Milbank

Insights

Structured Credit Practice

Roll-Up, Roll-Up – Protecting CLO Positions in Priming Transactions

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1. Introduction

The growth of the leveraged loan markets in both Europe and the US over the past several years has led to significantly increased access to financing for borrowers. While a burgeoning leveraged loan market is overwhelmingly positive for the collateralised loan obligation ("**CLO**") market, the shift of power in favour of borrowers has led to some underlying loan documentation containing fewer lender protections than has historically been the case. These "**Cov-Lite Loans**" typically include few (if any) financial maintenance covenants and contain wide permissions for various transactions, including additional borrowing and/or asset sales[1].

CLOs in both Europe and the US are usually permitted a relatively significant exposure to Cov-Lite Loans[2]. This provides an important expansion in the universe of assets that CLOs can acquire and improves portfolio diversity for the benefit of investors. However, a development in certain liability management techniques[3] by borrowers has caused some concern among lenders and rating agencies in the wider loan market[4]. Such liability management techniques have seen borrowers take advantage of provisions contained in Cov-Lite Loan documentation to raise new super senior debt secured on all or part of the existing collateral supporting the Cov-Lite Loan while subordinating existing creditors. Predominantly seen in the US so far[5], such techniques may also start to trend in Europe[6] as expected default rates grow against a stubbornly volatile economic environment.

Responding to growing concerns around the use of these new liability management techniques, the Milbank structured credit teams in London and New York have developed and introduced a new construct into CLO documentation[7] to permit, and optimise, CLO participation in Asset Priming Transactions and Uptier Priming Transactions (each as described in more detail in *Asset Priming Transactions and Uptier Priming Transactions* below). These transactions have been introduced to facilitate CLO managers taking protective action if a Cov-Lite Loan borrower and/or an activist proportion of its lender group seeks to subordinate existing creditors, thereby permitting CLOs the benefit of participation in the resultant super senior debt.

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[1] In the US, 86% of the USD1.3 trillion in outstanding U.S. leveraged loans are considered "covenant lite". *See S&P Market Insight - "Covenant-lite deals exceed 90% of leveraged loan issuance, setting new high"; https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/covenant-lite-deals-exceed-90-of-leveraged-loan-issuance-setting-new-high-66935148*.

[2] In the CLO 2.0 era, European CLOs have trended towards a growth in their Cov-Lite Loan concentration limit from c.20% in 2013 to c.30% in 2022, with some permitting up to 40% exposure, mirroring the increased number of Cov-Lite Loans on the asset supply side in recent years.

[3] Where such borrowers are potentially distressed, but not yet in a default or formal restructuring / insolvency scenario.

[4] See, for example, S&P Global Ratings' publication of 15 June 2021 ("*A Closer Look At How Uptier Priming Loan Exchanges Leave Excluded Lenders Behind*").

[5] Examples include transactions by J Crew (2016), Petsmart (2018), and Serta Simmons, Boardriders and Trimark (2020).

[6] Intralot was the first European bond issuer to complete an uptiering liability management transaction in 2021, with Milbank advising the ad hoc group of bondholders on this transaction.

[7] See Bain Capital Euro CLO 2022-2 DAC ("**Bain 2022-2**") which introduced this feature in the European CLO market in September 2022 (having initially been seen first in the US CLO market in June 2022), with Milbank advising the managers on both these transactions. A number of subsequent US CLOs have also included this feature, across transactions rated by each of S&P, Moody's and Fitch.

2. Asset Priming Transactions and Uptier Priming Transactions

In "**Asset Priming Transactions**" [8], permitted investment and/or restricted payment "baskets" in Cov-Lite Loan documentation are utilised by borrowers to move assets outside the existing creditors' covenant group to an "unrestricted subsidiary"[9]. This frees-up such assets to provide collateral for new financing raised by the "unrestricted subsidiary" and therefore "primes"[10] existing creditors as to those assets by removing them from the scope of the existing covenant and security net.

