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Amid COVID Market Volatility, Are CLOs The Next RMBS?

By **Stephen Brown and Abraham Salander** (April 20, 2020, 6:52 PM EDT)

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For the past several years, market observers have warned of risks associated with collateralized loan obligations, or CLOs.

By way of example, in October 2018, referring to CLOs, The New York Times published an article titled "Wall Street Loves These Risky Loans. The Rest of Us Should Be Wary."[1] The article compared CLOs to residential mortgage-backed securities, stating that, as happened with RMBS, the leveraged loans pooled in CLOs were "being made to risky borrowers, lending standards [were] dropping fast, and regulators [were] easing the rules."[2]

More recently, on March 19, 2020, The Wall Street Journal published an article about leveraged loans and CLOs titled "The Next Coronavirus Financial Crisis: Record Piles of Risky Corporate Debt." The authors noted that CLOs are "susceptible to violent price swings and have been one of the worst-performing debt investments" for the month of March.[3]

In this article, we will: (1) provide a short introduction to CLOs; (2) compare RMBS in the lead up to the Great Recession to CLOs today; and (3) compare the types of claims related to RMBS that were litigated after the Great Recession to potential claims relating to CLOs.

Background on CLOs

Most observers say that the market of leveraged loans is about $1.3 trillion.[4] Of that market, "CLOs own about 54% of all leveraged loans outstanding."[5] While there is no single definition of what qualifies as a leveraged loan,[6] the loans typically pooled in CLOs "are very large loans made to already highly leveraged companies, often in the retail or manufacturing sectors of the economy."[7]

While the loans obviously vary from deal to deal, the loans generally are below investment grade, with the "average rating of the underlying collateral typically about single-B."[8]

At the start of the CLO process, a collateral manager "meets with potential investors and agrees to the terms of its performance as well as the risk profile and tranche structures the CLO will ultimately take."[9] The collateral manager then will direct a special purpose vehicle, referred to as an issuer, "to issue notes in exchange for capital from the investors."[10] The SPV, "using the investors' money and operating at the recommendation of the manager[,] purchase[s] the assets to securitize them."[11] A CLO is "ordinarily ... made up of 100 to 250 loans."[12]

The CLO notes are issued pursuant to an indenture, which is entered into between the issuer and a trustee. Separately, the issuer enters into an agreement with the collateral manager that gives the collateral manager the authority to select and manage the loans for the CLO.[13]

The indenture may also require the collateral manager to provide officer's certificates regarding the loans, including that the loans satisfy the requirements of the definition of "collateral obligation" in the indenture and that the information on the schedule of collateral obligations is true and correct.[14] The collateral manager must perform its obligations with reasonable care and good faith and with the same skill and attention that it uses to manage comparable assets for itself and its other clients.[15]

The notes issued by the CLO are issued in different tranches which have different ratings. The senior notes issued by the CLO will be rated investment grade (AAA) and the junior tranches will be rated below investment grade.[16] The senior notes achieve this investment-grade rating (even though the underlying loans are below investment grade) primarily through structural features of the CLO.[17]

Specifically, per the CLO's waterfall, the senior noteholders are paid first, and the junior noteholders are only paid if certain credit tests are met. If the tests are not met, then in general distributions are withheld from the junior classes, and the available money is instead usually used to pay down the senior notes.[18]

The collateral manager "receive[s] compensation and management fees contingent on the performance of the asset pool over time."[19] A base fee, which is paid to the collateral manager before any distributions to noteholders, typically is a percentage of the principal amount of the loans in the CLO. Some CLOs also provide for a subordinated management fee, which usually is paid to the collateral manager after the senior holders have been paid.

This fee is considered "an incentive fee for the managers to make prudent investment decisions for the benefit of investors throughout the whole capital structure."[20]

A CLO indenture also will define what constitutes an event of default. Such events of default may include a default in a payment due to the senior notes or the failure to meet a specified level of overcollateralization (the percentage by which the value of the collateral of the loans exceeds the outstanding principal balance of the notes).

When an event of default occurs and is not remedied, certain noteholders in the controlling class (e.g., a majority) may direct the trustee to take certain actions, including to direct the trustee to declare the principal on the notes to be immediately due or direct the trustee to sell loans.

