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The International Comparative Legal Guide to:

Securitisation 2012

A practical cross-border insight into securitisation work

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New Structural Features for Collateralised Loan Obligations

Craig Stein

Paul N. Watterson, Jr.

Schulte Roth & Zabel LLP

Introduction

2011 saw a revival of offerings of collateralised loan obligations ("CLOs"), one of the structured credit products that proved resilient during the credit crisis. CLOs primarily invest in loans to non-investment grade commercial and industrial enterprises and, unlike collateralised debt obligations ("CDOs") which invested in mortgage-backed securities, CLOs suffered few events of default and still fewer liquidations that resulted in losses to investors. [See Endnote 1.] Although the ratings of many CLO notes were downgraded during the credit crisis, the rating agencies raised the ratings of CLO notes in 2011 because of the improved credit quality of the underlying loan portfolios and changes in the ratings methodology for CLOs. Notwithstanding this favourable track record, managers and investors identified deficiencies in the indentures of CLOs issued before 2009. Changes in regulations and tax law also required adaptations in CLO indentures. As a result, structural changes have been made in the governing documents for CLOs issued in 2011 and early 2012.

Some of these structural changes are fundamental. Thus far, indentures for new CLOs require that the CLO invest primarily in senior secured loans to borrowers in the United States and use a "cash flow" model; CLOs which invest primarily in loans to European borrowers or which use a "market value" model have not returned. Post-debt crisis CLOs are not permitted to invest in many types of assets, such as structured finance securities and credit default swaps, in which the prior generation of CLOs could invest because these assets are now widely perceived by investors as posing a greater risk. As a result of the involuntary bankruptcy of a CDO in 2011, CLO indentures have strengthened the provisions intended to prevent a CLO noteholder from successfully forcing the CLO issuer into a bankruptcy proceeding. Changes in regulations also have affected CLO documentation; for example, the new Rule 17g-5 of the U.S. Securities and Exchange Commission, by requiring that any information given to a rating agency be made contemporaneously available to other rating agencies, has changed both the process under which CLOs obtain ratings and the governing documents. Other structural changes to CLO governing documents that are discussed below responded to specific, unanticipated risks that were identified during the credit crisis.

Note Cancellations

Many CLOs failed overcollateralisation tests during the credit crisis, resulting in the diversion of cash that would have been distributed to the most junior class of subordinated notes (and, in some cases, mezzanine notes) to redeem senior notes. In several CLOs, an affiliate of the manager owned both the CLO subordinated notes and mezzanine notes, and surrendered mezzanine notes to the note registrar (which was the bank that acted as trustee for the CLO noteholders) for cancellation, with no payment made to the noteholder for the cancelled notes. As a result of the cancellation of the notes and the corresponding reduction in the debt owed by the issuer, the CLO came back into compliance with the overcollateralisation tests, and cashflows that would otherwise have been diverted to redeem the senior notes became available for distribution to the subordinated notes and the remaining mezzanine notes. These actions angered senior note investors. In one case KKR Financial reached an agreement with the senior noteholders, whereby the senior noteholders agreed not to challenge the surrender of CLO notes by a KKR affiliate for cancellation in exchange for KKR agreeing to refrain from taking a similar action in other CLOs that it managed. In another CDO, the note registrar declined to cancel the mezzanine notes, resulting in litigation before the Delaware Chancery Court, which in 2010 upheld the right of the mezzanine noteholder to tender its notes for cancellation. [See Endnote 2.]

In response to the controversy caused by these attempts to bring CLOs into compliance with overcollateralisation tests through mezzanine note cancellations, the indentures for new CLOs often deprive noteholders of the right to voluntarily surrender a note for cancellation. If the indenture preserves this right, it typically provides that if a noteholder surrenders its notes for cancellation (unless the notes are redeemed or repurchased pursuant to the priority of payments), the cancelled notes will be treated as outstanding for purposes of the overcollateralisation tests until all notes senior to the cancelled notes have been redeemed.