In "**Uptier Priming Transactions**" [11], Cov-Lite Loan borrowers generally seek to create a "superpriority" new money tranche that shares in the existing collateral pool in priority to the existing debt, either through permitted debt and lien baskets in their current Cov-Lite Loan documentation or, more commonly, with majority lender approval[12], by amending such Cov-Lite Loan documentation to expressly permit the incurrence of new debt supported by superpriority liens. Where amendments to the existing Cov-Lite Loan documentation are used to create a superpriority new money tranche, participation is often limited to the sub-set of existing lenders which consented to the amendments and is coupled with an ability for such existing lenders to "roll-up"[13] some or all of their existing loans into the superpriority new money tranche.

Common to both Asset Priming Transactions and Uptier Priming Transactions is that participation is usually limited to, and for the benefit of, a subset of existing creditors[14]. Those existing creditors that cannot participate then suffer from being effectively subordinated to (i) the new money incurred by the borrower (or its unrestricted subsidiary in the case of an Asset Priming Transaction)[15] and (ii) any portion of previously *pari passu* debt held by the participating creditors that is rolled-up into the superpriority new money tranche, in the case of an Uptier Priming Transaction[16]. As a result of the growing prevalence of such Asset Priming Transactions and Uptier Priming Transactions, it is becoming increasingly important for CLOs to ensure that their flexibility to participate in the same is equal to that of other creditors, in order to prevent the erosion of their existing credit position where possible and to enable them continued participation in the most senior and best collateralised debt being issued.

3. Protecting Positions for CLOs

By its nature, CLO documentation controls the ability of CLO managers to invest in certain types of assets, preserving and promoting portfolio diversification and credit quality for the benefit of investors. However, as discussed below, constraints that would inadvertently prohibit a CLO from participating in new liability management techniques (such as Asset Priming Transactions and/or Uptier Priming Transactions) and

[8] Examples include transactions by J Crew, Petmart, Revlon, Cirque du Soleil and Party City.

[9] This may be a case of simply "badging" an existing subsidiary as "unrestricted" or alternatively, creating a new SPV. Crucially, however, this entity is outside the constraints of the existing Cov-Lite Loan documentation and so can freely incur further debt which may be secured on the collateral moved away from the existing Cov-Lite Loan borrower and therefore fall structurally senior to such Cov-Lite Loan borrower's existing creditors vis-à-vis that collateral.

[10] Meaning that the seniority of existing creditors is superseded by new lenders.

[11] Examples include transactions by NYDJ, Serta Simmons, Boardriders and Trimark. Techniques may also be combined; for example, the Intralot transaction involved the uptiering of existing 2021 notes into Intralot's US group, which was also designated unrestricted for purposes of Intralot's remaining 2024 notes.

[12] In many US loans and certain "hybrid" European Term Loan Bs (with US-style covenants), amendments to facilitate such changes can often be made with only a sub-set (simple majority or two thirds) of lenders consenting.

[13] See *Protecting Positions for CLOs – Uptier Priming Transaction* below.

[14] Dubbed "creditor-on-creditor violence" by some market participants, some Asset Priming Transactions and Uptier Priming Transactions are being litigated by existing lenders that consider themselves "left behind". See Covenant Review publication of 1 September 2021 (*"Creditor-on-Creditor Violence: How to Address the "Parting Kiss"*).

[15] In Asset Priming Transactions existing lenders are de-collateralised and in Uptier Priming Transactions a superpriority tranche on the same collateral is created ranking ahead of existing lenders.

[16] In S&P Global Ratings' publication of 15 June 2021 ("*A Closer Look At How Uptier Priming Loan Exchanges Leave Excluded Lenders Behind*"), S&P acknowledges that there is a "*disparity in recoveries"* as between participating lenders and those that are left behind, with "*recovery expectations between winners and losers*" being particularly stark with respect to Uptier Priming Transactions, with the "roll-up" being "*larger and more damaging to non-participating lenders*".

acquiring the resultant new money obligations as "**Collateral Debt Obligations**"[17] could serve to render the CLO subordinated to other creditors to the detriment of its investors without sufficient flexibility in place. Moreover, as demonstrated by the current Schur Flexibles restructuring in Europe[18], CLO participation in such pre-insolvency / restructuring liability management transactions will also benefit Cov-Lite Loan borrowers themselves, given the depth, breadth and overlap of CLO holdings in the loan markets[19].

