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Crisis May Trigger Collateralized Loan Obligation Litigation

By **Ioannis Gkatzimas and John Anthony** (July 6, 2020, 3:44 PM EDT)

The economic downturn triggered by COVID-19 will likely lead to financial distress among companies that borrow using leveraged loans. Leveraged loans are extended to corporate entities that already have considerable amount of debt and/or relatively weak credit profiles.[1]

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The largest investors in these loans are collateralized loan obligation, or CLO, funds. CLO funds are structured investment vehicles that package leveraged loans in collateral pools and slice them up into tranches of CLO debt for sale to investors.

Over the last five years, the amount of outstanding CLO debt has almost doubled and it now comprises $680 billion of the approximately $1.2 trillion U.S. leveraged loan market.[2]

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The COVID-19 pandemic has a systemic effect that forced firms across industries to draw down on their revolving lines of credit to meet or preempt their liquidity needs. This includes consumer discretionary firms, many of which have less scope to withstand higher debt loads and weaker cash flows.[3]

Large companies that issue leveraged loans — such as Delta Air Lines Inc., AMC Entertainment Holdings Inc. and Hilton Worldwide Holdings Inc. — have all recently drawn on revolving lines of credit.[4] If these and other firms become unable to service their debt and ultimately fail to survive, the impact could cascade and affect CLOs.

Investors in CLO funds may target arrangers, managers, third-party service providers and rating agencies with lawsuits on multiple fronts. In addition, CLO managers may join others and target leveraged loan corporate borrowers for insufficient disclosures and practices in light of the unfolding COVID-19 pandemic.[5]

Increased Litigation Risk on Three Critical Fronts

CLO structures resemble asset-backed securities whereby senior tranches have priority over junior or equity tranches on cash flows received from loans in the collateral pool.

However, there are also certain aspects of CLOs, including binary valuation practices with respect to overcollateralization tests, the structure of CLO manager compensation incentives, and a higher level of discretion enjoyed by some CLO managers, that become important when we consider the issues that may arise in potential CLO-related litigation.[6]

1. Overcollateralization Tests

CLO funds perform specific tests to determine whether the leveraged loan pool that the fund holds is satisfying overcollateralization tests.

Leveraged loans are generally issued at or close to par, and trade below par primarily due to a deterioration in credit quality and/or unusual market conditions, like the ones induced by COVID-19. CLO funds often buy leveraged loans that trade below par opportunistically, often with the expectation that the loans will eventually repay at par.

CLO overcollateralization tests are somewhat binary in nature, allowing loans to be valued fully at par even if these loans were acquired below par but traded above certain thresholds.

For example, leveraged loans that were originally purchased at a discount but above 80%–85% of par, can typically still be valued at par for overcollateralization tests, even when recent trading activity indicates lower valuations.[7] Revised loan valuations for the overcollateralization tests are typically only required when loans default, or when the concentration of high-risk loans, as assessed by rating agencies, rises above the maximum allowed levels in the pool.

In a down market, managers may attempt to replace defaulted loans (or loans close to default) with other loans that overcollateralization tests would still value at par. Managers could sell strongly performing loans to facilitate such trades, which may reduce the quality of the loan collateral and increase the risk of the whole CLO structure.

Managers may also attempt to cross-trade certain loans between affiliated funds, taking advantage of differing collateral positions among these funds. Notwithstanding any nefarious activity, investors may object to the ongoing payment of management fees on portfolios with devalued loan collateral.

CLO managers expect to earn management fees, typically a combination of senior and subordinate management fees. Managers receive senior management fees independent of the outcome of overcollateralization tests, but failure to meet these tests prevents cash flows from moving down the waterfall to investors in the subordinated tranches and the payment of subordinate management fees.

Recent trends in loans that CLO funds bought as collateral are likely to increase the impact of valuation decisions that managers make related to overcollateralization tests. CLO managers have increasingly purchased so-called covenant light, or cov-lite, loans. These cov-lite loans now comprise around 80% of all outstanding leveraged loans.[8]

Rather than the usual maintenance covenants found in the loan indentures, which may trigger a technical default when a company fails to maintain specific financial ratios, cov-lite loans rely on incurrence-based covenants. Under incurrence-based covenants, poor financial performance simply prevents a company from issuing more debt.

As a result, companies with cov-lite loans may default much later, perhaps only due to their inability to

pay interest, impacting the overcollateralization test at a much later point in time.

2. Conflicts of Interest

Defaulted corporate loans present CLO managers with a potential conflict of interest as they attempt to balance the interests of the AAA senior tranche investors against those of the most subordinated equity investors.

On the one hand, AAA investors may prefer to quickly exit positions in defaulted loans. On the other hand, equity investors may prefer to tough it out, hoping for a partial price recovery rather than realizing the full decline in the price of defaulted loans as losses.

Managers have a higher incentive to maximize the returns to the equity tranche, as managers typically receive an incentive fee, in addition to the senior and subordinate management fees, that is dependent on the amount of equity value that remains after the senior tranches are repaid.

