Loss mitigation mechanics

Euro CLO primary practice around LML documentation

In this latest in the series of SCI CLO Case Studies, we examine the uptake of loss mitigation loan language in deals since the concept emerged a year ago

It is just over a year since the concept of the loss mitigation loan (LML) being used in CLOs emerged and subsequently began being incorporated into documentation, first in the US and then in Europe. It therefore seems timely to review how many deals are now incorporating LML wordings at the point of new issue and at reset or refi.

To provide a useful snapshot, we have focused on the European CLO market and examined deals over the past year. To do so, we have drilled down into the extensive document library held by Semeris *(https://semeris.com)*, which provided access and support for this article.

Background

But first some background. As the Covid pandemic took hold in spring 2020, leveraged loans looked vulnerable to the expected widespread economic downturn. At the same time, distressed loan investors realised that while CLOs were a significant holder of loans, they were unable to participate in certain styles of debt reorganisations.

As a result, some distressed investors deliberately structured reorganisations in a way that meant CLO holders were unable to hold the loan through the recovery process. This forced the CLOs to sell at a lower value than they could have achieved through the recovery process, transferring value to the distressed investors. A notable example came in the Acosta bankruptcy filing *(see SCI 23 June 2020 for more)*.

LML wording started to appear in CLOs as a reaction to this gaming of the system, by reducing the restrictions on CLOs participating in such restructurings. In essence, the wording allows the CLO manager to buy LMLs, which do not meet the normal rules of eligibility criteria up to a ceiling – currently 2% of a deal, but there are also cumulative limits – provided they are intended to mitigate losses on defaulted or credit risk obligations.

The first European deal to include LML-specific language was Deer Park CLO *(see SCI 20 October 20 for more information)*, which closed in September 2020. It did, however, have a predecessor the month before in RRME 4, which utilised extensive new workout language – though not specifying LMLs – in an effort to address the issue. Deer Park has nevertheless been the broad template for subsequent LML deals.

Challenges

Implementing LML wording into CLO documentation is far from straightforward, not least because it is an asset that doesn't meet the usual criteria – there are an array of rules around it, meaning that every part of a CLO's documentation is affected. Effectively, every time assets are mentioned and what can be done with them, language is now having to be added into hitherto broadly replicable deal paperwork.

Further, there are challenges around the different alignments of debt and equity investors. Primarily, concerns have been raised about whether LML money is being taken from interest or principal proceeds. Whenever the latter is used to pay for a LML, it therefore needs to be clarified in the documentation that it will be returned to the principal account as soon as possible to reassure the debt holders.

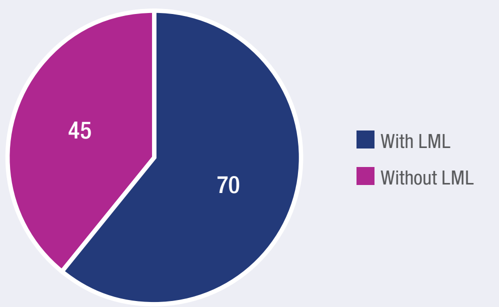
Overall, wording is far from standardised, with issues around aspects such as extended LML (where LMLs are longer than the maturity of the notes) and the use of alternative expressions – such as loss mitigation obligations or LMOs – rather than LMLs. Equally, by their nature, LMLs require interplay with longer-standing features, notably restructured obligations. See the panel on definitions for more.

Data

Lack of standardisation makes quantitative examination difficult, but it is possible to create a broad picture and general sense of market behaviour. We looked at all the European CLOs in Semeris' document library that closed from when LMLs started to appear in the US up until now – i.e. 3Q20 to 2Q21.

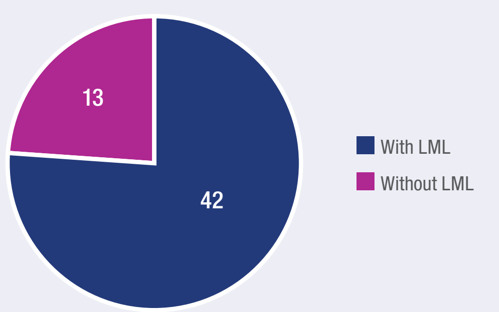
From those, we identified how many deals had no LML language in their documentation and those that had some. For the latter, we included not only deals that had the two most common and extensive definitions – Loss Mitigation Loan and Extended Loss Mitigation Loan (see definitions panel for more) – but also those that mentioned other key related expressions: Distressed Exchange; Equity Workout Security; Extended Workout Obligation; Loss Mitigation Loan Target Par Balance Condition; Potential Workout Obligation; Principal Proceeds Workout Obligation; Restructured Loan; Restructured Obligation Criteria; Specified Equity Security/ies; Workout Loan; and Workout Transaction.

