CLO Litigation: A Coming Storm

US Outlook: CLO Litigation Arising From The 2020 Downturn

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Given the extraordinary impact of COVID-19 on the world economy, a global recession is now very likely, if not a certainty. According to Fitch: "83% of sector and structured finance asset performance outlooks are negative, up from 21% at the beginning of 2020. There are no positive sector outlooks."[1] Among its many effects, this broad multi-sector downtown will severely impact the hundreds of billions of dollars of Collateralized Loan Obligations ("CLOs") that have been issued in recent years. Wide-ranging, cross-sector defaults are expected for the loans that collateralize CLOs, and extreme loss severity is expected when those defaults occur. CLO structures may therefore experience unprecedented losses that extend toward even the more senior and risk-remote tranches. These losses are likely to spawn various types of CLO-related litigation. This memo provides background on the CLO market, CLO structure, and the types of disputes that can be expected to arise as losses mount.

1) The Collapsing CLO Market

A CLO fund is a special-purpose vehicle that raises money from noteholders and invests the proceeds in pools of leveraged loans made to below-investment grade companies. CLOs are structured to take advantage of arbitrage opportunities, where the cost of funding the acquisition of leveraged loans (*i.e.*, interest payments to noteholders, fees paid to fund advisors, and operating expenses) is less than the income generated by those leveraged loans, leaving excess spread to pay "equity" investors holding the most junior tranche, who are often the sponsors or managers of the fund. As low interest rates over the last decade caused investors to seek alternative investment opportunities, the CLO market has expanded dramatically—in the U.S. alone, the CLO market has doubled in size since 2008, to well over $600 billion.[2] Borrowers have used this ready supply of financing for a wide variety of purposes, including private equity buy-outs of companies like Dell and Staples, share buybacks, and acquisitions.[3] Roughly 50% of U.S.-based leveraged loans have been packaged into CLOs, many concentrated in sectors that will be hit hardest by the current financial downtown, including retail, oil and gas, and travel.[4]

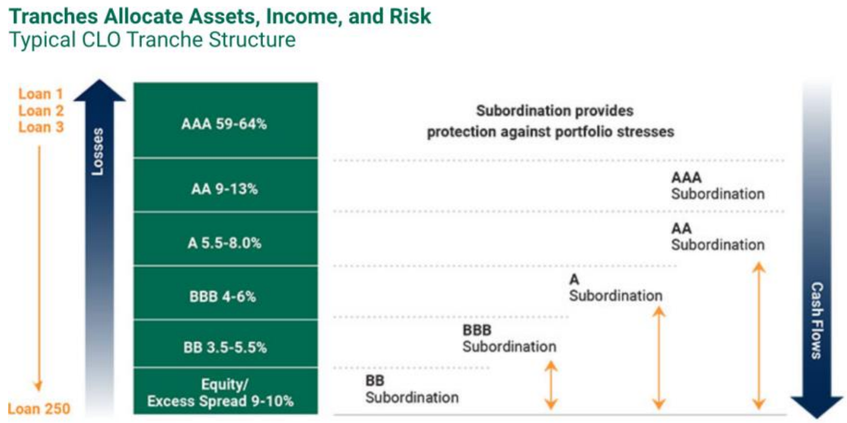
Just as mortgage underwriting standards relaxed in the mid-2000s to meet demand for RMBS issuance, the extraordinary demand for CLOs caused lenders to lend to riskier borrowers, loosen loan protections, and agree to less restrictive covenants. Lenders have increasingly financed companies that already had significant debt and lower credit ratings, with over half of leveraged loan borrowers now having at least five times as much debt as EBITDA.[5] While so-called "covenant-lite" loans made up a mere 15% of the leveraged loan market in 2008, today such loans make up almost 80% of outstanding issuance.[6] Leveraged loans are often also collateralized by less secure asset types such as receivables, inventory, or commercial leases, and provide lenders with fewer remedies. According to Moody's: "[t]he absence of stand-alone MAC (material adverse change) clauses and maintenance covenants, in combination with weakened incurrence covenants, means that leveraged loan documentation often offers limited protection to institutional loan investors."[7] This means such covenant-lite loans generally "do not provide institutional loan investors with the right to influence how borrowers respond to financial deterioration caused by the coronavirus."[8]

