Proskauer

CLOs: A New Frontier for Distressed Investors

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The recent chapter 11 filing of *Deluxe Entertainment*[1] has the distressed investing community talking about collateralized loan obligations, or CLOs. CLOs have become big business in the world of leveraged finance, and we believe their unique characteristics affect their increasingly frequent workouts. Here, we describe the nature of CLOs, their prevalence, their impact on the *Deluxe Entertainment* bankruptcy, and, lastly, we offer practical insights on how to deal with CLOs in the next restructuring cycle.

A. CLOs Generally

A CLO is a fund that raises debt and equity capital from investors, the proceeds of which are principally used to acquire a portfolio of senior secured loans (typically 150-250 different loans) issued to below investment grade borrowers. The principal and interest payments on the underlying loans held by the CLO are used to pay the CLO investors. The capital raised by CLOs is divided into separate tranches, each of which has a different risk/return profile based upon its priority claim to the cash flows produced by the underlying loan portfolio.[2]

Notably, and as discussed further below, CLO fund documents often include a variety of restrictions intended to help protect CLO investors from loss. Examples of these restrictions include limitations on the CLO's exposure to second lien or unsecured loans and the amount of CCC-rated debt that can be held in the portfolio. In addition, some CLO funds are not permitted by their origination documents to invest in equity securities.[3]

B. How Prevalent are CLOs?

According to recent research, the CLO market grew from a post-crisis trough of roughly $260 billion in 2012 to $620 billion as of January 2019.[4] At over $600 billion, CLOs represent half of the total $1.2 trillion U.S. leveraged loan market. The other half of the U.S. leveraged loan market is primarily held by loan exchange traded funds, separately managed accounts, credit funds, and banks.[5]

C. What Happened in *Deluxe Entertainment*?

In *Deluxe Entertainment*, the debtor's liabilities included a loan held by several CLO funds. The debtor attempted to pursue a stapled prepack, which is an arrangement whereby the company simultaneously solicited acceptances to an out-of-court exchange offer and a prepackaged chapter 11 plan "stapled" to it. The goal was to consummate the exchange offer out-of-court, but with the backstop of a 24-hour prepack in the event the debtor could not procure unanimous consent to the exchange offer. The prepack contemplated a one-day chapter 11 case. As the debtor was working to implement the stapled prepack, it became apparent the company would require at least $25 million in incremental financing. Around that time, however, Standard & Poor’s downgraded the credit rating of the company’s term loan to CCC.

Given the restrictions in some of the CLO fund documents, certain of the CLO funds that had previously expressed willingness to finance the company’s stapled prepack were no longer able to do so after the downgrade (presumably because, as is the case with many CLO funds, they could not hold more than 7.5% of CCC-rated debt in their respective portfolios). While certain lenders were able to provide $14 million of the incremental financing, that amount was insufficient to consummate the out-of-court transaction or the 24-hour prepack. The company attempted to quickly bridge the gap by canvassing the market for third-party lenders willing to fund the $9 million deficiency, but no additional financing materialized. As a result, the company was forced to pivot towards a longer prepackaged chapter 11 case, instead of the originally-intended out-of-court exchange offer or 24-hour prepack.[6]

D. Practical Insights

The existence of CLO funds in Deluxe Entertainment's creditor constituency seems to have had a direct impact on the company's restructuring path. If CLOs had not held the company's term loan debt or if the limitations regarding CCC-rated debt in certain CLOs' governing documents had surfaced earlier, it seems Deluxe Entertainment would have had a higher likelihood of consummating either the originally-intended out-of-court exchange offer or the 24-hour prepack. Indeed, it was suggested at the first day hearing in the bankruptcy case that the company would have had more time to plug the $9 million deficiency of incremental financing from third-party lenders had the CLO restrictions come to light earlier. Instead, the company had to switch gears and pursue a longer prepackaged chapter 11 case than it originally planned. While the end result was still a successful corporate restructuring, *Deluxe Entertainment* nonetheless is a case study teaching a lesson.

In the old days, bank lenders frequently had rights in their loan documents to restrict transfers of the loan. For the most part, banks were adverse to non-bank entities purchasing pieces of their loans because the non-banks were often not set up to issue and administer new debt. Additionally, they were subject to different accounting rules and therefore had different objectives and constraints in workout negotiations. Today's "covenant-lite" debt documents often do not include those transfer restrictions of yesteryear.

Going forward, borrowers must actively monitor the profile of investors holding their debt with particular attention to the presence of CLO funds and any restrictions in their respective governing documentation (which may vary by CLO)—this way, borrowers can account for and properly address any potential hurdles with sufficient lead time. Similarly, distressed investors also must endeavor to understand the motivations and limitations of any CLOs when strategizing around a distressed investment opportunity. Because such information may not be publicly available, debtors and creditors alike may need to ask CLOs directly about any limitations in their governing documents and/or be aware of all the potential provisions in the CLOs' governing documents that could impact the restructuring. For instance, just being aware that many CLOs have limitations on the amount of CCC-rated debt that can be held in their portfolio alone may prove valuable.

Indeed, the proliferation of CLOs may increasingly shape restructuring outcomes. By way of example, an interesting dynamic may form among lenders in a group if some lenders are CLO funds while others are more flexible investment funds—the more flexible investment funds may be negotiating for the class of creditors to receive reorganized equity while the CLO funds could be bargaining for the class to receive take-back paper (given certain CLO fund documents do not permit CLOs to hold equity securities).

Another example could arise when a distressed company has a loan held by both CLO and non-CLO funds. In such a situation, assuming the CLO fund lenders do not hold a blocking position in the class, the non-CLO fund lenders may propose a restructuring predicated on the infusion of new capital on a dilutive basis (*e.g.*, through a rights offering) made available to all lenders in the class. If successful, the non-CLO fund lenders could obtain an outsized share of the reorganized company compared to what they would have received had there been no participating CLO fund lenders. Additionally, many CLO funds may decline to participate in rescue financing to a troubled company because they want to minimize their exposure to CCC-rated debt, especially if CLO fund managers wish to preserve capacity for their 7.5% buckets in anticipation of a market downturn. Or, CLO funds may restrict their new loan commitments to restructured borrowers who will have investment grade ratings upon implementation of a restructuring that deleverages them.

Ultimately, a distressed investor unaware of a CLO fund's potential differing motivations will not be as effective as an investor with more awareness of the realities at play. Given the CLO funds' sizeable share of the leveraged loan market (particularly senior secured loans), they will play a key role in the next restructuring cycle. All relevant parties in interest will need to understand how CLO funds affect the dynamics of corporate reorganizations. Thus, we have come full circle. Experienced lenders of yesteryear learned long ago – know thy co-lenders.

[1] Case No. 19-23774 (RDD) (Bankr. S.D.N.Y. Oct. 3, 2019).

[2] *See* Scott Minerd et al., *Understanding Collateralized Loan Obligations*, Guggenheim Investments, May 2019, at 1.

[3] *See id.*, at 4. *See also* Jennifer Johnson, *Collateralized Loan Obligations (CLOs) Primer*, National Association of Insurance Commissioners' Capital Markets Bureau, at 4-5.

[4] *See* Emily Liu & Tim Schmidt-Eisenlohr, *Who Owns U.S. CLO Securities?*, FEDS Notes (Figure 1), Board of Governors of the Federal Reserve System, July 19, 2019, https://doi.org/10.17016/2380-7172.2423.

[5] *See* Minerd et al., *supra*, at 6.

[6] *See* Case No. 19-23744 [ECF No. 12] ⁋⁋ 7-8.

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