COVID-19 Coronavirus Business Impact: CLO Indenture Update

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April 2020

Dechert LLP

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Mark Twain is often misquoted as saying "History never repeats itself, but it often rhymes." Whoever said them, these words certainly come to mind in the current economic crisis brought about by the COVID-19 pandemic. Although the circumstances are quite different from the credit crisis of 2007-2008, CLO market participants find themselves navigating a number of the same issues that arose during that crisis. Given the incredible, and fast unfolding, events of the last couple of months, market participants have faced a gauntlet of difficult circumstances brought about by defaults and downgrades of assets within current CLO portfolios.

Interestingly, at a time when many lenders have shown admirable restraint in dealing with borrowers (including leveraged loan and SPV borrowers), so as to avoid a repeat of the mistakes made during the great financial crisis of 2007-2008, many rating agencies have interpreted their mandate in a different light. As of April 20, 2020, over one thousand CLO tranches have been put on negative watch or outlook by the three major rating agencies,[1] and according to Creditflux, only 18% of US CLO managers have avoided negative rating action.

Because of this, many in the CLO market have had questions regarding the provisions in CLO indentures dealing with defaults and downgrades. While every transaction is different, and specific answers will depend on the fine print in the underlying documents, this OnPoint is intended to serve as a general guide and refresher as to the impact of distressed assets and debt tranches under a typical CLO indenture. For more specific questions, please feel free to reach out to any member of the Dechert Global CLO Team, and we would be more than happy to assist.

Considerations With Respect to Collateral Obligations

Downgraded Obligations

The COVID-19 crisis and resulting shutdown of huge swaths of the global economy have resulted in a swift domino effect of negative consequences for CLOs. The most immediate consequence has been a large scale downgrade of leveraged loan ratings by rating agencies. While CLOs are generally allowed to hold a small portion of so-called "CCC Loans" (loans rated below 'B3' or 'B-', depending on the rating agency), these are subject to strict concentration limits and collateral quality testing. CCC Loans in excess of such concentration limits are subject to a haircut or discount designed to protect against further downward credit migration, and if the loans are downgraded to a sufficiently low rating, they may be treated as defaulted.

[1] Moody's Investor Service, Inc., S&P Global Ratings and Fitch Ratings, Inc.

Concentration Limits and Collateral Quality Tests

As noted above, CCC Loans are subject to strict concentration limits, typically around 7.5% in most CLOs.[2] If any such concentration limit is exceeded, then the CLO will not be permitted to purchase new CCC Loans under the CLO's investment criteria. In addition, for those CLOs with Moody's ratings or otherwise applying Moody's methodology, as loans are downgraded the weighted average Moody's rating factor of the portfolio will rise, which may lead to the CLO failing the Moody's rating factor test. A failing Moody's rating factor can, in some cases, shut off the CLO's ability to reinvest principal proceeds entirely, or may result in any newly-purchased assets being required to have lower Moody's rating factors than the portfolio as a whole. If rating downgrades continue throughout the loan market, this could severely limit the availability of suitable assets for purchase by CLOs.

CCC Excess and the Overcollateralization Tests

CCC Loans in excess of the concentration limit for such loans — based on the greater excess with respect to each rating agency rating the loans — will typically be carried at their market value, or the lower of market value and recovery rate, for purposes of the overcollateralization tests. Most CLO indentures require CCC Loans with the lowest market values to be included in the CCC excess. Therefore, if rating agencies downgrade large portions of the portfolio of loans held by the CLO below B3/B-, this could lead to failing overcollateralization tests, which would result in the CLO amortizing the secured notes with interest proceeds, and could lead to the inability to reinvest principal proceeds. See "*Investment Criteria*."

Note that CLO indentures typically carve out certain categories of loans — most commonly defaulted loans and deferring loans, though in some cases also discount and current pay loans — from the definition of CCC Loans used to calculate the CCC excess. Depending on how these other categories of loans are valued, CLO managers may find that classifying a portion of CCC Loans in these other categories results in a higher overall overcollateralization ratio.

Treatment as Defaulted Obligation

Extreme downgrades could lead to a CCC Loan being treated as a defaulted obligation. Most CLO indentures treat a loan as a "Defaulted Obligation" if the loan (or another obligation issued by the same obligor subordinate or *pari passu* to such loan) has either an S&P Rating of "SD" or "CC" or lower, a Fitch Rating of 'D' or 'RD', or a "probability of default" rating by Moody's of 'D' or 'LD' (or, in any case, had such a rating before it was withdrawn). For the consequences of a loan becoming a Defaulted Obligation, see "*Defaulted Obligations*."

