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Alert

CLO Guidance — The Impact of COVID-19 — Considerations for Managers of Collateralized Loan Obligations

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The recent worldwide outbreak of coronavirus disease 2019 ("COVID-19") has resulted in extraordinary actions, including quarantines and "social distancing," which is currently disrupting economic activity in the United States and globally.

This, coupled with a disruption in the energy industry due to a severe drop in oil prices resulting from a lack of agreement on drilling output limits by certain OPEC nations, is having a negative effect on certain industries.

On Sunday, March 15, 2020, the Open Market Committee of the Federal Reserve Bank reduced the target range for the federal funds rate to 0.00% — 0.25%, and the U.S. Congress is currently considering emergency legislation to support the economy throughout the crisis. Actions by federal, state and local governments to mitigate the impact of the coronavirus, as well as continued market volatility arising from the spread of coronavirus, are likely to affect collateralized loan obligations ("CLOs") and their underlying assets. CLO managers should consider the effects this will have on their CLO transactions and should note the following:

1. CLOs usually carry their collateral obligations (other than collateral obligations purchased at a discount) at par value for purposes of overcollateralization tests; however defaulted collateral obligations are typically counted at market value for overcollateralization tests, and collateral obligations whose ratings are "CCC+" or below (to the extent not treated as defaulted obligations) are also typically adjusted for purposes of the overcollateralization tests.
2. For CLOs purchasing collateral obligations at deeply discounted prices (below certain threshold prices, depending on the ratings of the obligations) at this time, it is important to recall that these collateral obligations typically will be carried at their purchase price for purposes of the overcollateralization tests.
3. Should loan prices continue to decline, CLO managers should review their ability to swap discounted collateral obligations with the sale proceeds of a collateral obligation without having to treat the new loan as a discount collateral obligation. In addition, CLO managers should take note of their minimum purchase price criteria.
4. If CLO loan portfolios deteriorate (whether as a result of price declines, ratings downgrades on individual loans, or a general weakening of obligors' financial strength) and rating agencies begin to downgrade CLO notes, the ability to trade loans may be suspended if a "restricted trading period" goes into effect under a CLO's indenture.

5. CLO managers should review their CLO indentures to determine their ability to agree to amendments, restructurings and workouts in anticipation of loan obligors looking to take certain actions.
6. Engagement letters for CLOs usually have "no material adverse effect" conditions that are broadly written and expressly include the absence of adverse market conditions, which if not satisfied in the discretion of the CLO arranger, entitle the arranger to determine not to proceed with the CLO.
7. Arrangers and other banks that provide warehouse credit facilities (whether in anticipation of a CLO or as permanent financing) will usually retain full discretion to approve assets to be acquired under the warehouse facility. During adverse market conditions, the bank could use this discretion to cease approving assets.
8. CLO managers that have warehouse credit facilities with market value default triggers or funding conditions might want to consider their options if a trigger is hit (e.g., make additional equity contributions, liquidate certain assets, or prepay the facility).

There will be economic challenges posed by the coronavirus and the global response to it, and CLOs are likely to feel the effects. Schulte Roth & Zabel will continue to provide updates as further developments become known.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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