Amend and Extends

The leveraged loan market has experienced a boom in amend and extend solutions to the problem of how to refinance the large amount of leveraged loans coming due in the next few years (sometimes referred to as the "refinancing cliff"). In a classic amend and extend transaction, the credit agreement is amended to provide better economic terms for the lenders in exchange for extending the maturity of the loan. CLO noteholders have questioned whether the manager of a CLO is authorised to agree to these extensions. First, if the reinvestment period for a CLO has ended, may the CLO nevertheless agree to an amend and extend? Second, may the CLO agree to the extension of the loan's maturity if it will cause the CLO to fail its weighted average life test? Third, should the manager decline to participate in the amend and extend transaction if the amended loan would not meet the CLO's eligibility requirements for investment in a new loan?

Many CLO indentures do not provide the manager with clear

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guidance on these three questions, and managers have adopted varying policies regarding amend and extend transactions. Many managers of CLOs believe that they are authorised to approve these transactions as amendments to loans in the portfolio, even if the CLO's indenture would not permit the CLO to purchase the amended loan. Some managers have taken the view that an amend and extend may cause a loan's maturity to extend beyond the legal final maturity of the CLO or cause the CLO to fail its weighted average life test, while other managers take the opposite position.

As a result of the recent wave of amend and extend transactions, specific provisions regarding the parameters for amend and extend transactions are often included in new CLO indentures. For example, new CLO indentures may prohibit the CLO from approving an amend or extend which extends the maturity of the loan beyond a specified date (such as the maturity of the CLO's notes) or would cause the CLO to fail its weighted average life test.

Reinvestment After the Reinvestment Period

This issue came to the forefront in Black Diamond CLO 2005-1. In that CLO, the manager made commitments during the reinvestment period to purchase loans, with the settlement of the purchases to occur after the reinvestment period ended. Senior noteholders objected to the trades being settled with funds received by the CLO after the reinvestment period had ended and insisted that the CLO instead use these funds to pay the noteholders. The trustee in the transaction brought an interpleader action in the United States District Court in order to resolve the dispute among the parties as to the distribution of these funds. Based on an analysis of the relevant indenture provisions, the court ruled that these funds were not available for reinvestment and should be distributed to the noteholders. [See Endnote 3.]

The Black Diamond decision has been misunderstood as standing for the proposition that a CLO may only reinvest funds received before the reinvestment period ends. But many CLO indentures authorise the CLO to apply funds received after the reinvestment period both to settle investment commitments made during the reinvestment period and, subject to more strict criteria, investment commitments made after the reinvestment period has ended. The indenture for any new CLO should specify with precision what funds received after the reinvestment period ends may be reinvested and the additional reinvestment criteria, if any, that are applicable to such reinvestment.

Rating Agency Condition or Rating Agency Confirmation ("RAC")

Since 2008, rating agencies have been more reluctant (and slower) to give a letter (a RAC letter) confirming that an action by the CLO, such as a supplemental indenture or replacement of the manager, will not result in a downgrade or withdrawal of the rating on the notes. This has prevented many CLOs from taking actions recommended by managers in circumstances in which the indenture requires RAC as a condition to the CLO taking the action.

The definition of RAC in many new CLO indentures has been adapted to reflect these practical limitations on when and how each rating agency will give RAC. Some indentures no longer require that RAC come in the form of a letter from a rating agency addressed to the CLO; instead, RAC can now come in the form of a press release or announcement by the rating agency, or a statement by the rating agency to the CLO, manager or trustee that RAC is not required, or that the rating agency's practice is no longer to provide RAC for the proposed action, or that the rating agency no longer views itself as a "Rating Agency" for a specific CLO. In addition, indentures now specifically identify when RAC is required from one rating agency but not from another rating agency. In some transactions, the controlling class has obtained additional protections (such as objection rights) when, as a result of this change in the definition of RAC, the traditional form of RAC letter is not required to be obtained for an important action by the CLO.