Defaulted Obligations

In addition to downgraded assets, it is likely that there will be an increase in the number of leveraged loan payment defaults in the months ahead. Further, certain waivers or amendments to the underlying instruments (in an effort to stave off payment defaults) and other adverse events could cause loans included in CLOs to be treated as Defaulted Obligations.

With respect to potential payment defaults, the distinction between a Defaulted Obligation and a Deferring Obligation can make a difference with respect to how the asset is treated for purposes of the collateral quality tests, the coverage tests and CLO-level events of default. In addition, it's worth considering that the CLO manager can

[2] The relatively recent low-levered, or "high CCC," CLOs in the market have much higher thresholds (up to 50% in some cases), and may well have an advantage over other CLOs in the market in the coming months.

generally direct the trustee to sell Defaulted Obligations at any time without restriction (i.e., such sales are not subject to the restrictions on discretionary sales).

What is a Defaulted Obligation?

Subject to certain carve-outs discussed below, a Defaulted Obligation is generally one as to which one or more of the following has occurred:

- Payment Default: There is a failure to pay principal or interest when due, in respect of either the loan in question or another, senior or *pari passu* loan of the same obligor, past a certain maximum grace period if (and only if) the CLO manager certifies that the default is not due to credit-related causes, and irrespective of any waiver or forbearance by the lenders.

- Insolvency: Bankruptcy proceedings are commenced with respect to the obligor, subject to a period of time for the proceedings to be discharged in the case of involuntary proceedings.

- Downgrade: A downgrade or withdrawal of credit rating occurs, with respect to either the loan in question or another, senior or *pari passu* loan of the same obligor (see "*Downgraded Obligations*").

- Cross-Acceleration: There is a default (other than a payment default) and acceleration under the related underlying instruments.

- Determination: CLO manager determines that the loan should be treated as defaulted.

- Participation Default: In the case of a loan held in the form of a participation, there is a default or other adverse events in respect of the participation seller.

However, certain types of loans[3] may not be counted as Defaulted Obligations after a payment default, insolvency or downgrade, so long as they have not defaulted on their payment obligations on the specific loan held by the CLO.

Overcollateralization and Interest Coverage Tests

Defaulted Obligations are haircut or discounted for purposes of the overcollateralization tests, typically at a mark corresponding to the expected recovery amount according to the relevant rating agencies for the first three years the asset is defaulted (but no higher than the asset's then-current market value), and zero afterwards. If any Defaulted Obligations are held for a three-year period, any measurement under the CLO indenture using the aggregate principal balance will exclude such Defaulted Obligations.

For purposes of the interest coverage test, only interest proceeds actually received with respect to a Defaulted Obligation are included in the calculation of the interest coverage ratio (as opposed to including interest proceeds that are expected to be received during the related collection period). Defaulted Obligations are given further negative treatment in the interest coverage test, because any amounts received in respect of a Defaulted Obligation (including interest payments) are treated as principal proceeds until the total collections on the loan since it became a Defaulted Obligation equal its principal balance on the date it became a Defaulted Obligation.

[3] Such loans would include so-called current pay loans and debtor-in-possession loans.

Due to these haircuts and exclusions, in the event that a substantial portion of the loans in a CLO were to become Defaulted Obligations, it could lead to a failure of the overcollateralization and interest coverage tests, which would result in the deal amortizing the secured notes with interest proceeds, and could lead to the inability to reinvest principal proceeds. See "*Investment Criteria*".

Furthermore, Defaulted Obligations are typically haircut at their market value in calculating the overcollateralization-based event of default trigger in a CLO. See "*Events of Default — Event of Default for Overcollateralization Failure on the Class A Notes*". Therefore, beyond the simple inability to reinvest, in the event that a substantial portion of the loans in a CLO were to become Defaulted Obligations, this could give rise to an acceleration of the CLO notes.

Collateral Quality Tests

Collateral quality tests (such as portfolio rating, spread, diversity, recovery rate and average life) provide the standards for the aggregate portfolio of loans owned by the CLO. When calculating these tests, CLOs largely exclude Defaulted Obligations, which can put stress on the ability of the tests to be satisfied. The failure of the collateral quality tests can lead to the inability to reinvest principal proceeds or an inability to sell, unless such sale improved the non-compliant test. See "*Investment Criteria*".