3. Amended CLO Contracts

Strong demand for CLOs in recent years has provided some managers with greater scope to amend CLO documentation. Decisions can be made on trading rules, collateral quality tests and asset allocation.[9]

Some of the more recent CLO structures have no contractual restrictions on adopting certain amendments. Others only grant consent rights if the manager determines that there would be a material adverse effect on the notes, or provide very short time frames for objections.

In a deteriorating credit environment, amendments that are harmful to investors tend to come to the forefront. Managers should carefully document their decision-making process as they act in their role of fiduciaries for CLO investors.

A few examples of such manager activities include trading and managing collateral, treating all tranches equitably, complying with CLO documentation, and amending CLO documentation to align with industry custom and practice when necessary.

We have already had an entrée of what might be in store through Zohar v. Patriarch Partners LLC. Here, there was a convergence of allegations regarding conflicts of interest and valuation decisions made by a manager overseeing a portfolio of distressed loans.

Noteholders alleged that the manager exploited their fiduciary status to expropriate equity, pay themselves dividends, and extract ongoing fees including by inflating the value of illiquid collateral.

Similarly, the U.S. Securities and Exchange Commission focused on how the manager had categorized distressed assets to ensure the ongoing payment of fees. The court ultimately dismissed the claims in both cases.[10]

Potential Impact on Other Parties Involved in CLOs

The other participants in the CLO industry — like arrangers, third-party service providers and rating agencies — may face litigation risks that have similarities with prior litigation in other areas of structured finance.

CLO arrangers may face litigation risk from representations made to investors at the inception of the CLO, including representations about the collateral. Arrangers also often provide warehouse facilities that accumulate leveraged loans for ultimate placement into CLO funds.

In a declining market, these placements may not occur, which can result in disagreements between arrangers, managers, and third-party first-loss providers over how to liquidate loans to repay warehouse lines.

Rating agencies may also encounter litigation similar to that following the 2008 global financial crisis. According to S&P Global Inc.,[11] the most highly rated AAA tranches — typically representing around 60% of a CLO — can withstand a level of stress similar to that experienced during the Great Depression before they start experiencing losses.

Yet even downgrades can have major ramifications for holders of AAA tranches, such as banks. Indeed a recent report by S&P identified CLO structures as elevated risk, with expectations of downgrades to investment grade tranches.[12] Given the credit market dislocation that COVID-19 has induced, the cumulative default assumptions for loans in the collateral pool will likely be tested, and questions may be asked about the correlation assumptions.

Financial Industry Authorities Following CLO Activity and Phase-Out of Libor

In its May 2019 financial stability report, the Federal Reserve noted some concerns about unexpected losses on higher-rated CLO tranches that could be exacerbated by insufficient market liquidity.[13]

Not surprisingly, the Federal Reserve included certain types of newly issued AAA CLO tranches in its recent liquidity facilities related to COVID-19.[14] Investors and regulators are also considering potential issues associated with the Libor transition that is expected to take place at the end of 2021.

Unlike bonds, which often pay interest based on a fixed-rate coupon, leveraged loans are typically floating-rate obligations, that pay interest based on a floating rate calculated as the sum of a benchmark rate like Libor plus a credit spread.[15]

Some critical objectives for CLO structures are to minimize value transfer between senior tranches and junior and equity tranches and to avoid market disruption.

In addition, CLO investors have been always mindful of basis risk between assets and liabilities in CLOs (i.e., the difference between the rates paid on the loans in the collateral pool and the rates promised to CLO investors). Rates on CLO tranches have been typically tied to three-month Libor.

However, the borrowers of the leveraged loans that make up the collateral pool have the option of paying a rate tied to either one- or three-month Libor.[16] In periods of widening spreads between the one-and and three-month Libor, borrowers of the underlying loans would elect to pay the lower one-month rate.[17]

This could have an impact on equity tranche investors which are first to experience the impact of cash flow shortfalls. The Alternative Reference Rates Committee which oversees the transition away from Libor, supports the voluntary use of the Secured Overnight Financing Rate, or SOFR, in cash and derivative markets.

Although the SOFR market is still developing, the adoption of similar SOFR-based rates on both the asset and liability side of CLOs has the potential to mitigate basis risk.

However, the adoption of new benchmark rates based on SOFR also introduces uncertainty and it is likely to experience some litigation related to the Libor transition.

Rating Agency Actions and Models Likely Among Key Economic Inquiries

The problem is that when loans default, they often tend to default at the same time. In modeling parlance, experts will have to question whether these models properly account for tail risk — the risk of large losses during extreme market events.

Academics have highlighted the risk that CLO models fail to account for this tail risk.[18] Rating agencies are likely to point to limited data on the impact of so-called black swan events — such as the one that we are currently experiencing as part of the unfolding COVID-19 crisis — and whether losses are outsized given the overall decline in broader economic activity.

However, unlike other classes of structured finance products, corporate loans — the collateral in CLO structures — have extended data availability stretching back to over a century, including correlations that can improve the modeling of tail risk.