Leveraged loans have already been widely downgraded over the past month and prices have dropped by about 15%, to levels not seen for years.[9] In recent days, between 25 and 50% of outstanding loans have traded at less than 80 cents on the dollar, in territory deemed distressed.[10] While CLO collateral is not required to be marked-to-market, many CLO noteholders, including mutual funds, are required to do so. As these funds price their CLO holdings based on secondary market transactions (some occurring in dislocated markets, resulting in fire-sale pricing), marks will likely fall, and some may fall dramatically. At the same time, leveraged loan defaults are expected to skyrocket, from a total of 1.1% in 2019 to 5-7% this year, and 8-9% next year.[11] The CLO market has never experienced (let alone weathered) year-on-year defaults of this magnitude. As the majority of leveraged loans securing CLOs are covenant-lite, loss severity is also expected to be severe, in excess of the levels observed during the 2008 financial crisis.[12] It is already estimated that the market downturn will wipe out $200 billion in leveraged loan value, or about 15% of current issuance.[13]

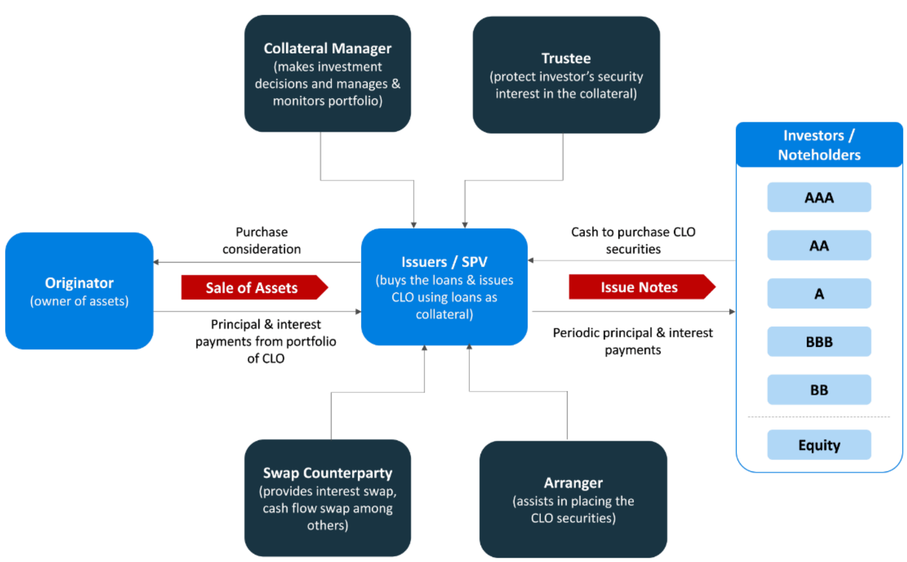
As with most asset-backed securities, such as CDOs and RMBS, the debt issued by CLO funds (*i.e.*, notes) is divided among senior and mezzanine tranches, as well as a fully subordinated tranche referred to as "equity." Each tranche of notes receives interest and principal according to its respective priority level out of income generated by payments from the loan pool.[14] CLO notes are mostly purchased by institutional investors, including insurance companies, mutual funds, asset managers, pension funds, banks, as well as by non-financial firms.[15] Many of these investors purchase not only senior, AAA-rated tranches, but also lower-rated mezzanine and even equity tranches, which together make up approximately the bottom third of CLO capital structures.[16] For these investors, the predicted double-digit defaults and extreme loss severity, would put equity tranches underwater and may cause significant defaults in mezzanine tranches later this year and next. Depending on the length of the downturn, even senior tranches may face significant risk. As Fitch has cautioned, even its dire expectation of 15% losses through 2021 assumes a quick, "V"-shaped economic downturn. If we face a prolonged downturn instead, losses into 2022 could begin to hit levels that will reach even tranches that were initially rated AAA. Loss severities of that magnitude are more likely if factors such as sustained low energy prices impair the value of the assets securing the underlying loans.

2) CLO Structure And Participants

As described above, CLO notes are issued to investors in tranches, or layers, each of which have differing payment priorities, credit quality, and credit ratings. The senior-most tranche has the highest priority in the payment "waterfall" and is the last to take losses; thus it has the highest credit quality and pays the lowest coupon. Lower tranches, conversely, are less protected and have lower credit quality, but higher coupons:[17]