A. Asset Priming Transactions

From a practical perspective, CLOs have generally been prohibited from participating in Asset Priming Transactions on the basis that the "**Eligibility Criteria**"[20] governing the types of assets that can be purchased mandate, among other things, that the obligor of the asset to be purchased has at least a minimum amount of "other indebtedness" – most usually of at least €150,000,000 in Europe and $150,000,000 in the US. However, where an "unrestricted subsidiary" raises new money from acquiring and securing part of the existing collateral pool, such entity (particularly if newly incorporated) is unlikely to meet this "other indebtedness" threshold.

To accommodate Asset Priming Transactions, CLOs seek to modify this minimum "other indebtedness" restriction, allowing the required threshold to be satisfied by looking at the aggregate of the indebtedness of both the obligor of the existing Cov-Lite Loan held by the CLO, together with that of any relevant "unrestricted subsidiary"[21]. CLOs can therefore follow the (often highest-quality) collateral from the existing Cov-Lite Loan into the new structurally senior debt (provided that it would otherwise meet the remaining Eligibility Criteria), irrespective of whether the borrower thereunder is otherwise a single-issuance obligor.

B. Uptier Priming Transactions

Similarly, CLOs have typically been precluded from participating in Uptier Priming Transactions if the resultant superpriority new money tranche variously (i) lacks at the time of acquisition a sufficiently high rating[22], (ii) is considered a "**Current Pay Obligation**"[23] or (iii) has a long-dated maturity as compared to the CLO's own liabilities – any or all of which may be the case where the existing borrower is taking defensive action to alleviate its own credit distress. The addition of carve-outs to the Eligibility Criteria[24] addressing each of items (i) to (iii) above allows the CLO to participate in the superpriority new money tranche issued in connection with an Uptier Priming Transaction (and, crucially, any "roll-up" of existing liabilities into such superpriority new money tranche[25]), similar to those which are disapplied when a CLO

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[17] Meaning that such CLO assets can be acquired from both principal and interest, are counted for determining coverage and collateral quality tests and meet all relevant Eligibility Criteria, Concentration Limits and Reinvestment Criteria.

[18] The Schur Flexible Holdings GsembH's term loan B is in the process of being restructured pursuant to a consensual package participated in by a large number of CLO managers – as the borrower was already in an active insolvency / restructuring process, CLOs were able to use the "Corporate Rescue Loan" and "Loss Mitigation Obligation" mechanics common to existing CLO documentation to do so. See "*Compare and Contrast: Corporate Rescue Loans*" and "*Compare and Contrast: Loss Mitigation Obligations*" below.

[19] Recent reports from Bloomberg and Reuters have suggested that CLOs now hold around two thirds of the leveraged loan market; https://www.bloomberg.com/news/articles/2022-04-13/clos-face-pain-from-looming-risk-of-leveraged-loan-downgrades#:~:text=CLOs%2C%20which%20buy%20about%20two,loans%20at%20fire%2Dsale%20prices; https://www.reuters.com/business/finance/banks-snubbing-junk-rated-loan-funds-worsens-financing-logjam-2022-07-19/.

[20] Being the criteria that assets purchased by a CLO must satisfy in order to be considered a "Collateral Debt Obligation".

[21] For example, see Bain 2022-2 which pioneered this feature in the European CLO market.

[22] Typically, this requirement would be not lower than "CCC-" or equivalent.

[23] Being CLO Collateral Debt Obligations that would otherwise be treated as defaulted but as to which no payments are due and payable that are unpaid and with respect to which the CLO manager has reasonably determined, amongst other things, that the obligor will continue to make scheduled payments of interest and principal. Although CLOs in both Europe and the US can purchase Current Pay Obligations (subject to some exceptions in Europe), this is constrained by small basket sizes of 2.5 – 5.0%. CLOs accommodating the acquisition of Uptier Priming Debt are therefore extending these buckets by a further 2.5 – 5.0% where the Current Pay Obligation is Uptier Priming Debt.

