Feature

KEY POINTS

- If different groups of lenders make loans to different borrowers and benefit from different guarantors or collateral, the credit risk borne by some lenders will differ from the credit risk borne by others.
- The objective of Collateral Allocation Mechanisms ('CAMs') is to equalise the credit exposure of lenders under syndicated credit facilities more effectively than do pro rata payment and sharing provisions when the lenders have different guaranties or collateral.
- It has been estimated that there may be approximately 150 global credit facilities with CAMs. Although frequently seen in US-style credit documentation, CAMs are seen rarely, if at all, in British-style credit documentation.
- In the bankruptcies for Lyondell, Aleris International and Cooper Standard, the CAMs effectively accomplished their intended purpose.

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Collateral Allocation Mechanisms ('CAMs') spread risk in global credit facilities

In this feature, Richard M Gray and Cecilio Castillero discuss the mechanics and efficacy of Collateral Allocation Mechanisms ('CAMs').

Equal and ratable treatment of lenders is a hallmark of syndicated credit facilities. In a simple, single-tranche credit agreement, this is achieved by requiring that payments be made to lenders on a pro rata basis and that amounts recovered in any other way (such as by set-off) be shared ratably among all lenders. Even in a credit agreement that includes one or more loan tranches, equal and ratable treatment can still be achieved with some minor drafting adjustments to the pro rata and sharing provisions, so long as the lenders have the same obligors (either as direct borrowers or as guarantors) and collateral. This is so because in any bankruptcy case, lenders holding *pari passu* claims against the same obligor and collateral will be treated equally as a matter of law. However, where a borrowing group includes subsidiaries around the world with multi-currency funding needs, more effort may be required to achieve equal treatment.

Consider a US parent company with US- and non-US subsidiaries, where each member of the group requires loans in the currency of its principal place of business, and a global loan syndication strategy that assumes lenders will look to the consolidated creditworthiness of the entire group. The simplest loan structure to achieve the desired results would be a single, multi-currency, global credit facility with one syndicate of lenders, available for borrowings by all members of the corporate group, where all members guarantee payment by all other members and provide collateral for their obligations. However, this structure may not be optimal (or possible) for many reasons, including: (1) the ability or willingness of individual lenders to make loans in certain currencies may differ because of how they fund themselves; (2) the ability of individual lenders to lend to borrowers in specific countries or currencies may differ because of local licensing requirements; (3) the withholding tax regimes of the jurisdictions where the borrowers are located may result in different treatment for individual lenders; (4) although US members of the borrowing group may guarantee obligations of other members of the group without adverse US tax consequences, guarantees of obligations of the US companies by non-US subsidiaries that are controlled foreign corporations may trigger unwelcome consequences under s 956 of the US Internal Revenue Code; and (5) principles of corporate benefit, financial assistance and the like may limit the ability of some companies to guarantee payment of certain loans to some members of the group, but not others. These considerations may lead to structures where different, though possibly overlapping, groups of lenders make loans to different borrowers and have different guarantors and collateral, all under the same umbrella credit agreement.

If different groups of lenders make loans to different borrowers and benefit from different guarantors or collateral, the credit risk borne by some lenders will differ from the credit risk borne by others. The typical pro rata payment provisions in a syndicated credit facility are inadequate to remedy the disparity because they only apply to amounts payable to lenders under a particular tranche by the same obligors. It would be awkward as well as legally ambiguous to provide that a pro rata portion of a payment made by an obligor (or the proceeds of collateral provided by it) be applied to amounts for which it is not liable. The typical sharing provisions sometimes are similarly limited and, more importantly, come into play only when payments are actually received by lenders. Lenders that have only indirect credit exposure to a borrower through a sharing provision that has not been triggered are not likely to have standing as a creditor in a bankruptcy case for that borrower, and they typically would not be entitled to the benefits of any class voting for the tranches in which they do not hold direct interests. In addition, since it is uncertain if or when the sharing provision would be triggered after a borrower becomes the subject of a bankruptcy case (because triggering depends on the final recoveries from all obligors under all tranches), the difficulty of valuing the loans properly would distort the secondary market for those loans. Enter the CAM.

COLLATERAL ALLOCATION MECHANISMS ('CAMS')

The objective of CAMs is to equalise the credit exposure of lenders under syndicated credit facilities more effectively than do pro rata payment and sharing provisions when the lenders have different guaranties or collateral. Under a typical CAM, each creditor agrees that the loans owed to it will be pooled with the loans owed to the other lenders upon the occurrence of an agreed trigger event and that all of the pooled loans

(with their ancillary guarantees and collateral) will then be reallocated to all of the lenders on a pro rata basis. By operation of the CAM, each lender under each original tranche becomes a creditor of all obligors under all tranches regardless of the original structure of the credit facilities. As a consequence, each lender acquires voting rights under each tranche whether or not it was originally a lender thereunder, and each lender acquires a claim in the bankruptcy of each obligor whether or not such obligor was liable under such lender's original tranche.