Deferring Obligations

While not explicitly excluded from the definition of Defaulted Obligation, loans that are deferring and capitalizing interest payments will generally not be treated as Defaulted Obligations to the extent that the obligor is not defaulting on any current cash-pay interest due under the underlying instruments. However, once the loan has been deferring payments for a specified period (typically the shorter of one year and two consecutive accrual periods if the loan is rated investment-grade, or the shorter of six months and one accrual period of below-investment grade), these loans become "Deferring Obligations," continuing until all capitalized and current interest thereon is paid in cash.

Deferring Obligations are given similarly negative treatment as Defaulted Obligations for purposes of the coverage tests and the collateral quality tests. They are subject to the same overcollateralization test haircut (for purposes of the coverage tests, though not usually the Event of Default overcollateralization ratio test) as Defaulted Obligations, and as with Defaulted Obligations, only interest proceeds actually received are included in the calculation of the interest coverage ratio.

Because a loan can often be amended to permit the capitalization of interest prior to the occurrence of an actual payment default, CLO managers should consider whether the more favorable treatment given to Deferring Obligations as compared to Defaulted Obligations (i.e., not being haircut in the overcollateralization-based event of default trigger and not having to count interest receipts as principal proceeds) merits pursuing such an amendment, rather than letting the loan suffer a payment default and be treated as a Defaulted Obligation.

Equity Securities

As assets go through a restructuring or workout scenario, it is likely that part of the package of obligations received by the lenders (including lenders that are CLOs) may include "Equity Securities" — generally defined as an asset that, at the time of purchase or receipt by the CLO, does not satisfy the requirements of a collateral obligation and is not an eligible investment. While CLOs are not generally allowed to purchase equity securities, they may receive equity securities in connection with an insolvency or workout so long as such equity securities would be considered "received in lieu of debts previously contracted" under the Volcker Rule.[4]

How CLOs navigate restructurings/workouts was a hot topic coming into 2020 and we would expect the current economic crisis to further magnify the issue given CLOs are generally subject to certain restrictions that are not applicable to non-CLO lenders in this context.

Receipt of Equity Securities

The Volcker Rule generally permits entities relying on the "loan securitization" exclusion (which includes most CLOs) to receive Equity Securities in a workout, because such Equity Securities would be "received in lieu of debts previously contracted." However, CLOs are subject to additional restrictions on receiving Equity Securities, including:

- Limitations on funds: Because principal proceeds may only be used to purchase an asset in compliance with the CLO's investment criteria, CLOs are generally not permitted to acquire any Equity Security that requires the CLO to put in "new money" to receive it, although some CLO indentures permit the use of interest proceeds or capital contributions to exercise a warrant on an existing collateral obligation.

- Tax guidelines: Generally, if the receipt of an Equity Security is protective of the CLO's investment, the tax guidelines will permit receipt of the Equity Security. However, depending on the type of Equity Security, the CLO may have to form a tax blocker subsidiary to hold the Equity Security.

Treatment of Equity Securities

Equity Securities are not considered "collateral obligations" under CLO indentures, and so are excluded from any test or other provisions of the indenture specific to collateral obligations. Equity Securities are also deemed to have a principal balance equal to zero. Any proceeds of an Equity Security received in exchange for a Defaulted Obligation are treated as principal proceeds (and not interest proceeds) until the total collections on such Equity Security equal the principal balance on the date the Defaulted Obligation became a Defaulted Obligation.

Sales of Equity Securities

As with Defaulted Obligations, CLOs may sell any Equity Security at any time without restriction. However, unlike Defaulted Obligations, many CLO indentures require the CLO manager to use commercially reasonable efforts to sell any Equity Security within three years after receipt, or within 45 days in the case of Equity Securities that constitute margin stock. The additional requirement to sell Equity Securities could result in the CLO receiving lower returns on an Equity Security than it otherwise could have if it continued to hold such Equity Security.

[4] Section 13 of the Bank Holding Company Act of 1956, as amended from time to time. Proposed changes to the Volcker Rule were proposed by the five regulators responsible for overseeing the Volcker Rule on January 30 of this year. These changes, if enacted, would allow an entity relying on the "loan securitization" exclusion from the Volcker Rule (including most CLOs) to hold up to 5% of their assets in the form of securities, without those securities having to have been received in lieu of debts previously contracted for. If the proposed changes to the Volcker Rule take effect, this should make it easier for CLOs to receive and hold securities without having to analyze whether they satisfy the "received in lieu" requirement of the current rule. However, currently there is no guaranty as to whether these changes will be enacted or not.

