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Expert Views: Coronavirus Impact

Considerations for CLO Participants in Light of COVID-19

Thu 04/30/2020 03:19 PM CDT

Editor's Note: Below is the latest in Reorg's Expert Views series: an article published by Schulte Roth & Zabel LLP and written by Craig Stein, Douglas I. Koff and James T. Bentley. This article accompanies Reorg's April 28 webinar, CLO Considerations for Distressed Investors, which featured the authors of this article. The webinar recording and presentation materials are available on the Reorg Media page HERE.

COVID-19's impact on the Collateralized Loan Obligation ("CLO") and leveraged loan markets has been significant and will continue to intensify. Fitch estimates a 5-6% default rate (up from 1.1% in 2019) for leveraged loans as a direct result of COVID-19. This would equate to approximately $80 billion of lost value, which is double Fitch's initial 2020 estimate, and exceeds the 2009 high achieved during the last great financial crisis.[1] This estimated default rate surges to 8-9% by FYE 2021 with a cumulative impact in excess of $200 billion of lost value.[2] Fitch notes that "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."[3] Forbes Magazine notes that "14% of the top loans of concern are due by the end of [2020], and 35% are due by the end of 2021."[4]

It is imperative for CLO managers, arrangers, private lenders and other participants to understand (i) the potential impact of underlying borrower loans defaults on CLOs, and (ii) the potential litigation risks that they may face as a result.

How Did the CLO Market Arrive Here?

Low interest rates and easy access to credit have allowed corporations to borrow a record $10 trillion.[5] While lenders expect most of this debt to be timely repaid, the $1.2 trillion leveraged loan subset – below investment grade-rated debt secured by corporate assets – is a primary cause for concern in the current financial environment. CLOs own approximately $600 billion of this $1.2 trillion market. Cash raised in the CLO market was used for a multitude of purposes, including by private-equity firms that were "borrowing billions at a time to buy brand names including Dell Technologies and Staples Inc."[6] Many CLOs are concentrated in sectors that already were already distressed prior to the pandemic and will continue to be affected by the current financial downtown, including retail, healthcare, travel, food and beverage.

In spite of the overwhelming negative rating agency forecasts, generally speaking, the CLO market likely should do better than the rest of the leveraged loan market because many CLOs are mostly comprised of first-lien loans and thus, have the best chance of being over-collateralized, which helps to obviate ubiquitous covenant-lite[7] features that have become market.[8] Further, a CLO collateral manager's credit discipline and underwriting should help to mitigate a CLO's loss due to defaulted underlying borrower loans.

COVID-19's Impact

Unlike mortgage bonds, very few CLOs defaulted during the 2008 financial crisis. The lack of prior CLO defaults and their relatively high yields made CLOs popular in the past decade. Nevertheless, no one could have anticipated COVID-19's momentous impact. If a CLO's underlying borrowers file for bankruptcy, then collateral managers of CLO's will likely be required to navigate the following issues:

- Difficulty in Borrower Refinancing. CLOs may be restricted in participating in the refinancing of a borrower's loan if the borrower's loan rating slides to a CCC-rating. Generally, CLOs are limited in the amount of CCC-rated loans that they may purchase to 7.5% (certain recent specialized CLOs have a larger CCC basket). In addition, loans held by the CLO in excess of this 7.5% limitation due to rating migration must be marked-to-market rather than carried at par for purposes of the CLO's overcollateralization tests. Moreover, many CLO noteholders, including mutual funds, are required to mark their holdings to market rather than at par regardless of the 7.5% basket.[9]

- Rating Cuts May Cause CLOs to Fail Overcollateralization Tests. Since the start of the COVID-19 crisis, rating agencies have been aggressively downgrading leveraged loan borrower ratings. As discussed above, these rating reductions may result in many CLOs failing over-collateralization tests (i.e., the excess value of its collateral compared to the principal value of its senior and junior notes). When CLOs fail overcollateralization tests, then they must divert payments from junior investors towards more senior investors.

- Acceptable Take-Back Paper. Many CLOs can take back certain securities in exchange for obligations owed to them by a bankrupt company provided the securities are compliant with the Volcker rule (i.e., the Volcker rule allows securities to be received in lieu of debts previously contracted). While fact specific, before receiving Volcker-compliant securities, CLO managers need to consider if inserting a tax blocker to house the securities is required to avoid potential tax liability. Moreover, CLO documentation requires a manager to sell equity securities obtained via a restructuring within a specific period of time. Depending on the time allotted, however, this may neither be practical nor feasible.

- Unacceptable Take-Back Paper. While CLOs can receive Volcker-compliant securities in exchange for their debt, CLOs generally cannot purchase new securities issued pursuant to a rights offering. Managers should be cognizant of these restrictions and ensure they stay abreast of a defaulted borrower's plan to reshape its balance sheet even before it files for bankruptcy. Further, to the extent possible, borrowers, managers and investors should know if other lender CLOs, if any, have their own limitations on taking back securities. These limitations may not be publicly available, and parties may need to ask a CLO manager about limitations in its governing documents that could impact a borrower restructuring. If there are common interests among CLOs, even ones that are separately managed, they may decide to work in tandem to assure their mutual best possible outcome.[10]

