpose of funding the business after the sale. This obligation to make payment under the waterfall was then discharged by way of set-off. ↩

3. Absent a contractual provision to this effect, that is a course open to a security agent to take: *Stabilus* at [122]. ↩

4. In the sense that the HYN holders have no economic interest in shared security/debtors' assets and would receive no return if the Distressed Disposal did not occur. ↩

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