Discount Obligations

A Discount Obligation is a loan acquired by the CLO for a price below a certain specified percentage of par, generally from 75-85% depending on the rating of the loan.[5] A loan may no longer be counted as a Discount Obligation if its market value rises above a higher threshold for a set length of time. Discount Obligations are carried at a haircut and typically subject to a concentration limit. However, a loan otherwise classified as a Discount Obligation may not be depending on how it was purchased.

Haircut of Discount Obligations

Discount Obligations are haircut for purposes of the overcollateralization tests at their purchase price. Therefore, purchasing a large amount of Discount Obligations could lead to par erosion for purposes of the overcollateralization tests. Additionally, to the extent any Discount Obligations later increase in market value, this increase will not be reflected in the overcollateralization test, unless the loan rises above the threshold to no longer be considered a Discount Obligation.

Concentration Limitation on Discount Obligations

Some (but not all) CLO indentures limit the portion of loans that can be purchased at a deep discount to par. Any limitation on purchasing Discount Obligations under the current leveraged loan market could result in the CLO being unable to reinvest, as virtually all loans may be trading at a significant discount to par in a period of extreme market dislocation. (For context, the average secondary loan market trading price during the 2008 credit crisis fell below 70%, according to the LSTA.)

Swapped Non-Discount Obligations

Many CLO indentures allow a small basket (typically sized around 5% of the portfolio) for the CLO to purchase a loan at a discount to par with the sale proceeds of another loan that wasn't a Discount Obligation at the time it was purchased, and if the new loan was purchased for a price no lower than the sale price of the sole loan, has the same or better rating, and is purchased above a threshold minimum price, the new loan won't be treated as a Discount Obligation even though it would otherwise qualify. Swapped Non-Discount Obligations can be a useful tool to either avoid the concentration limitation on Discount Obligations, or avoid a haircut in the overcollateralization test during a time when the loan market is trading at a discount.

Trading, Exchanges and Amendments

Investment Criteria

CLOs are required to comply with stated criteria for any purchases of additional loans (the "Investment Criteria"), both during and, if applicable, after the end of the CLO's reinvestment period. As discussed below under "*Distressed Exchanges*", this includes a distressed scenario if there is a "new money" purchase (as opposed to an exchange) of assets in connection with such a distressed scenario. In addition to the ordinary-course requirements, certain CLO

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[5] Due to the recent experience where the entire leveraged loan market was trading in discount territory, we have seen a number of recent CLOs in which this determination was based off of the lower of a specified percentage of par and trading below a specified percentage of a designated leveraged loan index. This will be an interesting segment of the market to watch over the coming months, given that managers will have to juggle attractive pricing with rating downgrades on leveraged loans.

indenture provisions may either relax (trading plans) or tighten (restricted trading periods) the restrictions on buying and selling assets.

Ordinary-Course Purchases During and After the Reinvestment Period

During the reinvestment period, CLOs can use principal proceeds to purchase additional loans that satisfy the CLO's Investment Criteria on a trade date basis. Generally these Investment Criteria require:

- any purchased loan meets the eligibility criteria for the CLO;
- each coverage test will be either be satisfied or maintained/improved;
- each requirement of the collateral quality tests and the concentration limits will either be satisfied or maintained/improved; and
- in the case of assets purchased with the proceeds of the sale of other assets, if the aggregate principal balance of all of the loans held by the CLO isn't at least equal to the target par balance, then either the adjusted collateral principal amount of the portfolio will be maintained or increased, or the principal balance of the purchased loans will be greater than or equal to the sale proceeds (in the case of sold loans that were Defaulted Obligations, credit risk loans or credit improved loans) or the principal balance (in the case of other discretionary sales) of the sold loans.

To the extent that a CLO is allowed to purchase additional loans after the reinvestment period (which will typically be limited to purchases using the proceeds of unscheduled prepayments and sale proceeds from credit risk loans), the above Investment Criteria must still be satisfied, but in addition:

- no Event of Default or restricted trading period can be ongoing;
- each coverage test typically must be satisfied, not just maintained/improved;
- typically either the purchased loan has to have the same or earlier maturity date as the sold or repaid loan, or the weighted average life test has to be satisfied, depending on the deal; and
- in many deals, the Moody's WARF test must be satisfied outright, or the S&P rating of the purchased loan must be no lower than the S&P rating of the sold or repaid loan.