Discount Obligations

As loan prices fell during the recession, managers of CLOs found it difficult to trade out of deteriorating loans and into higher quality loans because their indentures required deep discount loans to be carried at their purchase price, rather than par, when calculating the CLO's overcollateralisation tests. A "deep discount" loan was often defined in CLO indentures as (i) loans purchased below 80% of par, regardless of their ratings, or (ii) loans purchased below 85% of par if rated below B3. These restrictions were intended to prevent the manager from manipulating the par value of the CLO's portfolio and thereby improving its overcollateralisation ratios at the expense of the underlying credit quality of the portfolio (so-called "par building").

These restrictions had unanticipated consequences during the credit crisis, when even loans to high quality companies traded well below par. A CLO that sold a risky loan and used the proceeds to buy a loan to a more creditworthy borrower at the same price could suffer a decline in its overcollateralisation ratio, even though the credit quality of the portfolio improved. This occurred because the CLO had carried the more risky loan that it sold at par but was required to carry the new, less risky loan at its purchase price for purposes of the overcollateralisation tests. CLOs tried to amend their indentures to permit these deep discount "substitutions" to be made without suffering a decline in the overcollateralisation ratio. These changes to indentures required a CLO to obtain RAC from rating agencies. As a result, the rating agencies established new criteria for investments in discount obligations, and these criteria now appear in the indentures for many new CLOs. New CLO indentures often permit the CLO to purchase a loan at a deep discount but still treat it as a par obligation for purposes of the overcollateralisation tests if a number of conditions are met (including that the loan was purchased with the sale proceeds of a loan that was not itself a deep discount obligation).

Exchange Offers

An exchange offer is an offer by a company to its noteholders to exchange a new security for its outstanding notes. Many CLOs, particularly during the financial crisis when borrowers were under distress, owned loans for which the borrowers made exchange offers. Although some CLO indentures broadly authorised the manager to accept exchange offers, many did not explicitly permit the manager to accept such exchange offers or did not specify whether other requirements in the indenture (such as the eligibility criteria for investments in new loans) were applicable. New CLO indentures often provide express authority for a manager to consent to an exchange offer without obtaining noteholder consent even if the newly issued security does not comply with the requisite eligibility criteria. Some indentures impose limitations on the manager's discretion to accept an exchange offer if an event of default has occurred under the CLO indenture or if the new security is scheduled to mature after the CLO notes mature.

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Subordination Provisions

Some pre-credit-crisis CLO indentures contained apparent inconsistencies among the post-default liquidation provisions, the subordination provisions and the priority of payment provisions. In CDOs, these inconsistencies resulted in a number of lawsuits and interpleader actions by trustees as different classes of noteholders fought over how cash should be distributed following an event of default. New CLO indentures are resolving these issues in a number of ways. One approach is to provide for a separate priority of payments that applies to all distributions after the occurrence of an event of default or after acceleration of the maturity of the notes following an event of default (subject to the event of default being cured or waived or the acceleration being rescinded) or after liquidation of the portfolio commences. Other indentures retain a single priority of payments but state expressly that distributions to subordinated classes of notes under this priority of payments are subject to the subordination provisions.

Distributions After Liquidation Commences

There have been a number of disputes (primarily in CDOs) about whether funds should continue to be distributed to noteholders under the regular priority of payments on a scheduled payment date that occurs after liquidation of the portfolio commences (following an event of default under the indenture) but before the liquidation has been completed. One approach in new CLO indentures to avoid such disputes is to make clear in the indenture that once a liquidation commences, no distributions will be made on a scheduled payment date until the trustee determines that proceeds of liquidation should be distributed pursuant to the post-default remedial provisions of the indenture. Another approach is to permit distributions to be made on a scheduled payment date but to make those distributions under a separate priority of payments applicable to distributions after an event of default under the CLO indenture.

