CLOS AS RESTRUCTURING PARTICIPANTS

Given their extensive holdings of leveraged debt, CLOs are now increasingly likely to be influential in a restructuring process or liability management exercise. The potential restrictions inherent in the nature of a CLO may thus have a bearing on any given restructuring or maturity amendment. Restructurings have evolved to accommodate such restrictions but these factors continue to play out in the context of maturity extensions.

LIMITATIONS ON CLO MANAGEMENT

The collateral manager of a collateralised loan obligation ("**CLO**") is engaged to actively manage the CLO portfolio - which consists predominantly of broadly syndicated, leveraged loans - with the aim of maximising the arbitrage between returns on the portfolio and the CLO debt liabilities.

The ability of the CLO collateral manager to manage the portfolio of collateral obligations is governed by a range of investment criteria, asset-level eligibility criteria and portfolio-level concentration limits that regulate the composition of the portfolio over the life of the deal. These criteria and limits operate to manage the risk and maturity profile of the portfolio, helping to ensure returns for investors in the CLO are in line with those they accepted when the price of the CLO debt was locked in.

The vast majority of a CLO portfolio – typically in excess of 90% - is required to consist of senior secured debt obligations, which are the most robust form of collateral from a credit perspective. However, there are buckets for other types of collateral obligation to accommodate a limited amount of riskier assets in order to, for example, boost yield for investors, and tolerate certain restructuring activities arising in the portfolio over the life of the CLO.

EVOLUTION OF CLOS AS RESTRUCTURING PARTICIPANTS

Specific categories of provisions that permit restructuring processes within the portfolio have evolved in CLO documentation, in recognition by CLO collateral managers and investors that it can be beneficial for the CLO to retain an asset during a restructuring. This enables investors (in particular, investors in the equity) to participate in the upside created from the restructuring, rather than the CLO being subjected to a forced sale of the asset ahead of the restructuring for a price that is lower than the price the CLO paid to acquire it.

To ensure the risk profile of a CLO portfolio remains acceptable to investors and the introduction of restructuring provisions does not detriment pricing of the CLO debt, the evolution of these provisions has been accompanied by limitations and caps on their use. For example, while corporate rescue loans are a way for CLOs to advance new money to support a formal restructuring process, they must rank senior in the obligor's capital structure. Loss mitigation loans are a more flexible tool than corporate rescue loans and permit a CLO to advance new money in order to mitigate losses where considered reasonably necessary to enhance and/or protect the recovery value of the relevant collateral obligation. However, there are restrictions on the CLO's use of proceeds (in particular, principal proceeds) to acquire loss mitigation loans.

SPECIFIC RESTRUCTURING TECHNIQUES FACILITATE CLO PARTICIPATION

Some lender syndicates have employed specific techniques to support CLO participation in restructuring processes. These techniques help CLO lenders navigate around provisions in the CLO documents that would otherwise prohibit the CLO holding the restructured asset and/or impose haircuts on the value of the restructured asset for the purpose of the CLO overcollateralisation tests.

Avoidance of "CCC" buckets

A primary driver of CLO collateral managers in a restructuring will be to procure that the reinstated first lien debt has a rating that is high enough to keep it out of the "CCC" buckets, which are typically set at 7.5% of the CLO portfolio. Any excess of "CCC" rated assets over those buckets will be subject to haircuts for the purpose of overcollateralisation tests and may subject the collateral manager to trading restrictions.

Structuring around equity

CLO collateral managers will want to avoid a restructured asset being treated as equity for the purpose of the CLO. By its nature, equity – a much riskier asset than debt and without a fixed income stream – does not align with the risk profile of a CLO. While a CLO may be permitted to receive equity in a restructuring of a collateral obligation, that equity may be discounted entirely or (if it qualifies as a loss mitigation loan) be subject to punitive treatment for the purpose of the overcollateralisation tests.

Utilising HoldCo PIK

One technique aimed at avoiding restructured collateral obligations being classified as equity under the CLO is to structure the excess cashflows on the asset as a dividend up to a HoldCo, creating HoldCo PIK debt. If the HoldCo PIK debt is the most senior debt at the HoldCo level, the CLO collateral manager may be able to fit it within the "PIK Security" bucket of the CLO (typically sized at up to a maximum of 5% of the portfolio).