Comparing RMBS Before the Great Recession to CLOs Today

It should be noted that, during the last financial crisis, CLOs survived relatively unscathed.[21] There have, however, been changes to the CLO market between 2008 and today.

First, the market for leveraged loans has grown significantly since 2008. By one estimate, in 2018, the market for leveraged loans grew by "around 15%," which is similar to the "estimated 16% growth for the

US subprime market in 2006." [22] With respect to CLOs specifically, the market "has more than doubled since 2010," and is up to $660 billion.[23]

Second, underwriting standards for leveraged loans have loosened, as evidenced by the increase in so-called cov lite loans, which are loans made without certain borrower covenants that provide protections to lenders (from about 40% in mid-2016 to about 60% in 2018).[24]

Indeed, in a December 2018 article, Moody's noted that "[l]everaged loan covenants have been deteriorating for many years in a borrower-friendly market, leaving protections much weaker than they were in advance of the financial crisis."[25] While comparing a cov lite leveraged loan to a low-documentation subprime loan is not an apples-to-apples comparison, there was a similar increase in low-documentation subprime loans in the lead up to the Great Recession, from 30% in 2001 to 40% in 2006.[26]

Third, "strong investor demand has allowed CLO managers to loosen controls over investment quality, such as to allow increases in permitted exposures to riskier loans."[27]

None of this is intended as a prediction that CLOs will suffer losses comparable to RMBS after the Great Recession. Indeed, the Federal Government has taken steps that may help avert CLO losses, including passing the Coronavirus Aid, Relief and Economic Security, or CARES, Act, which will generally support the flow of credit to U.S. businesses, including those with loans held by CLOs.[28]

It is notable, however, that market observers were expressing concern even before the economic fallout from the coronavirus.

CLO Litigation Likely Will Be Different From RMBS Litigation

Following the Great Recession, there was an explosion of litigation related to RMBS. In this section, we will describe several common types of RMBS claims that have been litigated and then analyze analogous CLO-based claims.

First, after the Great Recession, certificateholders asserted securities claims under section 12(a)(2) of the Securities Act of 1933 relating to false statements in the prospectus supplement for the deal.[29]

CLO notes, however, usually are sold pursuant to Rule 144A to qualified institutional buyers.[30] This means that CLO notes are exempt from registration and that section 12(a)(2) does not apply.[31] Any securities claim arising out of the noteholders' purchase likely would need to be brought under section 10(b) of the Securities Exchange Act of 1934.

A claim under section 10(b) generally is more difficult to prove than a claim under section 12(a)(2) because, as courts have observed: "unlike securities fraud claims pursuant to section 10(b) ... plaintiffs bringing claims under sections 11 and 12(a)(2) need not allege scienter, reliance, or loss causation."[32]

Noteholders also may seek to bring common law fraud or misrepresentation claims relating to their purchase of the notes, but these claims too may be difficult to prove. For example, in General Retirement System of the City of Detroit v. UBS AG, the plaintiffs alleged that the "defendants fraudulently induced the [plaintiffs] into buying an equity position in a collateralized loan obligation."[33]

Proving this type of fraud claim generally requires a plaintiff to show: (1) a material misstatement of fact that was made to induce reliance, and (2) justifiable reliance.[34] In General Retirement System, the court dismissed the plaintiffs' fraud claims, in part because the plaintiffs failed to plead facts that "establish justified reliance where plaintiffs are recognized as sophisticated investors as a matter of law."[35] This is not to say that such a claim is impossible.

In Norddeutsche Landesbank Girozentrale v. Tilton, the plaintiffs pleaded a fraud claim based on fraudulent statements in offering materials for a CLO, and the claim survived summary judgment.[36]

In summary, if noteholders do attempt to assert claims for false statements in CLO offering materials, those claims may be harder to prove than the securities claims that were brought by RMBS certificateholders.

Second, RMBS trustees (on behalf of certificateholders), brought a substantial number of suits against mortgage originators and sponsors alleging breaches of the representations and warranties which are made in RMBS deal documents concerning the characteristics and quality of the mortgage loans.[37]

In a CLO, there are standards that the collateral manager must follow when selecting loans to purchase and when managing the loans, and the collateral manager generally is required to provide certain certifications with respect to the loans that are acquired for the CLO.

