Milbank

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Alternative Investments Group Client Alert: CLO 1.0 vs. 2.0 – Part I of a Series: Re-pricings

The recent strong resurgence of activity in the U.S. collateralized loan obligation (CLO) market has sparked significant interest in the distinguishing characteristics of post-credit crisis CLOs ("CLO 2.0") as compared with their pre-2008 predecessors ("CLO 1.0"). In general, CLO 2.0 transactions feature higher levels of subordination, tighter collateral eligibility requirements, and shorter non-call and reinvestment periods. There are many other important distinguishing characteristics as well. This is the first in a series of Milbank client alerts that will take a close look at new concepts or new variations of old concepts that have started to become common in CLO 2.0 documentation.

RE-PRICINGS

With many CLO 2.0 transactions currently approaching the end of their non-call periods at a time when collateral loan spreads are tightening, transaction participants are increasingly focused on CLO liability re-pricing flexibility, which has become a common CLO 2.0 feature. In a nutshell, re-pricing is a shortcut to refinancing. The option to refinance, in whole, one or more classes of notes, was common in late generation CLO 1.0 transactions. Today, CLO indentures commonly permit a majority of the CLO's equity holders to direct a refinancing of any class of notes after the applicable non-call period. In a refinancing, the terms of the new notes are negotiated between the CLO manager and the investors providing the refinancing. To protect the holders of any class not part of the refinancing, there usually are a number of conditions to effecting the refinancing, including that (i) the spread on the refinancing debt cannot exceed that of the refinanced notes, (ii) the agreement(s) governing the refinancing contain limited recourse and non-petition provisions, (iii) payments on the new notes are subject to the priority of payments waterfall in the existing indenture, (iv) consent and voting rights for the refinancing holders are the same as those of the existing holders, (v) the rating agencies confirm that the ratings for the remaining classes will not be downgraded (or, in some transactions,

notice is provided to the rating agencies) and (vi) a customary tax opinion be delivered with respect to both the new and existing debt.

In a re-pricing, the only change to the terms of the re-priced class or classes is to the spread over LIBOR (or to the interest rate, in the case of any fixed rate classes), a change effected through a supplemental indenture. Therefore, the option to re-price spares the time and expense of negotiating and entering into agreements with new noteholders and obtaining rating confirmations from the rating agencies and tax opinions from counsel. Structured appropriately, re-pricing, as an alternative to refinancing, also avoids the risk of the new debt being characterized as a new offering, which could require the preparation and dissemination of new offering materials.

Under recent CLO indentures, a re-pricing typically may be initiated at the direction of a majority of the CLO's equity holders. Many indentures provide that AAA-rated notes are exempt from re-pricing, although this is not always the case. In some cases, investors in AAA-rated notes are entitled to receive make-whole payments if their notes are re-priced. Notice of a re-pricing is typically provided well in advance (between 25 to 45 business days) to allow the affected holders to decide whether or not to consent to the re-pricing of their notes. Non-consenting holders will be paid the outstanding principal and accrued interest on their notes, and their notes will be sold to consenting holders or (to the extent not sold to consenting holders) into the market by a "re-pricing intermediary." While rating agency confirmations typically are not required, rating agencies sometimes require notice of the re-pricing.

Managers and equity holders have been negotiating re-pricing provisions as an option to provide for a more expeditious and less expensive means to refinance the CLO issuer's notes. Debt investors may also prefer to be re-priced rather than refinanced as it is a more cost-efficient and quicker alternative to re-deploying capital in a new transaction, given the fact that, in a lower interest rate environment, having one's notes redeemed may otherwise be inevitable. Alternatively, certain debt investors may not want to facilitate attempts to re-price notes upon the earliest sign of decreasing collateral spreads, and as a result may wish to include as conditions to initiating a re-pricing (i) that the CLO manager provide evidence that spreads have tightened by a certain threshold amount over a certain amount of time, (ii) payment of a premium or fee to re-price a class of notes (which cost could be less than the anticipated cost of a refinancing but would also provide an additional incentive to existing holders to agree to re-price their notes), or (iii) that a certain threshold of existing holders consent to the re-pricing. Managers and equity holders may argue, however, that such

conditionality is not appropriate if re-pricings can occur only after the non-call period, at which time the CLO issuer would otherwise be permitted to redeem the notes, either by refinancing or liquidation of assets.

It bears noting that because re-pricing features can invoke special tax-related considerations, they should be designed in collaboration with experienced tax lawyers.

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