While there may be an increasing number of credit risk loans that can be sold in order to generate proceeds to reinvest post-reinvestment in the current environment, finding loans that can satisfy all of these tests —– in particular, the same or better rating without making any other coverage test worse off — may be challenging. In addition, the requirement that the coverage tests must be satisfied outright, and that no restricted trading period may be in effect, could block any reinvestment after the reinvestment period if too many loans, or any of the rated CLO notes, are downgraded. See "*Downgraded Obligations*" and "*CLO Note Downgrades and Restricted Trading Periods*."

Trading Plans

Trading plans allow a CLO manager to buy and sell groups of assets on behalf of a CLO and measure compliance with the Investment Criteria on an aggregated basis across all of the sales. This can be particularly useful for complying with (or maintaining or improving) the collateral quality tests to allow the CLO to purchase a collateral obligation that it would not have otherwise been able to purchase. For example, a loan that would, on its own, cause the CLO to be further out of compliance on its weighted average life test can be paired with another loan that has a shorter maturity, so that after giving effect to both purchases, the weighted average life test is maintained or improved. This can be useful in a time of credit dislocation by allowing a manager to trade into loans that may present a good credit for the portfolio but would not otherwise be permitted due to their rating, average life, etc.

CLO indentures limit the portion of assets bought under a trading plan, typically to no more than 5-7.5% of the collateral principal amount. In addition, there are restrictions on how disparate the maturity dates of assets bought under a trading plan can be (given that these loans are being grouped, radically different maturities would result in the CLO losing the benefit of the grouping), on entering into a new trading plan if prior trading plans have resulted in breaches of the Investment Criteria, and on the number of trading plans that can be used at any one time. In addition, rating agencies typically must be notified of trading plans. However, depending on the terms of the specific indenture, the CLO manager may have the ability to modify the terms of a trading plan already in progress.

Distressed Exchanges/Exchange Transactions

A Distressed Exchange occurs when a CLO accepts a security or other obligation back from an obligor in connection with a restructuring to avoid a default and the CLO manager determines that the received asset(s) constitute a diminished financial obligation of the obligor. In many CLOs, the definition specifically indicates that the obligation being received in the exchange must come from an obligor unrelated to the obligor of the exchanged asset. Further, the definition of a Distressed Exchange is often unclear as to whether or not the manager can utilize "new money" to effectuate the exchange in some manner. Taken together, these circumstances can make utilizing the Distressed Exchange feature very difficult for many CLO managers.

Notwithstanding the foregoing, Distressed Exchanges are generally exempted from the standard Investment Criteria, and the assets received in a Distressed Exchange are not required to be eligible loans under the CLO indenture. In addition, Distressed Exchanges can be entered into at any time during or after the Reinvestment Period. This gives the CLO manager a great deal of flexibility to participate in the workout of a loan and receive back an asset that the CLO otherwise wouldn't be allowed to hold, as long as the strict requirements of a Distressed Exchange are met. However, assets received in a Distressed Exchange are typically penalized for purposes of the CLO's asset coverage and other tests, and are either treated as Defaulted Obligations (to the extent they otherwise meet the eligibility criteria for loans but for the fact they were received following an obligor default) or Equity Securities. Therefore, while being able to participate in a Distressed Exchange may help the CLO manager recover some value in a workout, it often will not help maintain compliance with the CLO's coverage tests.

Beyond the simple ability to take back a Defaulted Obligation or Equity Security in a workout, some CLOs actually allow the CLO to receive a loan that counts as eligible under the coverage tests and other CLO criteria as long as certain criteria are met, including that it meets the eligibility criteria for newly-acquired loans (often subject to carve-outs from the required ratings, etc.). In addition, there may be a limited basket for the CLO to acquire other obligations in an exchange transaction and receive full credit for the received assets under the indenture, subject to satisfaction of a longer list of strict requirements with respect to the asset (e.g. that it otherwise qualifies as an eligible loan under the indenture, is no less senior than the exchanged asset, etc.) as well as the portfolio (satisfaction of the concentration limits, satisfaction (or maintenance or improvement) of the collateral quality test levels, etc.)

Amendments

CLO managers are generally not restricted in their ability to consent to amendments to loans held by CLOs, except that (i) many deals require the CLO to notify the applicable rating agencies of certain material changes or specified amendments to the loans, and (ii) there are strict limits on the CLO’s ability to consent to amendments that extend the maturity of a loan.