Yet the systematic nature of COVID-19 may shock correlation in unforeseen ways.[19] Rating agencies were one of the parties involved in the structured finance litigation that followed the financial crisis with similar issues.

For example, in a 2015 settlement with the U.S. Department of Justice, S&P admitted that delays in updating modeling assumptions led to higher ratings for collateralized debt obligations and other structured finance instruments.[20]

COVID-19's Impact on CLOs: Final Thoughts

The credit market disruptions caused by COVID-19 could trigger CLO-related litigation. Courts will need to carefully consider trading activity, compliance with documentation and indentures, asset valuations and the impact of manager decisions on investors holding the various tranches in light of custom and practice in the CLO industry.

Many will seek to answer questions about representations made by arrangers and about the credit risk modeling assumptions relied upon by rating agencies and CLOs. Any weaknesses in CLOs are likely to be exposed and amplified by the COVID-19 crisis and the expected Libor transition adds an additional layer of complexity.

Market participants will call on economic and industry experts to examine key players' activities in CLO transactions, especially given the complexity and evolving nature of this market.

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[1] Leveraged loans are syndicated to multiple lenders and tend to have below investment grade credit ratings (e.g., at or below "BB+" according to Standard and Poor's). Leveraged loans are sometimes classified as risky loans with credit spreads that exceed a threshold level above benchmark rates, however this becomes a more ambiguous definition in volatile markets.

[2] Reuters, CLO issuance falls 48% as rush of loan downgrades threatens investor distributions, April 17, 2020. As a point of comparison, over the last five years, the U.S. corporate bond market has increased in size by approximately 20% (SIFMA, US Fixed Income Issuance and Outstanding, May 8, 2020).

[3] S&P Global Market Intelligence, Update: Coronavirus-related US revolving credit drawdowns surge to $275B, May 8, 2020.

[4] Aaron Weinman, Delta Air Lines' US$1.5bn loan gives CLOs rare gem in muted US market, Reuters, April 24, 2020; Gillian Tan, Wynn to Draw Down Part of $850 Million Line Amid Virus Pain, Bloomberg, March 11, 2020; American Banker, Banks urgently pitch investors on lending to needy companies, March 13, 2020.

[5] For example, regulatory authorities like the SEC have recently emphasized the importance of accurate and frequent disclosures by companies to investors with respect to COVID-19 challenges. See U.S. Securities and Exchange Commission, The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19, April 8, 2020.

[6] By virtue of their role as custodian of the loan collateral, trustees may face some of the same risks as managers.

[7] CLOs may require valuations related to overcollateralization tests for loans purchased at substantially discounted prices, typically below 80-85% of par. In such cases, valuations can be based on price and/or quote information obtained from data providers, or on expected recovery values estimated by rating agencies (usually whichever is lower).

[8] Creditflux, May 4, 2020.

[9] Moody's Investor Services, "Transaction documents can host hidden risks for CLO investors," July 26, 2018.

[10] United States District Court Southern District of New York, Zohar CDO 2003-1, LTD et. al. v. Patriarch Partners, LLC, et al., Opinion and Order, December 29, 2017; Wall Street Journal, Judge Dismisses SEC Fraud Case Against Financier Lynn Tilton, September 27, 2017.

[11] Moody's and Fitch have similar definitions.

[12] Standard & Poor's, "COVID-19 Is Testing The Resilience Of Global Structured Finance", May 18, 2020.

[13] The Federal Reserve noted that the market for CLO notes is not very liquid even in normal times, and is therefore likely to deteriorate during periods of stress, amplifying price movements. See Federal Reserve, Financial Stability Report, May 2019. Concerns about illiquidity are a key motivation for the recent intervention by the Federal Reserve into the AAA-rated CLO market.

[14] However, the Federal Reserve also noted that CLOs benefit from long term capital, unlike other structured finance vehicles.

[15] The origins of the leveraged loan market is the syndicated bank loan market, where banks preferred to provide floating rate loans. In the modern leveraged loan market, investors are attracted to the floating rate feature as it reduces their exposure to interest rate risk relative to fixed rate coupon bonds. See Columbia Threadneedle Investments, Uncovering an overlooked benefit to floating-rate loans, August 1, 2019.

[16] Some loans include even longer Libor tenors.

[17] Risk, "CLO investors find silver lining in Libor's demise," September 17, 2019.

[18] See, for example, Azizpour, S., Giesecke, K., Schwenkler, G., "Exploring the Sources of Default Clustering," Journal of Financial Economics, July 2018; and Duffie, D., Eckner, A., Horel, G. and Saita, L. "Frailty Correlated Default," Journal of Finance, October 2009.

[19] See Frank Partnoy, The Looming Bank Collapse, The Atlantic, accessed June 10, 2020.

[20] The United States Justice Department, Justice Department and State Partners Secure $1.375 Billion Settlement with S&P for Defrauding Investors in the Lead Up to the Financial Crisis, February 3, 2015.