CLOs are issued by special-purpose vehicles called CLO issuers (or, colloquially, CLO funds), with the CLO notes they issue sold to investors by one or more underwriting banks. Initially, CLO funds typically enter into warehouse agreements with CLO arrangers (or other lenders), and then use the cash from these agreements to purchase pools of loans, which are then securitized and serve as collateral securing repayment of the CLOs. With the inflow of cash from the CLO notes, collateral managers repay their initial warehouse loans, and security interests in the assets are retained by the vehicle. The collateral manager typically is able to determine the final assets to be included in the CLO by trading in and out of collateral, and reinvesting collateral proceeds, during a "reinvestment period" that can last a number of years. The collateral manager is subject to restrictions on the type and quality of collateral permitted in the fund. A security interest in, and custodianship of, the collateral is granted to the trustee, for the benefit of noteholders. As the CLO fund generates income from interest and principal payments on the underlying pool of leveraged loans, the trustee directs these payments (net of certain specified fees and expenses) to particular tranches of notes pursuant to a distribution "waterfall."[18] The following chart outlines the typical CLO participants and their roles:



Regular "overcollateralization" and "interest coverage" tests are run to confirm that the collateral is anticipated to generate sufficient funds to meet ongoing interest obligations and repay at least the more senior tranches of the CLO notes. These tests provide vital protection to senior noteholders, as failure of an overcollateralization test (and, in some cases, an interest coverage test) will cut off cash flows to more junior tranches until the test failure is cured. Various classes of noteholders may also be granted control rights under the CLO's governing documents, which give them the right to direct or approve the disposition of CLO collateral, particularly where that collateral is impaired. As the legal documentation for CLOs—and thus the specific details of CLO structure and the relationship and obligations between the relevant participants—can be tailored for a given deal, the general descriptions above may vary from case to case.

3) <u>CLO-Related Disputes</u>

We have drawn on our decade-long experience and expertise litigating issues concerning CDOs, RMBS, and other asset-backed securities to identify types of significant CLO-related disputes that we expect may arise as CLO collateral begins to default and suffer losses. Additionally, we believe that CLO-related disputes will raise a host of new issues given their differing structures and governing agreements. We are carefully studying these differences and their implications to prepare for the wave of litigation we expect to occur in this space.

a. <u>Disputes Involving CLO Managers</u>

Defaults are likely to bring increased scrutiny of the duties and conduct of CLO collateral managers. As outlined above, the CLO collateral manager is responsible for selecting and managing the collateral that produces the income necessary to repay CLO investors. CLO collateral managers owe general fiduciary-type duties to the CLO fund. In addition, collateral managers are contractually required to comply with various investment criteria and other obligations set forth in the CLO warehouse agreement, collateral management agreement, indenture, and other governing documents. Following the financial crisis, distress in the CDO market resulted in a number of investor suits alleging misconduct by collateral managers. We anticipate that similar suits may be brought in the CLO market in the wake of the coronavirus pandemic.

Historical examples of CDO-related litigation may provide some insight into the types of suits that will be brought against collateral managers. In *House of Europe Funding I, Ltd. v. Wells Fargo Bank, N.A.*, 2014 WL 1383703 (S.D.N.Y. 2014), House of Europe Funding ("HOE"), a CDO issuer, sued the CDO collateral manager (and the CDO trustee) for breaching the eligibility criteria restricting the type of collateral the CDO issuer was permitted to purchase. The indenture limited the collateral manager's right to invest the CDO issuer's funds in other CDOs to a maximum 15% of the CDO issuer's assets and required the collateral manager and trustee to report its compliance with these restrictions in monthly investor reports. HOE alleged that the collateral manager and the trustee breached the limitation on investing in CDOs and failed to properly report that breach in monthly reports. On a motion to dismiss, the court upheld HOE's claims against the collateral manager (and the trustee), finding that HOE had adequately alleged breaches in connection with purchases of assets that exceeded portfolio restrictions. The case later settled for an undisclosed amount.

Managers may also be subject to litigation where they fail to take action with respect to impaired collateral as required under the terms of the governing indentures. For example, in *U.S. Bank National Association v. Triaxx Prime CDO 2006-1, Ltd. et al.*, 2016 WL 3552272 (S.D.N.Y. June 23, 2016) a senior CDO noteholder successfully obtained an order directing the CDO's manager to sell certain collateral (RMBS) that had been in default for more than three years. The collateral manager had refused to sell these assets despite language in the management agreement providing that defaulted collateral was required to be sold promptly. On appeal, the Second Circuit affirmed the lower court's decision that the issuer was obliged to sell the collateral. *See U.S. Bank Nat'l Ass'n v. Triaxx Asset Mgmt. LLC*, 687 F. App'x 8 (2d Cir. 2017).

