

English law ICAs: what's next for distressed disposal 'LMEs'?

Introduction

Recent years have seen a material increase in debtors and creditors in the US and Europe seeking to use contractual methods as an alternative to formal restructuring tools to address liquidity and balance sheet issues. These methods – which fall under the umbrella of 'liability management exercises' or 'LMEs' – cover a broad spectrum of actions but share the common feature of seeking to implement a transaction within the confines of the terms of the debt documents and without any formal restructuring or insolvency procedure. This breadth has led to wide-ranging use cases including 'vanilla' amendments, maturity extensions, new money transactions and more comprehensive restructurings (e.g., drop-downs, uptiers and debt-for-equity transactions).

Certain of these options rely on the use of distressed disposal provisions, which are a standard feature of English law governed intercreditor agreements ("ICAs"). Although precise terms vary, these provisions broadly provide a mechanism for a specified class of creditors to facilitate, in a distressed scenario, a disposal of some or all of the debtor's business free of out-of-the-money liabilities and encumbrances which are subject to the ICA (this will usually cover junior ranking financial debt and intra-group / shareholder loans). This reflects the intention that, subject to certain safeguards, out-of-the-money claims of junior creditors or shareholders should not impede enforcement by senior creditors. Importantly, as a distressed disposal does not typically need to be to a third party, this can be used to deliver a debt-for-equity swap (subject to the terms of the ICA), by transferring assets to a newco in which senior lenders are issued equity in exchange for releasing their claims against the debtor (a "credit bid") and at the same time releasing out-of-the-money claims.

Where both this distressed disposal mechanism and an in-court restructuring, such as a Part 26A restructuring plan, are potential options (which will depend on relevant

circumstances), there are several reasons why in certain cases, the distressed disposal mechanism may be the preferred option. These will be fact-specific and require, among other things, a detailed assessment of the terms of the distressed disposal provision – minor changes at origination may materially impact the ability to use the tool when required.

- **Lack of forum to challenge:** the Court's involvement in a Part 26A plan provides a potential forum for challenge. Although this can often be navigated through appropriate planning – including in respect of the requirements of the new Practice Statement for Part 26A plans – a distressed disposal LME does not require Court supervision or, generally, engagement with affected creditors and so may limit options for upfront challenge. A creditor wishing to challenge an LME may, absent an injunction, therefore be forced to do so post-implementation through formal and costly proceedings.
- **Consent threshold:** although dependent on the specific terms of the finance documents, the consent threshold to implement a distressed disposal LME may be a simple or two-thirds majority of a specified class of creditors, and so lower than the 75% consent threshold required from each class for a Part 26A plan (subject to cross-class cram down and the ability to leave certain creditor classes out of the vote).
- **Non-pro rata treatment:** fairness requirements in a Part 26A plan require any differing treatment to be justified and this will be scrutinised by the Court. In contrast, if relevant ICA terms are complied with, LMEs can, and have, been used to implement restructurings where minority creditors are treated differently from a majority in the same class or excluded from participation entirely. This reflects the fact that an LME does not impose a standalone requirement (unless contractually agreed) to negotiate with all creditors or provide them with extensive information.

- **Out-of-the-money creditors:** in line with the English law principle that parties are generally free to negotiate such contractual terms as they see fit, there is no requirement that an LME provides value to out-of-the-money creditors who are subject to the ICA, unless the terms so require. That said, parties relying on the distressed disposal provision may choose to run some form of marketing process or seek independent valuation evidence and/or fairness opinions to reduce challenge risk or bring themselves into specified “safe harbours” under the ICA. The position in a formal restructuring is generally more complex and may be impacted by, in the case of English proceedings, fairness assessments and, in the case of US and several European regimes, absolute priority requirements (or modified absolute priority requirements).

Challenge risk

Despite some of these potential benefits, there is an increasing pattern of well-funded challenges to LMEs in both the US and Europe. Minority creditors have launched (or intimated) challenges to certain distressed disposal LMEs involving English law governed ICAs (*Selecta*, *Hurtigruten* and *Hunkemöller*) on a number of grounds. Although the terms of such challenges are complex, they collectively implicate two key elements which have to-date been significant considerations in the use of LMEs in the English market: (i) the minority protection principle and (ii) directors’ duties.

Minority protection principle

A key focus area is the scope of the minority protection principle under English law, which has - outside the LME sphere - formed the basis for the Court to imply a term that the powers of a majority must be exercised in good faith and in the interests of the class as a whole. The central question is whether this applies to the ‘instructing group’, i.e., the creditors directing the enforcement / distressed disposal under the terms of the ICA.

Eminent lawyers have produced conflicting evidence on this point in the US proceedings in *Selecta*. Lord Neuberger (for the majority creditors) has opined that there is no basis for implying this principle into the ICA for a number of reasons, including that the ICA contains a detailed regime to determine the nature of instructions which can be given by the instructing group, and agreed restrictions and limitations. In response, Dame Elizabeth Gloster (for the minority creditors) considers broadly that the principle does apply to the ICA, and that consequently the instructing creditors were not permitted to issue an enforcement instruction for the purposes of procuring an advantage over

creditors in the same class. Abuse of this principle is also a central ground of the challenging creditors in the English proceedings in *Hunkemöller*; creditors in *Hurtigruten* have also intimated that they may claim on this basis.

If the principle is found to apply, this may raise questions as to what this means in practice for an instructing group directing enforcement to deliver a distressed disposal LME under an English law ICA. For example, whether this imposes an implicit condition of *pro rata* treatment, what makes exercise of the powers abusive rather than simply an exercise of rights negotiated between sophisticated counterparties, and whether other features (e.g., prior consultation) may become part of the playbook to de-risk post-implementation in a similar way as for Part 26A plans.

Directors’ duties

As seen in *Selecta* and *Hunkemöller*, a further area of potential challenge is directors’ duties: for example, the argument that directors risk breaching, or breached, their duties by proceeding with an LME. This assessment will be fact-sensitive and informed by a range of factors including the commercial rationale for the transaction, medium- and long-term plans to address any residual liabilities and, importantly, the jurisdictional regime to which the directors are subject. As things stand, we have not yet seen a judicial challenge to a distressed disposal LME on the basis of English directors’ duties.

Conclusion

In the current landscape, pending the outcome of the ongoing cases above, the challenge risk to distressed disposal LMEs should be carefully considered when benchmarking against other processes, such as a Part 26A plan or a pre-packaged administration. Features such as non-*pro rata* treatment of similarly situated creditors, the extent of engagement with creditors and nuances in the terms of the distressed disposal provision should all be considered. In addition, the views and requirements of those required to implement a distressed disposal (e.g., security trustees) continue to be important.

There is also a question as to whether the current landscape will result in a change to terms across ICAs. At present, while there is some standardisation, there are also important differences which may have significant intended or unintended consequences in a distressed scenario. While we do not expect any radical changes to ICA terms, there could be a shift to more standardisation to address concerns raised as part of ongoing challenges in a manner that the market accepts. However, in the age of increasing complexity, it is equally possible that these provisions could become an area of more bespoke upfront negotiation, rather than – as is often still the case in origination – being negotiated as a lower priority matter close to signing.

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