[24] For example, see Bain 2022-2 which pioneered this feature in the European CLO market.

[25] A roll-up of the CLOs existing debt would generally be facilitated by the underlying obligor buying back / prepaying some or all of its liabilities in consideration for rolling into the superpriority tranche. Accordingly, in European CLOs, the roll-up would be considered a "cashless roll" as opposed to a Restructured Obligation and be tested as the purchase of a new Collateral Debt Obligation (against the Eligibility Criteria applicable to Uptier Priming Transactions and the relevant

looks to purchase a Corporate Rescue Loan (as described below) from an obligor which is in a formal restructuring or insolvency process[26]. Recognising the inherent advantages for CLOs in participating in Uptier Priming Transactions, certain recent US CLOs have permitted the purchase of superpriority new money debt as part of an Uptier Priming Transaction during a "Restricted Trading Period", where a CLO would otherwise be precluded from investing.

4. Compare and Contrast: Corporate Rescue Loans

There are a number of parallels between "**Corporate Rescue Loans**" (known as "**DIP Loans**" in the US) and the ability of CLOs to participate in Asset Priming Transactions and Uptier Priming Transactions. The Corporate Rescue Loan concept was introduced at the outset of the CLO 2.0 era[27] to allow CLOs to participate in superpriority debt issued by an obligor in a formal restructuring or insolvency process[28]. Crucially, current CLO documentation provides for a Corporate Rescue Loan to be acquired as a Collateral Debt Obligation. This brings with it a number of benefits, predominantly: (i) the ability to use principal proceeds to purchase the asset and (ii) the asset having a carrying value for the purposes of determining coverage and collateral quality tests (albeit that the "Reinvestment Criteria" or the "Investment Criteria"[29] must also be satisfied upon acquisition).

The ability of CLOs to purchase Corporate Rescue Loans has become ubiquitous across both the European and the US markets, with CLO managers, investors and rating agencies all recognising that additional flexibility for CLOs to participate in such distressed situations is key to preserving overall value for CLOs and accepting the necessary carve-outs (in particular as to default status, ratings and maturity) to the otherwise applicable Eligibility Criteria to facilitate this. However, to qualify as a Corporate Rescue Loan, the underlying borrower must currently be in a restructuring or insolvency process. Accordingly, this would not capture Asset Priming Transactions or Uptier Priming Transactions, which typically seek to manage a borrower's liabilities and re-calibrate its debt profile by injecting further cash before any such restructuring or insolvency processes have commenced.

Asset Priming Transaction and Uptier Priming Transaction mechanics therefore act as an adjunct to the Corporate Rescue Loan concept, applying similar carve-outs to the Eligibility Criteria to permit CLOs to acquire the resultant assets as a Collateral Debt Obligation in a still-solvent reorganisation of creditor priority.

5. Compare and Contrast: Loss Mitigation Obligations

Building on the ability to acquire Corporate Rescue Loans, the "**Loss Mitigation Obligation**" concept was introduced in both European and US CLOs during 2019-2020[30] to provide CLOs with greater flexibility to invest into "new money" obligations of a distressed borrower. To facilitate this and to provide complete flexibility for the CLO manager to respond to the many and varied restructuring scenarios it may be faced with, Loss Mitigation Obligations fall completely outside of the general Collateral Debt Obligation constraints that would otherwise require that the Eligibility Criteria and the Reinvestment Criteria are satisfied[31].

Reinvestment Criteria). In US CLOs, this would typically be characterised as a "Swapped Defaulted Obligation" because no new money is involved in the acquisition.

[26] See *Compare and Contrast: Corporate Rescue Loans* below.

[27] See Dryden XXVII Euro CLO 2013 B.V. which closed on 9 May 2013 and was the first deal in Europe to include this concept.

[28] In the US, this would include proceedings under Chapter 11 of the United States Bankruptcy Code; in Europe this would also include analogous restructuring or insolvency proceedings outside the US.

[29] Including, for example, that collateral quality tests (such as maximum weighted average life or weighted average rating factor requirements) and overcollateralisation tests are satisfied or maintained or improved.