Collateral managers for CDO funds following the financial crisis also faced accusations, and litigation, related to their alleged manipulation of overcollateralization tests through the above-market purchase of new collateral intended to overstate the value of the collateral in the fund—*i.e.*, the numerator in the overcollateralization test. For example, in *SEC v. ICP Asset Management LLC*, Case No. 10-cv-04791 (S.D.N.Y.), CDO collateral manager ICP Asset Management ("ICP") was accused of engaging in round-trip transactions with a large investment fund to overstate the value of the collateral in order to prevent failure of an overcollateralization test that would have shut off payments to junior notes owned by an affiliate of the collateral manager. ICP ultimately settled these claims with the SEC through a consent judgment requiring payment of more than $23 million in restitution and penalties. The CDO funds managed by ICP, called the Triaxx funds, also became embroiled in civil litigation with a senior investor, which ultimately settled on undisclosed terms. *See AIG Fin. Prods. Corp. v. ICP Asset Mgmt., LLC*, Index No. 651117/2011 (N.Y. Sup.); *see also AIG Fin. Prods. Corp. v. ICP Asset Mgmt., LLC*, 2013 NY Slip Op 05177 (N.Y. App. Div. 1st Dept. Jul. 9, 2013) (affirming denial of motion to dismiss first amended complaint). Recent reports indicate that similar conduct may be occurring in the CLO market today and, as we discuss below, we expect significant valuation-related disputes to arise in this market.[19]

Investment decisions made by CLO managers are likely to be subject to similar scrutiny—whether during the ramp-up or reinvestment periods during which the CLO manager is permitted to exercise discretion in executing trades to improve the CLO's credit quality, or following the reinvestment period, when the manager's discretion is more limited. Indeed, investors in two CLO funds filed a lawsuit last month (which was voluntarily dismissed shortly thereafter) against the funds' collateral managers and certain other parties alleging manipulation of the funds' investment criteria. *See The Charitable Donor Advised Fund, L.P. v. U.S. Bank, N.A.*, C.A. No. 1:20-cv-1036 (S.D.N.Y.). It is essential that CLO collateral managers clearly understand, and adhere to, their responsibilities in respect of the underlying collateral. Litigation is likely to arise where warehouse lenders or investors feel a manager has breached these or other duties, and creditors or investors have been harmed as a result.

b. <u>Disputes Involving CLO Arrangers</u>

CLO arrangers are the organizing entities responsible for creating the CLO issuer, establishing the CLO structures, and making presentations to potential investors concerning those structures and the quality of the assets to be held by the CLOs. Arrangers may face a variety of claims. Investors who feel that the risks associated with a CLO were misrepresented may—depending on the information presented to them by the arranger—seek to bring various kinds of misrepresentation or omission claims. For example, in *General Retirement System of City of Detroit v. UBS, AG*, 799 F. Supp. 2d 749, 754 (E.D. Mich. 2011), investors brought claims against a CLO arranger alleging that the arranger fraudulently induced plaintiffs to buy a CLO equity position. Specifically, plaintiffs alleged that defendants "represented expected returns of 10–15% based on conservative estimates of defaults and losses," yet that defendants "knew that these representations were untrue when they made them." Plaintiffs brought suit after the market for asset-backed securities deteriorated in 2007, and a federal court denied in part defendants' motion to dismiss plaintiffs' fraud claim in 2011.

As noted above, arrangers also often extend warehouse lines of credit to managers to purchase loans intended to serve as CLO collateral. By some estimates, there are as many as 60 warehouse lines currently outstanding in the U.S., and between 40 and 50 in Europe.[20] Arrangers, managers, and others who agreed to bear the risk of such financing will face difficult choices regarding how to deal with the deteriorating leveraged loans they hold, many of which may now be difficult to securitize. Disputes among these parties are likely to arise in connection with, for example, the method and timing of any collateral liquidations, the priority given to the securitization of any outstanding collateral, and the realization of risks among the financing participants where the performance of the relevant loans falls short of that required to meet the terms set by the warehouse facility.

Arrangers may also face lawsuits in respect of their involvement in the CLO market more generally. *In re Citigroup Inc. Securities Litigation*, 753 F. Supp. 2d 206, 246 (S.D.N.Y. 2010) presents an example where plaintiff shareholders bought a putative securities fraud class action against Citigroup as a CLO arranger, alleging that Citigroup misled investors by failing to disclose the "risky nature of Citigroup's leveraged-loan and CLO business and the extent of [the] Company's exposure to losses." Plaintiffs' CLO-related claim was dismissed because they failed to demonstrate that Citigroup had an obligation to disclose such information to shareholders, notwithstanding that Citigroup had made some partial disclosures concerning Citigroup's anticipated growth of its CLO business. We expect the sufficiency of such disclosures to be aggressively litigated and tested in future cases.

c. <u>Disputes Among CLO Investors</u>

Disputes may also arise as investors holding different tranches of notes disagree as to their respective priorities of payment when cash flows diminish, or where one of the parties seeks to accelerate payments or to commence liquidation of the collateral. CLOs—like CDOs and RMBS—are tiered investments that purposely prioritize some investors over others, and CLOs—like CDOs—are typically structured to ensure that the collateral must regularly achieve certain performance-based tests, including minimum over-collateralization levels for certain tranches.