It has been estimated that there may be approximately 150 global credit facilities with CAMs. Although frequently seen in US-style credit documentation, CAMs are seen rarely, if at all, in British-style credit documentation. At least three CAMs have involved debtors that have recently emerged from bankruptcy cases in the US: Lyondell Chemical Company (approximately $24bn of funded debt), Aleris International (approximately $2.8bn of funded debt), and Cooper Standard (approximately $1.2bn of funded debt). Set forth in the box overleaf is the CAM from the first lien pre-bankruptcy credit facility for Lyondell Chemical Company. Although CAMs differ transaction-by-transaction, the Lyondell CAM is a good illustration of the most basic elements of a CAM.

Trigger Event: The trigger event in the Lyondell CAM is the occurrence of the 'CAM Exchange Date'. This is defined to include certain events related to bankruptcy or insolvency as well as certain writs of attachment and similar judicial process. The bankruptcy or insolvency trigger event is virtually always present in CAMs. Acceleration is a common trigger event, and payment defaults (sometimes only at final maturity) are also seen, although less frequently.

Exchange Mechanism: Under the Lyondell CAM, as is the case in most CAMs, the trigger event causes an automatic exchange of interests under the various tranches resulting in each lender holding a pro rata share (defined in the Lyondell CAM as the 'CAM Percentage') of the loans under each tranche, irrespective of the lender's original tranche. Because this reallocation of interests is styled as an exchange, the operation of a CAM is sometimes referred to as a 'CAM exchange'. As a result of the CAM exchange, each lender comes into direct privity with the obligors under each tranche as fully as if it were an assignee. In contrast, a few credit facilities provide for the ratable reallocation of risks by means of participations (in American parlance) or sub-participations (in British parlance) granted in the various tranches. Aside from the administrative difficulty (and attendant adverse impact on secondary trading) resulting from overlapping participations in all of the loans under the various tranches, this manner of sharing the risks fails to confer upon lenders the rights that flow from direct privity with obligors. These disadvantages are probably what prompted amendments to the CAMs for Aleris and Cooper Standard shortly before their bankruptcy filings to substitute automatic reallocation by exchange for reallocation by means of agreements to acquire participations.

Pooled Obligations: The pooled obligations in the Lyondell CAM, ie those obligations subject to reallocation among lenders, are defined as 'Designated Obligations'. Virtually all CAMs include outstanding loans in this definition. Complexities arise, however, when a credit agreement includes a letter of credit facility. A letter of credit issuer may come in for a surprise to see that the group of lenders obligated to fund participations in its letter of credit have changed without its consent by operation of a CAM. Similarly, lenders acquiring participations in undrawn letters of credit or in outstanding reimbursement obligations may be surprised to learn that they are required to disburse additional funds to cover these participations. Some CAM provisions (such as in Lyondell) have treated the issue by entirely excluding letters of credit from the CAM exchange, while others include outstanding reimbursement obligations for drawn letters of credit but not undrawn letters of credit, and still others (such as in Cooper Standard) include undrawn letters of credit as well. The mechanics required to include undrawn letters of credit, including the repeated recalculation of the lenders' credit percentages, can become quite complicated, and it may be difficult to explain to lenders their contractual obligations to make further disbursements while their obligors are in bankruptcy. Similar considerations would apply in financing structures that include bankers' acceptances and bills of exchange.

Currency of Obligations: If a credit facility includes debt denominated in more than one currency, the amount of all outstanding obligations must be determined at the time of the CAM exchange using a single, common currency in order to calculate the pro rata shares of the lenders. Calculating these shares is important not only to enable the CAM exchange to take place, but also to ensure that voting rights (both in the bankruptcy and under the credit documentation) correspond to actual credit exposure. However, if the obligations remain denominated in multiple currencies after the initial calculation takes place, then those voting rights may cease to correspond to relative credit exposures as foreign exchange rates fluctuate over time. Accordingly, most CAMs, including the Lyondell CAM, take the additional step of actually converting the exchanged obligations into US dollars at the time of the exchange. Since most lenders are comfortable lending in US dollars, this choice of currency should avoid the problem noted above concerning the inability or unwillingness of some lenders to make loans in certain currencies. Nevertheless, some lenders may still prefer to keep the original currencies of their loans unchanged. For this reason, some CAMs allow each lender to decide at its option whether to redenominate the currency of the obligations owing to it, and other CAMs (principally those where US dollars and Canadian dollars are the only currencies) leave the loans in their original currencies. It may be noted that when obligations are converted into another currency, the interest rate should change as well to reflect the new currency. For example, if euro-denominated obligations are converted into US dollars, the credit documentation should provide that interest formerly calculated by reference to EURIBOR should thereafter be calculated by reference to US dollar-LIBOR. However, notwithstanding the facts that the currency of a loan may be converted and the formula for calculating its interest rate may change, it is typical that interest spreads do not change. Thus, for example, if a US dollar-term loan A with an original maturity of five years was originally priced at LIBOR plus 2 per cent and a euro-term loan B with an original maturity of seven years was originally priced at EURIBOR