Sales After an Event of Default

There is a perceived inconsistency between the right typically given to the most senior class(es) of notes (the "Controlling Class") to direct the trustee to sell loans in the CLO's portfolio after an event of default has occurred under the CLO's indenture and the right of the manager to make sales of certain types of loans. This perceived inconsistency led to a number of disputes in CDO and CLO transactions during the credit crisis, and some trustees have declined to permit the manager to make any sales of loans if an event of default has occurred. New CLO indentures may expressly permit certain sales (for example, sales of credit risk or defaulted loans, equity securities, margin securities or assets subject to withholding tax) to be made by the manager after an event of default has occurred under the CLO indenture, but the manager may lose this power if the Controlling Class of notes directs the trustee to liquidate the portfolio.

Sales of Nonconforming Assets and Unsalable Assets

Issues have arisen where a CLO purchases a loan and subsequently the manager or the trustee determines that the loan did not comply with the eligibility criteria in the indenture at the time of purchase. Is the manager permitted or required to sell the asset? At what price? Does the manager need to comply with the normal sale restrictions in the indenture? Does the manager have any obligation to purchase the loan from the CLO? In a few cases disputes and even litigation ensued. Some indentures for new CLOs provide that, if the manager discovers that a loan was purchased in violation of the eligibility criteria, the manager has no obligation to sell the loan, whereas other indentures specify the requirements under which the manager may sell the asset. If the indenture specifies that the asset *must* be sold, it often permits the manager to sell it to any party (including the manager, one of its affiliates or a fund or account that is managed by the manager or one of its affiliates) that will purchase the loan at a price equal to the CLO's purchase price. On a related point, some indentures now authorise the manager to dispose of an "illiquid" asset which is not cashflowing and which cannot be sold in the market. These provisions may authorise the manager to offer the asset to noteholders of the most senior class (and thereafter to other classes in order of seniority) and, if there are no takers in any class of noteholders, to take ownership of the asset itself or to transfer it to a charity or an "abandoned property account". This provision becomes important at the maturity of the CLO notes, because unsalable assets have made it difficult to terminate indentures after the other assets in the portfolio have been sold.

Section 457A

Section 457A of the U.S. Internal Revenue Code of 1986, as amended (the "Code"), generally requires U.S. taxpayers to include in income any compensation that is deferred under a nonqualified deferred compensation plan, unless the income is subject to a "substantial risk of forfeiture". Compensation is generally considered subject to a substantial risk of forfeiture only if the recipient's rights to such compensation are conditioned upon the future performance of substantial services. CLO managers are generally paid fees pursuant to the priority of payments in the indenture which specifies the priority in which cash from the underlying portfolio is distributed to investors and to service providers. Because many CLO managers charge "subordinate fees" and "incentive fees" which are paid only if cash is available at the bottom of the waterfall, and the payment of such fees is often not subject to a "substantial risk of forfeiture" within the meaning of Section 457A, there is real risk that the amount of such fees would not be determinable and paid at the time required by Section 457A. As a result, U.S. CLO managers would be subject to an additional 20% tax and interest penalty charge when such amounts are finally determined and included in the U.S. CLO manager's income. U.S. CLO managers need to structure new CLOs in order to ensure either that Section 457A would not apply or that the compensation arrangement operates in compliance with Section 457A.

FATCA

The so-called "FATCA" provisions of the U.S. Hiring Incentives to Restore Employment Act (the "HIRE Act"), which was signed into law on March 18, 2010, generally require every foreign financial institution ("FFI"), including a CLO organised outside the U.S., to enter into an information sharing agreement with the U.S. Treasury Department (generally by June 2013) and to comply with specific documentation and reporting requirements with respect to its U.S. investors. A CLO that is not in compliance with FATCA will generally be subject to a 30% withholding tax on any "withholdable payment", which is broadly defined to mean any payment of income (including interest) from sources within the U.S. and gross sale proceeds from the sale of property that can produce either interest or dividends from U.S. sources. Substantially all of a CLO's income and potentially all cash receipts and proceeds of loans to U.S. obligors may become subject to FATCA withholding

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beginning in 2014 (for income) and 2015 (for proceeds) if the CLO fails to enter into the required information sharing agreement. Indentures for new CLOs give the managers additional authority to enable the CLO to comply with these requirements or to redeem its securities if it cannot. As the requirements of FATCA are clarified, CLO managers will need to develop compliance systems and adopt approaches to enable their CLOs to comply with the FATCA regime and minimise the risk of withholding.