As various CDO-related cases litigated in the years after the 2008 financial crisis underscore, courts have been willing to intervene in inter-investor disputes where prioritization or structures are not being implemented in accordance with relevant statutes or the terms of the applicable indenture agreements. For example, in *Oxford University Bank v. Lansuppe Feeder, LLC*, 933 F.3d 99 (2d Cir.2019), a senior noteholder exercised its right to direct that CDO collateral be liquidated following an event of default in order to accelerate the repayment of its notes after the CDO issuer's failure to make payments triggered an event of default under the indenture. Junior noteholders (who stood to receive no distribution of cash under the order sought by the senior noteholders) intervened, seeking to prevent the liquidation. The junior holders were unsuccessful, as the court held that the governing documents entitled the senior noteholders to proceed. As leveraged loan defaults rise and CLO cash flows decline, we expect CLO prioritization and structure disputes to be vigorously litigated between competing tranches of investors.

d. <u>Disputes Involving CLO Trustees</u>

Indenture trustees can also find themselves in the crosshairs when required to act in the face of the competing interests of noteholders and other interested parties. For example, in *Wells Fargo Bank, N.A. v. Wrights Mill Holdings, LLC*, 127 F. Supp. 3d 156 (S.D.N.Y. 2015), a CDO trustee brought an action against senior noteholders and a prospective purchaser of the CDO's collateral. The purpose of the action was to determine whether the trustee was obligated to sell the collateral pursuant to a provision that empowered the CDO's equity investors to decide—by a two-thirds vote among them—to approve the sale of collateral in certain circumstances. Similarly, in *Hildene Capital Management, LLC v. Friedman, Billings, Ramsey Group, Inc.*, 2012 WL 3542196 (S.D.N.Y. Aug. 15, 2012), noteholders alleged that the trustee breached its duties by allowing a debt issuer to repurchase $35 million of CDO collateral for just $5.25 million, through a side payment to the CDO fund's equity investor who held a right to approve collateral sales. Similar disputes may arise for CLOs where trustees are directed by the controlling class of noteholders to liquidate the collateral to accelerate and protect the repayment of senior holders, while more junior holders that will be wiped out by such a liquidation employ efforts to stop them. By way of further example, in the *House of Europe* case (cited previously), the trustee for HOE was accused of failing to properly report, if not prevent, the collateral manager's breach of the indenture's investment criteria. *See House of Europe Funding I, Ltd. v. Wells Fargo Bank, N.A.*, 2014 WL 1383703 (S.D.N.Y. 2014).

e. <u>CLO Valuation Disputes</u>

As noted, while CLO funds are not, themselves, obligated to mark their collateral to market, many CLO investors, such as mutual funds, mark their CLO holdings to market. Given that CLO prices are often based on transactions in a secondary market that is currently depressed (and may suffer further dislocation), potential suits may arise for such investors regarding the appropriate valuations for their investments. Similar valuation issues may arise for CLO managers who purchased collateral using warehouse lines of credit extended to them by CLO arrangers, if the arrangers now wish to liquidate any collateral that has not yet been placed into a CLO fund. These are just two examples of the various ways valuation disputes may arise. These disputes will turn on complex expert and financial analysis and any parties relying on, or obligated to undertake, such valuation would be well-advised to anticipate such disputes.

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The above provides background for some of the significant disputes and litigation we expect to develop in the CLO space given the multi-sector economic downturn we are experiencing. If you have any questions about the issues addressed in this memorandum or otherwise, please do not hesitate to reach out to us.

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[15] Emily Liu and Tim Schmidt-Eisenlohr, "Who Owns U.S. CLO Securities?," *FEDS Notes, The Federal Reserve*, July 19, 2019, https://www.federalreserve.gov/econres/notes/feds-notes/who-owns-us-clo-securities-20190719.htm.
[16] *Supra* Aramonte and Avalos. Many individual CLOs, however, have less than one-third protection for senior AAA tranches.
[17] *Source:* Morgan Stanley Research.
[18] *Source:* Livermore Investments.
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