If there are substantial losses to the value of CLO notes, noteholders may examine the collateral manager's conduct and assert that the collateral manager breached its obligations under the indenture or the collateral management agreement.[38]

As with claims in the RMBS context, these claims likely would need to be brought by the trustee, not the noteholders themselves, because CLO indentures contain a no-action clause that prevents individual noteholders from bringing an action on their own except in limited circumstances.[39]

Additionally, it is important to note that a collateral management agreement typically will state that a collateral manager can only be held liable for acts or omissions that constitute bad faith, willful misconduct, or gross negligence in the performance of its duties.

While this standard is a high bar, in the RMBS context, at least at the early stages of litigation, courts generally were willing to accept allegations that RMBS originators or sponsors had acted with gross negligence, thus allowing trustee plaintiffs the opportunity to engage in wide-ranging discovery.[40] Notwithstanding these hurdles, if events of default occur in CLOs, noteholders may seek to have trustees pursue these types of claims against collateral managers.

Third, once RMBS cases started to settle for hundreds of millions of dollars, disputes arose between certificateholders regarding the distribution of the settlement proceeds. To resolve such a dispute, the trustee generally would institute a proceeding to seek instruction from a court on how to proceed.[41]

In the CLO context, similar types of disputes have been brought as interpleader actions.[42] As collateral managers manage a CLO portfolio of loans in the uncertainty caused by the coronavirus, disputes may arise among noteholders or between noteholders and the collateral manager as to how distributions should be made (e.g., whether credit tests in the waterfall are met or not).

Given the rights afforded to senior noteholders after the occurrence of an event of default, there also may be disputes about whether such an event of default has occurred. CLOs are structured to treat senior and junior noteholders differently, and these types of disputes therefore are bound to arise.

The above is not an exhaustive list of potential CLO-based claims. If there are substantial losses on CLO notes, noteholders and their lawyers likely will be creative in the claims that they assert. While deal documents and the structure for most CLOs is similar, there is substantial variation in the details.

At this time of uncertainty, one thing everyone involved in the CLO market can be doing is paying attention to loan performance and reading your deal documents closely.

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[1] Matt Phillips, Wall Street Loves These Risky Loans. The Rest of Us Should Be Wary, The New York Times (Oct. 19, 2018).

[2] Id.

[3] Matt Wirz & Nick Timiraos, The Next Coronavirus Financial Crisis, Wall Street Journal (Mar. 19, 2020) ("When downgrades and defaults mount, CLO managers stop making payments on their most junior bonds, prices plummet and the market for new CLOs shuts down. Lower-quality CLO securities were the worst performers this month out of 29 types of debt measured by Citigroup Inc. analysts, losing 22% through March 13."); see also Hannah Lang, Virus could deal blow to leveraged loans. What's that mean for banks?, The American Banker (Mar. 11, 2020) ("With the coronavirus outbreak spurring increasing worries about the economic fallout, there are shades of 2008 in 2020. Which segment of the financial sector could be hardest hit, if any, is still a matter of debate. But some industry watchers say a worsening crisis could unmask the historically high levels of risky corporate debt, including leveraged loans, with a spillover effect for banks.").

[4] Bank of England, Financial Stability Report at 42 (November 2018) ("There is no consistent definition of leveraged loans—meaning it is difficult to estimate the size of the market with precision. The global stock of leveraged loans is commonly cited to be US$1.3 trillion; the stock of loans included in the S&P leveraged loan index."); Lang, Virus could deal blow to leveraged loans, supra ("As businesses have loaded up on debt in the low-interest-rate years following the 2008 financial crisis, the global leveraged loan market is estimated to be anywhere from $1 trillion to $3 trillion."); Kristen Haunss, CLOs to warn investors coronavirus could impact performance, Reuters (Mar. 6, 2020) ("CLOSs are the biggest buyers in the US$1.2trn US leveraged loan market.").