Feature

Biog box

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LYONDELL CAM

On the CAM Exchange Date: (i) the Lenders shall automatically and without further act be deemed to have exchanged interests in the Designated Obligations such that, in lieu of the interests of each Lender in the Designated Obligations under each Loan in which it shall participate as of such date, such Lender shall own an interest equal to such Lender's CAM Percentage in the Designated Obligations under each of the Loans and (ii) simultaneously with the deemed exchange of interests pursuant to clause (i) above, the interests in the Designated Obligations to be received in such deemed exchange shall, automatically and with no further action required, be converted into the Dollar Amount, determined using the Exchange Rate calculated as of such date, of such amount and on and after such date all amounts accruing and owed to the Lenders in respect of such Designated Obligations shall accrue and be payable in US dollars at the rate otherwise applicable hereunder.

plus 2.50 per cent, the term loan B would bear interest at LIBOR plus 2.5 per cent after the CAM exchange, ie, it would have a spread 50 basis points higher than the term loan A, even though their terms were now identical (their original different maturities having been accelerated as a result of the bankruptcy).

SECONDARY TRADING AFTER A CAM EXCHANGE

In the Lyondell bankruptcy following the CAM exchange, it was initially unclear whether the credit documentation permitted loans under one tranche to be assigned by a lender without that lender also assigning at the same time a ratable portion of all of its loans held under the other tranches, ie whether the reallocation effected pursuant to the CAM exchange permanently locked in the lenders to holding ratable shares of all tranches (which the secondary loan market referred to as 'CAM strips'). This created near pandemonium in the derivatives market. Many lenders that possessed loan credit default swaps ('LCDSs') hoped to liquidate covered Lyondell credit exposure at LCDS auctions, but the LCDSs covered only specific loan tranches and required physical settlement. Accordingly, if Lyondell loans were permitted to be assigned only as strips across all tranches, in order to collect (for example) on an LCDS covering a $1m term loan A, a lender would have to assign $1m of term loan A *plus* ratable portions of its other term loans, even though it would receive compensation under its LCDS only for the term loan A. In the end, with the assistance of market advisories issued by The Loan Syndications and Trading Association, it was recognised that assignments of loans under individual tranches would be permitted.

Putting aside the legal debate that arose in the Lyondell bankruptcy, a market practice appears to have developed outside of LCDS auctions favouring post-CAM trading on the basis of strips. It avoids the need to assess the effect of different interest spreads for the various tranches and to evaluate whether the legal risks are the same for each tranche, for example whether a guarantee of one tranche is more vulnerable to fraudulent conveyance attack than a guarantee of another tranche. Trading in strips, therefore, can make pricing and trading more efficient.

EFFICACY OF CAMs

In the bankruptcies for Lyondell, Aleris International and Cooper Standard, the CAMs effectively accomplished their intended purpose. While many of the lenders and the administrative agents initially did not understand how the CAMs worked, and some legal ambiguities and administrative challenges presented themselves in how the documents were drafted, questions were ultimately resolved, in many cases with the assistance of market advisories issued by The Loan Syndications and Trading Association. In the case of Lyondell, the primary difficulties related to the question of whether loans could be assigned only as 'strips' across all tranches, or whether they could be assigned separately under individual tranches. In the Cooper Standard bankruptcy, the mechanics of the CAM exchange related to undrawn letter of credit exposure and the associated requirements for lenders to disburse additional funds were among the principal issues.

Certain issues that theoretically could have arisen did not in fact present themselves as problems in these bankruptcies. Although CAMs are primarily intercreditor arrangements, the conversion of loan obligations from one currency into another (and the related effect on the interest rates) can have a financial impact on the obligors. Section 365(e)(1) of the US Bankruptcy Code generally prohibits certain types of clauses that are automatically triggered by bankruptcy filings (so-called '*ipso facto*' clauses). The automatic currency conversions accompanying the CAM exchanges triggered by bankruptcy filings were not challenged in any of these cases as prohibited *ipso facto* clauses.

As noted above, several of the reasons for having a loan structure with different groups of lenders making loans to different borrowers arise from problems for certain lenders making loans in certain currencies, local law licensing requirements that affect the ability of certain lenders to make loans to certain borrowers and withholding tax considerations. One might reasonably expect one or more of these issues to be problematic after a CAM exchange occurs, but they did not arise in these bankruptcies. In the case of currency conversion, it may well be that the easy availability of US dollars rendered moot any theoretical concern. Local law licensing requirements is a potentially more serious issue, but the difficulty of identifying all of the lenders in a large global bankruptcy may negate the practical effect of these requirements. Finally, concerns about applicable withholding taxes and whether lenders are protected by appropriate 'gross-up' indemnities lose much of their importance when lenders are at risk for loss of the principal of their loans.

While one can speculate about the reasons that certain theoretical issues relating to the CAMs did not arise in these bankruptcies, it is not yet clear whether these issues will remain theoretical only. So far, CAMs have proven to be effective, have been implemented in accordance with their purpose and have yielded the expected results. For these reasons, and because multi-jurisdictional, multi-currency financings can be expected to continue, CAMs are likely to survive as mainstays for these types of transactions. The continued testing of CAMs may result in some unresolved issues being addressed more clearly and in greater detail. ■