CLO NON-TRADITIONAL RISK RETENTION LOAN FACILITIES: FORECLOSURE RISK IN PERSPECTIVE

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While the U.S. risk retention rules (the "U.S. Retention Rules") clearly permit the use of secured loan facilities to fund the economic interest in the credit risk (the "Retention Interest") that CLO managers ("Managers") or their majority-owned affiliates ("MOAs") must hold in their CLOs, they offer no corresponding guidance as to the legal implications of a lender foreclosing upon and subsequently liquidating such Retention Interest following an event of default. It has come to our attention that there is a great deal of confusion and unwarranted concern regarding foreclosure risk in this context.

The purpose of this memo is to outline the various means by which non-traditional ratable risk retention loan facilities ("Non-Traditional Loan Facilities") address and mitigate foreclosure risk, with the goal of providing Managers and other market participants with a realistic framework upon which to assess the implications of such foreclosure under the U.S. Retention Rules.

Background

Non-Traditional Loan Facilities, which provide lenders with a full-recourse structure that approximates the full economic return on the portion of the Retention Interest financed by the lenders (the "Financed Retention Interest"), as well as an enhanced return by virtue of the lender's entitlement to a specified portion of the Manager's management fees, were originally developed by Seward & Kissel to provide an attractive risk retention financing option for Managers or their MOAs (each, a "Borrower"). Non-Traditional Loan Facilities are unique financing structures that offer the following key structural advantages, among others:

No Restructuring. Non-Traditional Loan Facilities can be implemented while keeping the Manager's current business and organizational structure intact, since utilizing Non-Traditional Loan Facilities requires neither a reorganization of the Manager's existing management company nor the creation of a new management company.

Adaptability. Non-Traditional Loan Facilities are exceptionally adaptable to the challenges and constraints posed by the U.S. Retention Rules. They can be utilized (a) to finance vertical, horizontal or L-shaped Retention Interests, (b) to provide financing for single or multiple CLOs on a committed or uncommitted basis over a multi-year period, and (c) to facilitate compliance with both the U.S. Retention Rules and the risk retention rules of the European Union (the "EU Retention Rules"). In addition, they can and have been implemented in conjunction with other prevalent risk retention solutions, including various MOA and collateralized manager vehicle (CMV) structures.

Ratings. Non-Traditional Loan Facilities financing vertical or L-shaped Retention Interests are capable of being very highly rated, thereby broadening their appeal to entities such as insurance companies and other non-traditional lenders.

Express Authorization Under the U.S. Retention Rules. The U.S. Retention Rules expressly authorize Managers to, either directly or through an MOA, finance the acquisition of a Retention Interest with a full recourse loan, and to pledge such Retention Interest to secure such loan. Thus, rather than taking a "wait and see" approach or grappling with the regulatory uncertainty regarding the implementation of certain other risk retention structures currently in the market, Managers can derive comfort from the fact that the use of Non-Traditional Loan Facilities as a means for U.S. risk retention financing has been explicitly blessed by the relevant enforcement agencies (the "Agencies").

Structural Mitigants

Non-Traditional Loan Facilities contain robust structural protections designed to address and mitigate the possibility of lender foreclosure on the Retention Interest.

In contrast to the traditional bank loan facilities that have historically been used to finance EU Retention Rule-compliant CLOs, Non-Traditional Loan Facilities provide for a lengthy and unprecedented foreclosure grace period (the "Foreclosure Grace Period"), typically ranging from 100 to 120 days following the occurrence of an event of default. Should an event of default be triggered, this Foreclosure Grace Period affords the Borrower a considerable window of opportunity to either (a) cure such default, (b) refinance or prepay the loan, or (c) negotiate a restructuring and/or pledge alternative collateral. This Foreclosure Grace Period is frequently buttressed by a provision requiring the lender to negotiate a restructuring of the related facility in good faith following an event of default.

Another distinguishing foreclosure protection is the absence of market value triggers. Under the customary terms of Non-Traditional Loan Facilities, declines in the market value of the Retention Interest alone will not trigger an event of default.

