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Cooperation Agreements Help Distressed Lenders Negotiate as One

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Locke Lord Washington, D.C., Partner **Jonathan Young** and New York Partner **Jason Ulezalka** co-authored an article for Bloomberg Law detailing how distressed debtholders can leverage ?cooperation agreements to negotiate from a position of unity and strength to defend against a ?borrower undertaking an opportunistic restructuring strategy known as a liability management ?exercise (LME). The authors explain that the use of LMEs is growing in popularity among ?distressed private equity-sponsored portfolio companies as this technique allows borrowers to gain additional ?liquidity by restructuring funded debt, which also creates a clash between lenders.?

Young and Ulezalka describe the function of an LME: “In a classic scenario, a private equity sponsor works with a subset of debtholders (and often a group of new lenders) to recast the balance sheet and craft a creative solution to the borrower’s financial distress. This comes at the expense of existing lenders that aren’t participating in the LME and can take the form of, among other things, a ‘drop down’ transaction, (where valuable collateral is transferred to an unrestricted subsidiary and made available to support new borrowing), or as an ‘uptiering,’ (where the participants’ existing debt holdings are exchanged for newly issued senior priming debt).”

“This has caused lenders to start exploring and implementing a more front-end solution — cooperation agreements — designed to eliminate (or at least reduce) the potential for being on the receiving end of an LME transaction. Together, lenders agree to negotiate with a borrower in the context of restructuring discussions — an ‘all for one and one for all’ scenario,” Young and Ulezalka add.

Read the full Bloomberg Law article or view it below.

Cooperation Agreements Help Distressed Lenders Negotiate as One

Cooperation agreements are a new tool for distressed debtholders seeking to negotiate from a position of unity and strength. These agreements can also help debtholders defend themselves against a growing opportunistic strategy known as a liability management exercise.

LMEs let borrowers gain additional liquidity by restructuring funded debt — to the detriment of a subset of the borrower’s existing debtholders. Use of LMEs has grown significantly among financially stressed or distressed private equity-sponsored portfolio companies.

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at the expense of existing lenders that aren't participating in the LME and can take the form of, among other things, a "drop down" transaction (where valuable collateral is transferred to an unrestricted subsidiary and made available to support new borrowing), or as an "uptiering" (where the participants' existing debt holdings are exchanged for newly issued senior priming debt).

This clash between lenders is often referred to as "creditor-on-creditor violence," and rightly so given the detrimental and market-moving effect of these transactions on debtholders choosing not to participate in an LME. Aggrieved debtholders can choose to sue over an LME transaction, but they're seeking relief after the fact, as the transaction is closed.

This has caused lenders to start exploring and implementing a more front-end solution — cooperation agreements — designed to eliminate (or at least reduce) the potential for being on the receiving end of an LME transaction. Together, lenders agree to negotiate with a borrower in the context of restructuring discussions — an "all for one and one for all" scenario.

Lenders in a cooperation agreement generally can't enter into any side deal with the borrower or its affiliates with respect to the debt instrument in question, and they're typically prohibited from acting in a way that's materially inconsistent with the agreement. Some agreements also generally prohibit individual lenders from communicating with the borrower or its representatives.

Cooperation agreements often greatly affect the voting provisions in the credit agreement. Specifically, cooperation agreements often require that, if a supermajority of its lenders approves a particular action, then all of its remaining lenders must go along with that decision. They also can be used to alter or even potentially negate the existing voting provisions in the underlying debt instrument.

Lenders that sign a cooperation agreement are restricted from selling or otherwise transferring the underlying debt. No such lender can transfer its debt unless the proposed transferee is already party to the agreement, or if the transferee signs a joinder to the agreement on or before the transfer is consummated.

If a participating lender breaches the terms, cooperation agreements generally provide for an exclusive remedy of specific performance and injunctive relief—not money damages. Certain jurisdictions limit or prohibit specific performance as an appropriate remedy where money damages would protect the interests of the aggrieved party.

It's unclear how courts will rule on the enforceability of these remedy provisions, or whether a court considering injunctive relief will accept and honor a relief stipulation that money damages are unavailable. Any such ruling is sure to depend on the specific facts leading up to the case.

Participating lenders in most instances don't ask or allow their borrower to be a party to the cooperation agreement. This approach stands in contrast to the restructuring or plan support agreements that are common in bankruptcy negotiations, and typically have a specific restructuring proposal or Chapter 11 plan being discussed by the parties.

A cooperation agreement, however, is drafted in a broader context to govern the general conduct of the lender parties during their ongoing discussions with the borrower. These rules of engagement are created at the inception

of potential financial distress and may well be entered into in the absence of specific ongoing workout discussions.

Cooperation agreements have limited effect in blocking an LME that is already permitted under the existing terms of the relevant credit agreement. On that basis, we believe such agreements will be less effective in preventing drop-down LMEs, as most drop-down transactions use existing flexibility under the investment covenants and other relevant provisions.

However, a cooperation agreement should better prevent uptiering LMEs because most uptiering transactions can't be consummated without a majority of the lenders under the existing credit agreement voting to approve the transaction.

Instead of permitting their distressed borrower to divide and conquer, debtholders can choose to present a united front. A cooperation agreement can send a strong message to the borrower that its lenders are aligned and must be satisfied on a collective basis. That unified approach, properly executed, can lay the groundwork for all debtholders to achieve a superior recovery.

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