If the HoldCo PIK debt has features that make it ineligible as a "PIK Security", the collateral manager may need to look at fitting it within one of the categories of CLO restructuring provisions, such as loss mitigation loans. However, this may impact the value the debt is given in the overcollateralisation tests.

Structuring the HoldCo PIK debt so as to give it a small, regularly scheduled interest component, could, depending on the definitions and criteria of the specific CLO (including whether the "PIK Security" definition requires all interest to defer, or permits a regular cash coupon), give the collateral manager greater flexibility as to how to classify it under the CLO documents, and help it circumvent use of categories (such as loss mitigation loans) that would subject the asset to haircuts. Further, if that coupon is given a floating (rather than fixed) rate, the CLO can avoid use of the fixed rate bucket (which, in recent deals, is typically sized at 10-15% of the portfolio).

MATURITY EXTENSION

Long-dated collateral obligations, with a maturity falling later than the maturity date of the CLO debt, are subject to caps and (depending on the deal) haircuts under the CLO documents. CLOs have a limited bucket for long-dated collateral obligations, typically ranging from 2.5-7.5% of the portfolio. Most (but not all) deals impose haircuts on long-dated assets for purposes of the overcollateralisation tests, with certain deals giving punitive collateral treatment to long-dated assets that fall within, as well as outside, the permitted long-dated buckets. Therefore CLO lenders will be keen to manage the extent of maturity extensions arising in a restructuring.

Another factor influencing the maturity profile is the weighted average life test. This helps manage the risk of the CLO portfolio maturing after the CLO debt, thereby ensuring CLO debt investors will receive the return of their principal investment in line with the amortisation profile anticipated when they first purchased their investment.

"Snooze-drag"

CLO documents have typically included as a condition (subject to limited exceptions) to the collateral manager voting in favour of a maturity extension, that the weighted average life test be passing (or in certain deals, maintained or improved). However, there have not historically been restrictions on a CLO being passively dragged into an extended facility under the "snooze-drag" provisions in the underlying loan documents where the maturity extension has been pushed through by the requisite threshold of lenders, including where the CLO weighted average life test is failing.

Pressure from senior debt investors has led to some recent deals imposing restrictions on the collateral manager utilising "snooze-drag" in this way, including, for example, an obligation on the collateral manager to vote against the maturity extension if the conditions that would permit it to vote in favour are not satisfied, subjecting the CLO to a forced sale of a collateral obligation that is subject to a maturity extension the collateral manager did not vote in favour of, and/or imposing haircuts on assets that have had their maturity extended in this way.

Transparency on "snooze-drag"

Investors are now looking for increased transparency on use of "snooze-drag", with some recent deals requiring investor reports detail collateral obligations that have been subject to a maturity amendment where the weighted average life test is not satisfied, including how the collateral manager voted on the extension, or collateral obligations that have been subject to a maturity extension where the CLO has been "snooze-dragged" into it.

Use of schemes and plans

As flexibility to use "snooze-drag" is reduced, the use of schemes of arrangement or statutory restructuring plans will likely become more prevalent. A scheme may be utilised to bind passive or dissenting CLO lenders into a restructuring by way of court mandate, when those lenders would otherwise be unable to participate due to, for example, restrictions on them voting on a maturity extension under the CLO documentation.

ENHANCED CLO PARTICIPATION IN RESTRUCTURING

Whilst the terms of the specific CLO would need to be reviewed in the context of the fact pattern of a particular restructuring or liability management scenario to assess the scope for the CLO lender to participate, with the use of particular restructuring techniques CLO lenders can play a significant role in any such process.

FOR MORE INFORMATION

This briefing provides an overview of some common features of the transactions discussed and is not intended to be exhaustive. It does not constitute legal advice and is provided purely for informational purposes. We recommend that you seek specific legal, regulatory, tax and accounting advice for any transactions that you wish to undertake.

Our Structured Finance team is available to discuss any of these issues with you and answer any specific questions you may have. If you would like more information about the topics raised in this briefing, please speak to your regular contact at Weil or to any of the authors listed below:

JACKY KELLY

+44 20 7903 1045
jacky.kelly@weil.com

BRIAN MAHER

+44 20 7903 1292
brian.maher@weil.com

STEVEN ONG

+44 20 7903 1041
steven.ong@weil.com

SOPHIE BAINBRIDGE

+44 20 7903 1166
sophie.bainbridge@weil.com