- Potential for Protective Advances. In new issues, some CLO managers are seeking the ability to make protective advances, similar to their banking counterparts in order to preserve the values of their troubled-debt holdings. This would allow CLOs to more effectively participate in restructurings to maximize their investments. A manager's experience would likely play a significant role in an investor's willingness to agree to a protective overadvance mechanism. Rating agencies, such as Moody's, look at these measures on a case by case basis. CLOs generally operate under "will" level U.S. tax guidelines to ensure that such CLOs will not be engaged in a U.S. trade or business ("Tax Guidelines"). A CLO must comply with the restrictions set forth in the Tax Guidelines relating to the CLO's participation in a workout or restructuring or the extension of additional advances, unless the CLO obtains advice (or opinion) of U.S. tax counsel to ensure that any deviations, taking into account the relevant facts and circumstances, will not cause the CLO to be engaged in a trade or business within the United States. Were the IRS to take that view that a CLO is engaged in a U.S. trade or business, it could cause a non-U.S. corporate CLO's net income attributable to such trade or business to be subject to U.S. federal income tax at a rate of 21% and "branch-profits" tax at a rate of 30%.

- Current Liquidation of Warehouse Assets. Note also that some CLO managers have begun liquidating the loans they had been accumulating in warehouses. Loans in such warehouses amounted to $10 to $12 billion in early March, according to research by Wells Fargo Securities.[11] Moreover, some investment funds were unable to meet margin calls, resulting in liquidation, while other investment funds were forced to liquidate assets to de-lever, both of which caused further price depreciation. This liquidation may be an opportunity for managers and investors with cash on hand to purchase assets at depressed prices.

Potential CLO Litigation Issues

Unquestionably, litigation involving CLOs will arise from the COVID-19 pandemic that will present novel issues. For the past dozen years, we have litigated numerous issues involving CLOs and other asset-backed securities during times of crisis, including cases that are currently pending throughout the country. Some examples of prior litigations for CLO participants to consider and anticipate include the following:

1. CLO Managers. Managers owe a fiduciary duty to the CLO itself and are contractually required to comply with criteria set forth in their management agreement, indenture and other governing documents. Investors have sued managers alleging misconduct (e.g., allegation may include ignoring investment limitations, failing to sell assets at the right time, and similar acts or omissions in which an investor asserts he or she has been damaged).

- Litigation Against Arrangers. Investors have sued arrangers on a number of grounds. For example, they have sued arrangers whom they believe have misrepresented or omitted investment risk. Litigation also may arise against arrangers (and managers) about the timing of the disposition of assets.

2. Investor Disputes. Investors holding different classes of notes may litigate the priorities of payments under the CLO waterfall, or seek court intervention regarding the meaning of CLO governing document provisions.

3. CLO Valuation Disputes. As noted, several CLO noteholders are required to mark their collateral to market, rather than at par. Because CLO prices are often based on transactions in the secondary market, investor lawsuits may arise by those who believe the collateral supporting their notes is undervalued. Similar litigation may arise between managers and arrangers with respect to warehouse assets that have not yet been transferred to a CLO.

4. CLO Trustees. Trustees may become involved in litigation when noteholders and other interested parties with competing interests provide differing instructions.

The above is not intended to provide a comprehensive overview of the issues facing managers, arrangers and other CLO participants, but rather to offer background about certain key issues that constituencies should consider as this COVID-19 global downturn continues to evolve.

Authored by Craig Stein, Douglas I. Koff and James T. Bentley.

[1] Mayra Rodriguez Valladares, "Distress In The Leveraged Loan And CLO Markets Will Significantly Hurt Lenders And Investors," *Forbes Magazine*, March 27, 2020, available here.
[2] Id.
[3] Fitch Ratings, "Fitch Ratings Updates 2020 Sector Outlooks to Reflect Coronavirus Impact," March 27, 2020, available here.
[4] Valladares, "Distress In The Leveraged Loan And CLO Markets Will Significantly Hurt Lenders And Investors," March 27, 2020.

[5] Matt Wirtz and Nick Timiraos, "The Next Coronavirus Financial Crisis: Record Piles of Risky Corporate Debt," *The Wall Street Journal*, March 19, 2020, available here.
[6] Id.
[7] While so-called "covenant-lite" loans made up a mere 15% of the leveraged loan market in 2008, in early 2020 such loans make up almost 80% of outstanding issuance. Sirio Aramonte and Fernando Avalos, "Structured finance then and now: a comparison of CDOs and CLOs," BIS *Quarterly Review*, Sept. 22, 2019, available here.
[8] In the past, banks were adverse to non-banks, such as CLOs, owning portions of syndicated loans because the CLOs often were restricted from issuing new debt and were subject to differing accounting rules, which may have put a CLOs and bank's objectives at odds during a borrower restructuring. These restrictions on assignments changed with the increase in covenant-lite loans and the desire for yield.
[9] CLO notes typically are purchased by institutional investors, including insurance companies, mutual funds, asset managers, pension funds, banks, as well as by non-financial firms. See Emily Liu and Tim Schmidt-Eisenlohr, "Who Owns U.S. CLO Securities?," FEDS Notes, *The Federal Reserve*, July 19, 2019, available here. Many of these institutions purchase different note tranches issued by the CLO. Therefore, they are not insulated by owning solely AAA-rated CLO notes.
[10] See "CLOs Seek Support for Distressed Holdings," Jan. 17, 2020, available here.
[11] Matt Wirtz and Nick Timiraos, "The Next Coronavirus Financial Crisis: Record Piles of Risky Corporate Debt," *The Wall Street Journal*, March 19, 2020, available here.