[5] Lisa Lee, Sally Bakewell & Katherine Doherty, Risky Loans in the CLO Market Could Be Trouble for U.S. Companies, Bloomberg Businessweek (Oct. 23, 2019); see also Bank of International Settlements Quarterly Review, September 2019 at 11 ("As of June 2019, over 50% of outstanding leveraged loans in US dollars ... had been securitized through CLOs.").

[6] See Bank of England, Financial Stability Report, supra, at 47 ("There is no consistent definition of leveraged loans").

[7] Loan Syndications & Trading Ass'n v. S.E.C., 882 F.3d 220, 223 (D.C. Cir. 2018).

[8] Jennifer Johnson, Collateralized Loan Obligations (CLOs) Primer, National Association of Insurance Commissioners, at 3 (Aug. 21, 2018); see also Financial Stability Board, Vulnerabilities associated with leveraged loans and collateralized loan obligations, at 5 (Dec. 19, 2019) (stating that there "is no commonly agreed definition for leveraged loans," but listing several relevant criteria, including "below investment grade credit rating for the loan (or borrower) (i.e., below BBB)").

[9] Loan Syndications, 882 F.3d at 229.

[10] Id. at 223.

[11] Id.; Johnson, Collateralized Loan Obligations, supra, at 2 ("Investor proceeds are used to purchase a portfolio of leveraged bank loans, whose principal and interest are used to pay debt service to the noteholders, with any remaining amounts paid out to the equity investors.").

[12] Loan Syndications, 882 F.3d at 223; see also George Oldfield & John Anthony, Collateralized Loan Obligations: Subprime Déjà Vu?, Law360 (Jan. 28, 2019) ("Once fully invested, an open-market CLO entity usually owns at least 100, and perhaps as many as 225 loans."). Generally there are three time periods relevant to a CLO's acquisition of loans: (1) an initial investment period during which the collateral manager directs the issuer to acquire loans; (2) a reinvestment period, which can be between two to five years, when the collateral manager can direct the trading of the loans; and (3) the post-reinvestment period, when the CLO mostly collects and distributes the payments from the indebted companies. See generally Johnson, Collateralized Loan Obligations, supra, at 4; U.S. Bank Nat'l Ass'n v. Black Diamond CLO 2005-1 Adviser, L.L.C., 839 F. Supp. 2d 639, 641-42 (S.D.N.Y. 2011) (discussing the "three district time periods" created by a CLOs indenture).

[13] Financial Stability Board, Vulnerabilities associated with leveraged loans and collateralized loan obligations at 3 (noting that "CLOs differ from many other securitization structures, in that they are actively managed by a CLO manager").

[14] Typically, section 3.1 of an indenture includes a requirement for a certification as to the loans as of the closing date, and section 12.2 includes a similar requirement for loan purchases during the reinvestment period.

[15] These provisions typically are found in section 2 of a collateral management agreement. In the indenture (typically in section 15), the issuer assigns its rights under the collateral management agreement to the trustee, but the trustee's ability to exercise those rights may be limited to the time period during which an event of default has occurred.

[16] Johnson, Collateralized Loan Obligations, supra, at 3; Oldfield & Anthony, Collateralized Loan Obligations, supra ("As AAA funding is the cheapest funding available, arrangers seek to maximize the size of the AA tranche to meet this stress scenario. Often the credit rating agencies allow the highest rated AAA tranche to represent a very high percentage (perhaps 60 percent) of an issuer's funding.").

[17] Generally, per the waterfall, the senior noteholders are paid first, and the junior noteholders are paid only if two credit tests are met: (1) an overcollateralization test which ensures that the value of the loans exceeds the principal balance of the notes by a specified percentage; and (2) an insurance coverage test which ensures that there is a sufficient cushion of monies available for distribution to

cover the required interest payments. See Johnson, Collateralized Loan Obligations, supra, at 3-4 (describing a CLO waterfall, the overcollateralization threshold, and the insurance coverage test).

[18] The CLO waterfall typically is located in section 11.1 of the indenture, with definitions relevant to the two credit tests scattered throughout the first section of the indenture.