Additional safeguards against the risk of lender foreclosure also include:

- Proportional Interest Deferral. Non-Traditional Loan Facilities are typically structured such that interest on the loan used to finance the Financed Retention Interest will be deferred proportionately with any deferral of interest on the CLO securities which comprise such Financed Retention Interest. Although any such deferred interest is ultimately due and payable at maturity on a full recourse basis, the deferral itself will not constitute a payment default.

- Stated Maturity Date. The stated maturity date of the loan made to finance the Financed Retention Interest is structured to mirror the legal final maturity date of such Financed Retention Interest.

- Cash-Trap Events. Non-Traditional Loan Facilities will often re-characterize certain events or circumstances that would customarily constitute events of default as cash-trap events, the occurrence of which would result in a certain portion of the collections being trapped in a reserve account, rather than giving rise to either loan acceleration or a lender foreclosure right.

- Limited Foreclosure Triggers. Lenders under Non-Traditional Loan Facilities have shown an increasing willingness to limit their foreclosure rights to certain specified events of default—primarily those relating to failure to pay debts when due and protection of the pledged collateral—where, absent a right to foreclose, the lender would have no other satisfactory remedy.

In their totality, the foregoing mitigants fundamentally amount to two layers of foreclosure protection: the first preventing the occurrence of certain events of default that would typically give rise to a foreclosure right, and the second forestalling a lender's right to foreclose and encouraging and facilitating the pursuit of alternative lender remedies after an event of default has occurred.

Even if it were to be assumed that lender foreclosure on the Retention Interest would result in a failure of the Manager to comply with the U.S. Retention Rules, our Manager clients have tended not to regard this as a noteworthy deterrent to utilizing Non-Traditional Loan Facilities. The strength of the protections outlined above would require an improbable convergence of Borrower missteps to trigger a lender foreclosure. An event of default would need to have occurred in spite of numerous protections designed to minimize its probability. The Borrower would need to have failed to avail itself of one of the numerous remedies available to it during an exceedingly favorable Foreclosure Grace Period. Under circumstances such as these, many prospective Borrowers have essentially concluded that, were Manager non-compliance with the U.S. Retention Rules to be the ultimate outcome, such non-compliance is unlikely to be the Manager's most significant concern.

Even supposing lender foreclosure rights were triggered, it is not a foregone conclusion that such rights would be exercised. It has been our experience that lenders under Non-Traditional Loan Facilities have generally expressed a strong reluctance to foreclose in this uncertain legal landscape and would thus only do so as a last resort. These lenders have instead expressed an inclination to primarily regard their foreclosure right as an instrument of leverage, designed to motivate Borrowers to pursue a cure or come to the bargaining table.

Implications of Non-Compliance

An exhaustive analysis of the threshold question of why the Agencies are unlikely to regard a foreclosure on the Retention Interest to be a violation by the Manager of the U.S. Retention Rules is beyond the scope of this memo. Still, it bears repeating that the U.S. Retention Rules expressly permit a Manager to use a full recourse secured loan facility to finance the acquisition of its Retention Interest. And although the U.S. Retention Rules do not explicitly address the consequences of Manager non-compliance, the Agencies have

acknowledged the lack of clarity regarding many aspects of the U.S. Retention Rules and have consistently stated that they will give market participants ample time to cure non-compliance while emphasizing that the most severe enforcement actions at the Agencies' theoretical disposal—such as civil monetary penalties and cease-and-desist orders—will be reserved for those who grossly and flagrantly attempt to circumvent the U.S. Retention Rules. Taking such facts into account, it seems implausible that such Agencies would pursue aggressive and punitive enforcement measures against a Manager who has (either directly or through its MOA) utilized a loan facility that is expressly authorized by the U.S. Retention Rules solely on the basis that the lender has chosen to foreclose upon the Retention Interest that the very same rules expressly permit to be pledged to such lender.

Conclusion

Non-Traditional Loan Facilities have emerged as a ubiquitous CLO risk retention financing solution. While there may be some degree of regulatory uncertainty surrounding lender foreclosure risk in connection with such facilities, the mitigants contained in the documentation for Non-Traditional Loan Facilities protecting such foreclosure from occurring are substantial and strong. Moreover, meaningful Agency enforcement action in the highly unlikely event of such foreclosure would be inconsistent with the Agencies' stated intentions and therefore seems to be a remote possibility.

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