However, even within these exceptions, the CLO manager needs to consider the impact of these amendments on the collateral pool. Rating agencies will receive notice of these amendments and may reconsider the rating of an asset that’s been subject to a credit amendment, with the possible consequences described under "*Downgraded Obligations*." In addition, rating agencies may reconsider the rating of CLO tranches backed by portfolios where too many of the loans have been amended to mature after the stated maturity of the CLO notes, even if the CLO manager did not consent to these amendments.

CLO Note Downgrades and Restricted Trading Periods

As noted in the introduction to this OnPoint, more than 1,000 CLO note tranches have recently been put on negative watch by the three major rating agencies Moody’s, S&P and Fitch. If CLO notes are downgraded, it can have significant impacts on the noteholders’ ability to sell, or in some cases, hold those notes, but from the perspective of the CLO manager, the primary impact would be the possible imposition of a restricted trading period on the CLO.

Restricted Trading Periods

A restricted trading period is triggered by a downgrade of the AAA-rated CLO notes or, in some CLOs, downgrades of the more junior investment grade-rated classes. During the restricted trading period, the CLO’s ability to sell assets is significantly restricted — discretionary sales are typically prohibited, and the CLO manager will have less flexibility to designate an asset as credit improved or credit risk unless it meets certain narrow criteria — and it will usually not be allowed to reinvest otherwise-eligible proceeds after the reinvestment period, as noted above under "*Ordinary-Course Purchases During and After the Reinvestment Period*."

A restricted trading period can typically be rescinded at the direction of the controlling class of noteholders. In addition, some CLO indentures provide that a restricted trading period will not exist if the adjusted collateral principal amount is at least equal to the target par balance, and in some cases if the coverage tests and certain ratings criteria with respect to the loans are satisfied.

Given the widespread recent downgrades of CLO note tranches, we expect that a number of CLOs will enter restricted trading periods, which will impact their ability to trade out of risky loans and into opportunities to improve their portfolios. CLO managers should familiarize themselves with the specific restricted trading period provisions governing their CLOs in light of this.

Events of Default

While most Events of Default result from affirmative actions (or inactions) that are at least somewhat in the control of the CLO manager and other service providers, there are two Events of Default in particular that could be triggered in connection with an extreme economic downturn: a failure to pay interest on the senior notes and an overcollateralization failure on the Class A Notes. Following an Event of Default, a majority of the controlling class can accelerate the maturity on the Secured Notes and, under certain circumstances, direct the liquidation of the portfolio.

Specific Events of Default

Event of Default for Non-Payment of Interest on the Senior Notes

Any default on interest payments when due on the senior, non-deferring classes of secured notes, or if the senior notes are not outstanding, the controlling class, on any payment date that continues after a short cure period would cause an Event of Default. This could occur if so many loan obligors defaulted on, or deferred, their interest payments during a single collection period that it left insufficient interest proceeds to cover the required interest payments on the senior notes. The secured notes other than the senior notes can defer interest payments without causing an Event of Default so long as the senior notes remain outstanding.

Event of Default for Overcollateralization Failure

An Event of Default would also occur if the sum of (1) the aggregate principal balance of the collateral obligations (other than Defaulted Obligations) plus (2) any principal proceeds in the accounts plus (3) the aggregate market value of all Defaulted Obligations is not at above at least a specified percentage (typically 102.5%) of the aggregate outstanding amount of the Class A Notes. This could occur if a substantial portion of the portfolio became Defaulted Obligations (as described above under "*Defaulted Obligations*"), even if that default were not due to a payment default. Notably, the haircuts to establish the overcollateralization ratio for this test are not the same as are used to calculate compliance with the coverage tests, in that they only apply to Defaulted Obligations (and not other types of loans, such as Deferring Obligations) when. See "*Deferring Obligations*."

Consequences of an Event of Default

Unlike in many debt structures, the occurrence of an Event of Default does not immediately cause a CLO to liquidate. Instead, in most cases the CLO indenture requires the deal to continue operating until the noteholders decide to exercise remedies, and even permits some additional trading of assets.

Conclusion

Once again, the CLO market is facing a perfect storm of challenges. We note that, similar to the last economic crisis, there seems to be no shortage of pundits predicting the death of CLOs (or otherwise casting the CLO as the villain yet again). However, CLOs are resilient structures with a number of structural safeguards, as is clear from this OnPoint. We believe the market, always among the most forward-thinking in the securitization market at large, will both navigate the current challenges and learn from them. While no one can accurately prognosticate the future, we are confident the evolution of the CLO will continue apace in the time to come.

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