[19] Loan Syndications, 882 F.3d at 223; see also U.S. Bank v. Black Diamond, 839 F. Supp. 2d at 641 ("The Collateral Manager supervises and directs the investment and reinvestment of the Portfolio Collateral on behalf of the Issuer in accordance with the Indenture in exchange for fees paid by the Issuer."). As a rough estimate of the market for collateral managers, as of 2018, the 30 largest CLO managers represented about 60% of CLO issuance. Jennifer Johnson, Collateralized Loan Obligations, supra, at 6.

[20] Johnson, Collateralized Loan Obligations, supra, at 6.

[21] Loan Syndications, 882 F.3d at 229 ("CLOs weathered the financial crises relatively well. In contrast to 435 ABS collateralized debt obligations that defaulted, no more than six CLOs defaulted during the crisis, and all six included features atypical for CLOs and were eventually cured."); see also Jennifer Johnson, Collateralized Loan Obligations, supra, at 1 ("Due in part to sound structural features, a low default rate environment for bank loans and prudent investment management, CLOs were considered 'survivors' of the financial crisis.").

[22] See Bank of England, Financial Stability Report, supra, at 47.

[23] Lee, et al., Risky Loans in the CLO Market, supra.

[24] See Bank of England, Financial Stability Report, supra, at 47 (describing how, "[i]n recent years, looser underwriting standards in the leveraged loan market have eroded traditional safeguards, such as maintenance covenants," which "require borrowers to meet certain financial tests every reporting period"); Oldfield & Anthony, Collateralized Loan Obligations, supra (noting that "[c]ov-lite loans lack a key element of lender covenant protection: the ability to intervene in advance of a payment default should the borrower's financial performance decline," and referencing Moody's research showing that "cov-lite loans are expected to achieve significantly lower recoveries following default as compared with loans with maintenance covenants").

[25] Moody's Investor Service, From covenants to cushions: Top 10 credit challenges CLOs face today, at 5 (Dec. 13, 2018).

[26] See Bank of England, Financial Stability Report, supra, at 47.

[27] Lee, et al., Risky Loans in the CLO Market, supra. Moody's provided the following examples of the recent evolution of CLO deal documents, among others: (a) "[w]ide latitude to classify certain types of trades as 'exchanges'"; (b) "[r]elaxation of trading provisions that increase the potential for par erosion"; and (c) "[t]he undermining of the over-collateralization (OC) tests via weaker par value haircuts." Moody's, From covenants to cushions, supra, at 1.

[28] For additional information, see Jenner & Block's analysis of the CARES Act (available at https://jenner.com/library/publications/19739), and Jenner & Block's analysis of the Federal Reserve's

recent actions to support the U.S. economy (available at https://jenner.com/library/publications/19820)

[29] See Fed. Hous. Fin. Agency v. Nomura Holding Am., Inc., 104 F. Supp. 3d 441, 453 (S.D.N.Y. 2015) ("This case is complex from almost any angle, but at its core there is a single, simple question. Did defendants accurately describe the home mortgages in the Offering Documents for the securities they sold that were backed by those mortgages? Following trial, the answer to that question is clear. The Offering Documents did not correctly describe the mortgage loans. The magnitude of falsity, conservatively measured, is enormous."), aff'd 873 F.3d 85 (2d Cir. 2017).

[30] Oldfield & Anthony, Collateralized Loan Obligations, supra ("In the U.S., a deal underwriter usually distributes tranches of CLO notes to qualified institutional buyers as defined under Rule 144A of the Securities Act.").

[31] See Emergent Capital Inv. Mgmt. v. Stonepath Grp., 165 F. Supp. 2d 615, 622 (S.D.N.Y. 2001) ("[L]iability for untrue statements under Section 12(a)(2) made in either a written prospectus or in oral communications relating thereto is limited to public offerings.").

[32] In re Morgan Stanley Info. Fund Secs. Litig., 592 F. 3d 347, 359 (2d Cir. 2010).

[33] 799 F. Supp. 2d 749, 754 (E.D. Mich. 2011).

[34] Id. at 765-66 ("To state a claim for fraud or silent fraud, plaintiffs must prove (1) a misrepresentation, or a material omission of fact, (2) which was false and known to be false by defendant, (3) that the misrepresentation or omission was made for the purpose of inducing the other party to rely upon it, (4) justifiable reliance, and (5) injury. For silent fraud, plaintiff must prove the additional element that defendants had a legal duty to disclose the material omission of fact.") (citations omitted).

