Open Letter from ELFA

ELFA Best Practices Guidance for Co-Operation Agreements in Europe

Background

Co-Operation Agreements, hereafter referred to as Co-Ops, are a fairly recent feature of European credit markets. Having originated in the US as a means for lenders to repel creditor-unfriendly tactics in debt restructurings, they quickly have become a familiar innovation to European leveraged credit practitioners.

In essence Co-Ops are agreements where a group of investors agree to only buy and sell debt instruments (bonds, convertibles or loans) between each other. In doing so, the signees are looking to protect the position of debt holders against potential aggressive actions undertaken by distressed issuers.

A Co-Op is a way to demonstrate broad based creditor support for an ad-hoc negotiation and is a way for a majority of creditors to demonstrate a united front, in preparation for negotiations with the issuer and their counsel. The fundamental difference between a Co-Op and ad-hoc groups, is the demonstration upfront of majority lender exposure.

However, there have been several instances, so far only in the US, where Co-Ops are limited to a select group of debt holders to the detriment of others, despite being in the same instrument or creditor class (creditor-on-creditor violence).

Often this action is aided by loose covenants in indentures that create loopholes to allow aggressive proposals. ELFA has been a long-time advocate of improved covenant terms within European Leveraged Finance and hopes that real monetary losses seen to certain creditors in the US because of loose covenants, may lead to improved scrutiny and push-back in the future.

We also note that Co-Ops can precipitate a restructuring event when this would not have been necessary without aggressive actions from a Co-Op which may lead to loss of value across the stakeholder community. However, Co-Ops, if executed in a fair manner, can not only address the intentional imbalances imposed on lenders by weak creditor protections, but also can be beneficial for all stakeholders in a distressed situation.

European Leveraged Finance

ELFA believes that it is in the best interests of all stakeholders to respect the fundamental principles of stakeholder ranking within capital structures and to defend against any mechanism that would upend them. In our view, adherence to such principles will reinforce the attractiveness of the European Leveraged Finance market to the benefit of both credit investors and asset owners.

ELFA also notes that there are significant differences across European insolvency regimes such that a US Co-Op model may not be suitable for different European contexts. We would therefore advocate against a “cut-and-paste” of aggressive US practices that could lead to increased volatility, as well as possible value destruction in the case of a European distressed situation.

One such area of concern arises from the differences in directors’ liabilities between those prescribed by US States and those in Europe. In the latter both national laws and EU directives could have different consequences for European companies that elect to pursue non-inclusive arrangements vis-à-vis creditors. Furthermore, European firms’ senior management and board members may be bound by their fundamental fiduciary duty of care to the company and its creditors, such that the utilisation of aggressive covenant terms to the detriment of creditors could be a violation of local laws. ELFA will address this issue more fully soon.

The purpose of this Best Practice guidance is to advocate for European Co-Ops to work for the benefit of all creditors in the European leveraged finance market, respecting the fundamental premise that pari-passu creditors receive equal treatment in a restructuring.

Best Practices Recommendations

1. The purpose of a Co-Op should be made clear at the outset. ELFA recommends that the Co-Op should act as a "time-out" for debt holders to allow all market participants time to assess certain news released to the market. This news will already be known to "insiders" and the Co-Op should allow for the levelling of the informational playing field.
2. A Co-Op should be seen as separate from a transaction, although it may lead to one. In a transaction, debt holders may incur fees by hiring financial advisors and law firms. ELFA's best practices for Co-Ops does not extend to guidance on transactions.
3. Best practice would be to have an open Co-Op, where all the lenders have a right to join and everyone in the Co-Op's claim will be treated equally. Should a transaction ultimately happen there will need to be a SteerCo that will earn market standard work fees and potentially underwriting fees should new money be required. A SteerCo should be announced at the beginning of the Co-Op process and it then can be amended with SteerCo's consent.
4. As best practice, there should be no fees payable to the SteerCo unless a transaction occurs. If, by necessity, fees are payable before a transaction, these should be transparent at the outset and kept to a minimum and subject to due consideration of the costs and benefits of such fees.
5. Joining a Co-Op should not involve any Material Non-Public Information (MNPI). Any party initiating a Co-Op should make the process public via a notification using market normal channels of communications.
6. A Co-Op should be open to all debt holders subject to proof of holding. There should be no gating of a Co-Op unless a date for such gating is disclosed with 10 business days' notice communicated either in the initial or subsequent public communication.
7. Broker/Dealers and Investment funds (all holders of debt who are not Broker/Dealers) shall make it clear that they are aware of a Co-Op when trading a bond or loan and prices traded on should be Co-Op or Non Co-Op.
8. The length of any Co-Op and associated restrictions should be carefully considered and reflect appropriately the specifics of each scenario. A blanket effort to extend the length of Co-Op arrangements is not something that we would welcome.

About ELFA

ELFA is a trade association comprised of European credit investors and non-bank lenders from over 60 institutional fixed income managers, including investment advisers, insurance companies, and pension funds. ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information, please visit ELFA's website: www.elfainvestors.com.

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