Tax Subsidiaries

Many CLO indentures did not permit the CLO to establish subsidiaries, which created difficulties when a CLO acquired securities in distressed exchanges during the recent recession, because some of these securities exposed the CLO to U.S. net income taxation. As a result, the indentures for new CLOs authorise the CLO to establish wholly owned subsidiaries to acquire securities of this type, such as U.S. real property holding company equity and equity in "pass through" entities that operate U.S. businesses. The indentures also specify detailed requirements for the organisation and operation of these subsidiaries.

Refinancing

CLO transactions have an optional redemption feature whereby after a specified non-call period, holders of a majority of the equity class of securities may direct the redemption in whole of the CLO's notes through a liquidation of its portfolio. The main requirement to effectuate such a redemption is that the proceeds of liquidation of the portfolio be sufficient to repay the notes at par plus accrued interest. New CLO transactions also provide that, after the specified non-call period, holders of a majority of the equity class of securities may direct the refinancing of any or all of the classes of the CLO's notes in order to achieve a lower cost of funds for the CLO. The indenture includes safeguards to protect the interests of the holders of notes that are not refinanced. In addition, indentures for some new CLOs include a note re-pricing mechanism whereby a majority of the equity, after the specified non-call period, may direct the CLO to re-price (by reducing the spread over LIBOR) any class or classes of notes, without the consent of the holders. Prior to the re-pricing of the notes, noteholders are given the option to retain the notes at the revised pricing level, and any holders not electing to retain the notes are required to be paid par plus accrued interest and surrender their notes. Such re-pricing only takes effect if all holders of the repriced notes consent to the re-pricing or if an intermediary is able to sell all of the notes of the non-consenting holders.

Additional Equity Contributions

Many indentures for new CLOs authorise the CLO to accept contributions in cash and in-kind from the holders of the CLO's equity securities (often consisting of subordinated notes) and also authorise such equityholders to waive their right to receive a distribution from the CLO. The CLO is authorised to use these funds for a broad variety of purposes which are described in the indenture. Typically, the equityholders may specify the purpose for which the funds will be used, which may include: (i) distribution as interest proceeds or as principal proceeds; (ii) repurchase of CLO notes for cancellation; (iii) exercise by the CLO of warrants or options; and (iv) holding a contributed asset as part of the CLO's portfolio.

Conclusion

Many positive structural features have been introduced into the governing documents of CLOs issued in 2011 and 2012. More changes can be expected. For example, CLOs rarely conform to the risk retention requirements in Article 122a of the European Union Capital Requirements Directive, but, as the classes of European Community investors that are covered by these requirements expand, the desire to market the CLO's securities to those investors will require changes to accommodate these requirements. In the next few years CLOs also will need to adapt to the risk retention requirements mandated by the Dodd-Frank Act. [See Endnote 4.]

Endnotes

1 Moody's Investors Service reported that only six of the more than 600 arbitrage CLOs experienced events of default during the credit crisis, of which three were cured, and that none of these events of default resulted in losses for investors in notes rated at least "A".

2 *Concord Real Estate CDO 2006-1, Ltd et al. v. Bank of America, N.A.* (2010).

3 *U.S. Bank National Association v. Black Diamond CLO 2005-1 Adviser, L.L.C. et al.* (2011).

4 Subtitle D of Title IX of the Dodd-Frank Act.

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- Product Liability
- Project Finance
- Public Procurement
- Real Estate
- Telecommunication Laws and Regulations
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