[35] Gen. Ret. Sys. of the City of Detroit v. UBS, AG, No. 10-cv-13920, 2012 WL 1278300, at *10 (E.D. Mich. Apr. 16, 2012), partial reconsideration granted on other grounds 2012 WL 2803912 (E.D. Mich. July 10, 2012).

[36] No. 651695/2015, 2019 WL 3944490 (N.Y. Sup. Ct. Aug. 20, 2019), aff'd 115 N.Y.S.3d 312 (N.Y. App. Div. 2019).

[37] See generally U.S. Bank, Nat'l Ass'n v. UBS Real Estate Secs. Inc. (MARM 2006-OA2), 205 F. Supp. 3d 386, 401-02 (S.D.N.Y. 2016) ("The PSA provided the Trustee of a Trust with a narrow and specific remedy if it learned that UBS had breached a representation or warranty as to a given loan held by the Trust. Upon discovery or notice of a breach, section 2.03 of the PSAs obligated UBS to do one of the following within 90 days: (a) cure the breach; (b) replace the loan with a suitable substitute; or (c) repurchase the loan from the Trust. ... In this action, the Trusts seek to have UBS repurchase certain loans and, if the loan has been liquidated, to pay the money damages equivalent of repurchase.").

[38] As one example of claims being brought against a collateral manager (although not brought by a trustee), in 2015, the SEC instituted enforcement proceedings against Lynn Tilton and the collateral managers of three CLOs pursuant to the Investment Advisors Act of 1940 and the Investment Company Act of 1940. See Initial Decision, In re Tilton, SEC Admin. Proc. File No. 3-16462, 2017 WL 4297256 (Sept. 27, 2017). The SEC alleged that Tilton and the collateral managers: "report[ed] misleading values for the assets held by the Funds and thus collecting unearned management fees and other payments; generally

breach[ed] fiduciary duties by failing to disclose a conflict of interest arising from Lynn Tilton's undisclosed approach to categorization of assets; and issu[ed] false and misleading financial statements that purport to comply with GAAP but do not, in that they contain misleading information relating to impairment and fair valuing of assets." Id. at *2. After a fourteen-day hearing, the presiding administrative law judge concluded that the allegations were "unproven." Id. at *1, 49; see also Finality Order, In re Tilton, SEC Admin. Proc. File No. 3-16462, 2017 WL 11421635 (Nov. 28, 2017) (providing notice that "the initial decision of the administrative law judge has become the final decision of the Commission").

[39] A CLO typically includes in section 5 a "no action" clause, which is a clause that prevents a noteholder from bringing a claim for violation of the indenture unless, among other things, (a) there is an event of default, and (b) the noteholders with not less than 25% of the notes in the most-senior class with notes outstanding directed the trustee to sue and offered to indemnify the trustee, but the trustee refused. Accordingly, if it is alleged that a collateral manager failed to adequately supervise and direct the investment of the loans, such a claim likely will not be brought by the noteholders.

[40] Morgan Stanley Mortg. Loan Trust 2006-13ARX v. Morgan Stanley Mortg. Capital Holdings LLC, 36 N.Y.S.3d 458, 459-60 (1st Dep't. 2016) ("We also hold that, under the highly deferential standard afforded to pleadings, the particular facts alleged in the amended complaint are sufficient to support plaintiff's claim of gross negligence, which should not have been dismissed.").

[41] See, e.g., In re Bank of N.Y. Mellon, 51 N.Y.S.3d 356, 358 (Sup. Ct. 2017) ("Petitioner The Bank of New York Mellon seeks judicial instructions on how to distribute a portion of the $8.5 billion settlement payment entrusted to it as trustee of 530 residential mortgage-backed securities trusts (the covered trusts). Certain certificate holders from the various trusts dispute how the settlement payment should be distributed."). Such a petition is brought by a trustee pursuant to Article 77 of the New York Civil Practice Law and Rules.

[42] See, e.g., U.S. Bank v. Black Diamond, 839 F. Supp. 2d at 641.