Looking at primary issuance as a whole for the period:



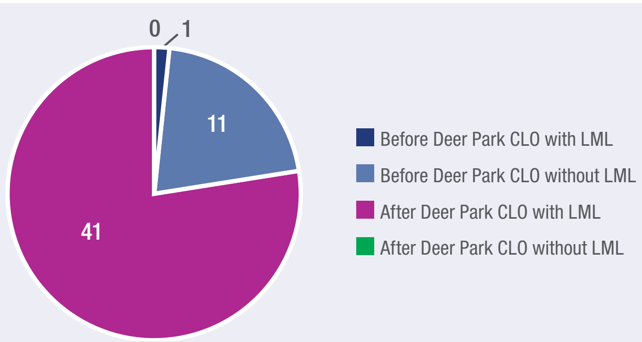
Source: Semeris

Extracting only new issues for the period, the numbers look like this:



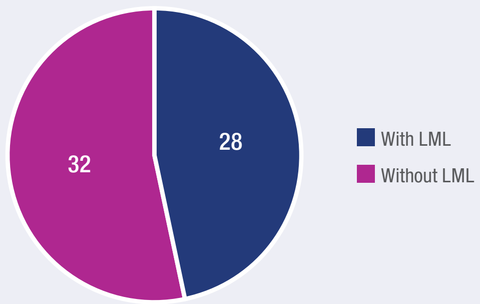
Source: Semeris

However, excluding the two static CLOs – both of which, by definition, do not include LML language – that closed during the period and breaking new issues down pre- and post- the closing of Deer Park CLO, the pattern becomes even clearer:



Source: Semeris

Turning to refis and resets (all of which occurred after Deer Park closed), the picture is more balanced – reflecting perhaps reticence to amend documentation on smaller refis, but it could also indicate the lack of buy-in to the LML concept from some debt investors.



Source: Semeris

In conclusion

As noted above, for the purposes of this article, we have not focused on what language is being used, just on where LML-related language has been included. However, from looking beyond the data to the non-standardised way it has been approached, it is clear that the language is still yet to be fully bedded in and at times can be ambiguous at best.

Nevertheless, the act of doing anything at all could still solve the original issue. An element of LML-related language in the bulk of deals could cause CLO-unfriendly restructurings to disappear and render the LML unused.

SOME DEFINITIONS

As noted in the main text, Blackstone's Deer Park CLO is generally accepted as Europe's first CLO to incorporate LML language. Below are the key definitions from the deal's documentation.

'Loss Mitigation Loan' means a loan or bond purchased by the Issuer (or the Collateral Manager on its behalf) in connection with an insolvency, bankruptcy, reorganisation, default, workout, restructuring, related scheme or similar event to mitigate losses with respect to a related Defaulted Obligation or a related Credit Risk Obligation held by the Issuer, as applicable, which loan or bond, in the Collateral Manager's judgment exercised in accordance with the Collateral Management and Administration Agreement, is reasonably necessary to enhance the recovery value of the related Defaulted Obligation or the related Credit Risk Obligation, as applicable, provided that, other than Extended Loss Mitigation Loans, which cannot become Collateral Obligations, on any Business Day as of which such Loss Mitigation Loan satisfies all of the Eligibility Criteria, the Collateral Manager may designate (by written notice to the Issuer and the Collateral Administrator) such Loss Mitigation Loan as a 'Collateral Obligation'. For the avoidance of doubt, any Loss Mitigation Loan designated as a Collateral Obligation in accordance with the terms of this definition shall constitute a Collateral Obligation (and not a Loss Mitigation Loan), in each case, following such designation.

'Extended Loss Mitigation Loan' means a Loss Mitigation Loan purchased by the Issuer in connection with the workout, restructuring or a related scheme to mitigate losses with respect to a related Credit Risk Obligation or Defaulted Obligation, which Loss Mitigation Loan matures after the earliest Maturity Date of the Notes.

'Restructured Obligation' means a Collateral Obligation which has been restructured (whether effected by way of an amendment to the terms of such Collateral Obligation (including but not limited to an extension of its maturity) or by way of substitution of new obligations and/or change of Obligor) and which satisfies the Restructured Obligation Criteria as at its applicable Restructuring Date; provided that the failure of a Restructured Obligation to satisfy the Restructured Obligation Criteria at any time after the applicable Restructuring Date shall not cause such obligation to cease to be a Restructured Obligation unless it is subsequently restructured again, in which case such obligation shall constitute a Restructured Obligation provided that it satisfies the Restructured Obligation Criteria as at its Restructuring Date.

Semeris *(www.semeris.com)* provided European CLO data for this report.

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