[30] "Restructured Loans" were introduced to the US CLO market in 2019, though typically carried at zero for coverage tests and limits on the proceeds that a CLO could utilise to acquire. The US CLO market subsequently developed the "Workout Obligation" concept, allowing limited carrying value and more extensive use of proceeds for acquisition provided that a number of the CLO's Eligibility Criteria are satisfied.

[31] Typically, Loss Mitigation Obligations will fall short of a number of the Eligibility Criteria at the time of acquisition, particularly where purchased with interest proceeds; however, CLOs do have the option to reclassify a Loss Mitigation Obligation as

However, understandably this necessarily permissive flexibility does also come with certain downsides: (i) the ability to acquire Loss Mitigation Obligations from principal proceeds is extremely limited, so surplus interest (as opposed to principal) that would otherwise be distributed to the equity is generally required in order to purchase the asset (the purchase may also be funded through contributions made by the manager and/or noteholders) and (ii) little or no carrying value is ascribed to Loss Mitigation Obligations for the purpose of determining coverage and collateral quality tests. Increasingly, investor and rating agency stipulations have trended towards requiring principal receipts on Loss Mitigation Obligations being repaid to the principal account to the benefit of rated debt holders, notwithstanding that the original source of funds was interest.

The Loss Mitigation Obligation concept does not require that the borrower thereunder is in an active insolvency or restructuring process[32] and so in some circumstances would facilitate a CLO's participation in Asset Priming Transactions and Uptier Priming Transactions. However, given its elevated position in the borrower's capital structure, the resultant superpriority debt from an Asset Priming Transactions and/or an Uptier Priming Transactions is a significantly different credit prospect from the more subordinate and even equity-like types of debt that could be captured as a Loss Mitigation Obligation, even where purchased with principal proceeds, and therefore justifies different treatment[33].

6. To Conclude

Permitting CLOs to participate in and acquire super senior debt arising from Asset Priming Transactions and Uptier Priming Transactions as a Collateral Debt Obligation recognises its comparably enhanced credit quality and expands the universe of how a CLO can avail of the super senior positions that are achieved through such transactions, whilst also avoiding the subordination and subsequent value erosion that non-participating creditors will suffer. Inclusion of the concepts is an important protection for collateral managers and investors alike to allow CLOs to take comprehensive protective measures in relation to new liability management techniques that could otherwise transfer value away from a CLO and significantly impede recoveries on a CLO's existing debt holding.

Structured Credit Contacts

London | 100 Liverpool Street, London, EC2M 2AT

John Goldfinch	jgoldfinch@milbank.com	+44 20.7615.3109
James Warbey	jwarbey@milbank.com	+44 20.7615.3064
Claire Bridcut	cbridcut@milbank.com	+44 20.7615.3084
Peter West	pwest@milbank.com	+44 20.7615.3242

a Collateral Debt Obligation to the extent all Eligibility Criteria (and other applicable acquisition requirements) are satisfied on a future date.

[32] Rather, the test is that the "new money" obligation is offered in connection with an existing "Defaulted" Obligation or "Credit Impaired" Obligation held by the Issuer with a view to assisting the borrower in mitigating related losses.

[33] Loss Mitigation Obligations can often be acquired with principal proceeds in circumstances such as where the asset is deferring, is subject to a tender offer, has a zero coupon, includes equity warrants, has a very low purchase price, or ranks *pari passu* (as opposed to senior) to the existing obligation held by the CLO; all of which would not likely be true of debt issued as part of an Asset Priming Transaction or an Uptier Priming Transaction.

New York	55 Hudson Yards, New York, NY 10001-2163

Jay Grushkin	jgrushkin@milbank.com	+1 212.530.5346
Sean Solis	ssolis@milbank.com	+1 212.530.5898
Jared Axelrod	jaxelrod@milbank.com	+1 212.530.5772
Martin Brennan	mbrennan@milbank.com	+44 20.7615.3199

Financial Restructuring Contacts

London	100 Liverpool Street, London, EC2M 2AT

Kate Colman	kcolman@milbank.com	+44 20.7615.3143

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