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Collateralized Loan Obligations

Private Investment Funds Investing in CLO Equity and CLO Warehouse Facilities

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Collateralized loan obligation (CLO) issuance totaled approximately $82 billion in 2013, outpacing 2012 total issuance by more than 50%. The establishment of private investment funds to invest specifically in CLO securities is likewise on the rise. This article provides a brief overview of CLO transactions, while also outlining certain key issues that funds may wish to consider when investing in CLOs, with a particular focus on investment in the most subordinated tranche of CLO securities, commonly referred to as the CLO "equity." See also "CLO 2.0: How Can Hedge Fund Managers Navigate the Practical and Legal Challenges of Establishing and Managing Collateralized Loan Obligations? (Part Two of Two)," The Hedge Fund Law Report, Vol. 6, No. 26 (Jun. 27, 2013).

Market Background

Broadly speaking, a CLO is a special purpose vehicle organized to purchase a portfolio of assets consisting primarily of leveraged loans, and to issue multiple tranches of liabilities consisting of rated CLO notes and unrated CLO equity, each with varying degrees of risk and expected returns. Collections on the CLO's loan portfolio are generally either used to pay CLO investors and service providers in the order of priority set forth in a stipulated payment waterfall or, subject to a number of limitations, reinvested in new loan assets. In instances where collections are insufficient to pay all amounts owed to the rated CLO notes and other secured transaction parties, the first loss will be borne by the CLO equity.

The majority of CLOs are arbitrage transactions, pursuant to which the CLO collateral manager actively purchases and sells loans in an effort to capture the spread between the CLO's assets and its lower-yielding liabilities. A minority of CLOs are balance sheet transactions, which are primarily motivated by an institution's desire to remove assets from its balance sheet in order to satisfy regulatory capital requirements and improve returns on risk capital.

A key component of a traditional cash flow CLO is its long-term, non-mark to market nature, which allows the CLO's performance to be driven by the underlying fundamentals of the loans as opposed to market fluctuations, which are often technically-driven. An investment in CLO equity has historically provided investors with a consistent income stream capable of withstanding challenging economic environments.

CLO Equity

Despite recent pressure on the spread between loan assets and the weighted average cost of CLO liabilities, CLO equity continues to be viewed as an attractive investment opportunity among private fund investors.

An investor seeking to acquire at least a majority of the aggregate principal amount of CLO equity can be quite influential in shaping the terms of the underlying CLO documentation. When negotiating the purchase of an "anchor" equity position, investors will often seek to obtain, among other things:

- the right to remove the CLO manager for certain "cause" events and to waive any event giving rise to cause;
- the right to appoint (or in some cases, reject) a proposed replacement manager;
- the right to direct any refinancing or (if applicable) re-pricing of the rated CLO notes;
- the right to direct the issuance of additional CLO securities;
- the right to consent to certain amendments and modifications to the CLO documentation; and
- stringent provisions relating to the events giving rise to the removal of the CLO manager for cause, including, where circumstances permit, "key man" provisions. See "Key Legal and Business Considerations for Hedge Fund Managers When Purchasing Collateralized Loan Obligation Management Contracts," The Hedge Fund Law Report, Vol. 3, No. 13 (Apr. 2, 2010).

Anchor equity investors will frequently seek provisions that afford the CLO manager maximum flexibility to actively manage the CLO portfolio both during and after the prescribed CLO "reinvestment period," thereby increasing the likelihood that sales proceeds and principal pay-downs from CLO assets will be reinvested in additional CLO assets (as opposed to being used to amortize the rated CLO notes), which in turn enhances potential CLO equity returns.

In certain extraordinary cases, anchor equity investors may even possess the leverage to negotiate the right to receive a portion of the CLO manager's management fees on each CLO payment date. Fee sharing arrangements of this nature are typically memorialized in a side letter among the CLO manager, the anchor equity investor and the CLO trustee.

CLO Warehouse Facilities

In the current environment of diminishing loan volume and considerable demand, CLOs will commonly utilize a warehouse facility in order to facilitate the purchase of a significant portion of the initial CLO portfolio prior to the CLO closing date. Before the financial crisis, the "first loss" commitments for such warehouse facilities were customarily provided by the CLO manager, its affiliates or its funds under management. In today's CLO market, however, it is becoming increasingly commonplace for the warehouse first loss position to be assumed by the prospective anchor equity investor in the subject CLO.

CLO warehouse facilities take a number of different forms, the most common of which is comprised of a senior loan facility provided by an affiliate of the CLO arranger and a subordinated first loss commitment provided by a designated first loss provider. The form of first loss provider commitments will also vary, the most predominant being an obligation of the first loss provider to purchase preference shares or make subordinated loans. Irrespective of its structure, the first loss commitment is designed to provide a cushion of overcollateralization to the senior warehouse lender.

Key Structural Issues for First Loss Providers

When reviewing CLO warehouse documentation from the perspective of a first loss provider, there are numerous provisions that warrant close scrutiny.

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Warehouse documents will typically include market value tests, the failure of which will trigger the liquidation of the warehouse portfolio. The consequences of such liquidations – which have historically occurred in a very accelerated manner and at suboptimal liquidation prices – are potentially severe. To illustrate this point, one need look no further than the recent financial crisis, when the widespread failure of market value tests brought about by plummeting loan prices resulted in the mass liquidation of CLO warehouse portfolios and substantial losses for first loss providers, and in some cases, senior lenders.

As the bearer of the "first loss" in any warehouse liquidation scenario, it is incumbent upon the first loss provider to carefully evaluate the mechanics of market value triggers. Ideally, the determination of the market value of any loan asset should be based upon bids from specified recognized independent pricing sources. If market values are to be determined by the senior lender, the documentation should contain a dispute mechanic whereby the first loss provider has the ability to dispute the accuracy of such valuations. If so disputed, the market value of such loan should generally be determined based upon the average bid price from two independent pricing sources mutually agreed upon by the first loss provider and the senior lender.

The first loss provider should also have the ability – and sufficient time – to cure any market value test failure by funding, in its sole discretion, additional amounts above its stated first loss commitment. In addition, if the warehouse facility documents deem the market value of "ineligible" or "defaulted" loan assets to be zero for purposes of calculating the market value tests, the collateral manager should be required to sell any such assets immediately, and compliance with the market value test after giving effect to such sales should be determined on a trade date (as opposed to settlement date) basis.

Another area of significant negotiation relates to the first loss provider's entitlement to proceeds upon the termination of the warehouse facility. Generally speaking, when the termination of the warehouse facility arises from the liquidation of the loan portfolio prior to the CLO closing date, the first loss provider will simply be entitled to receive the remaining liquidation proceeds after the senior lender and certain warehouse expenses are paid in full. Perhaps the most noteworthy consideration in this context is for the first loss provider to ensure that certain CLO start-up costs are not paid with such liquidation proceeds, but rather by the CLO arranger and/or the CLO manager pursuant to their CLO engagement letter.

If the warehouse facility terminates because the CLO has closed, the issues become more complicated. Generally, a portion of CLO issuance proceeds should be used to pay all amounts owed to the senior lender, certain agreed upon expenses incurred in connection with the warehouse facility, and the amount funded by the first loss provider. The first loss provider should also be entitled to receive the "net carry" during the warehouse period, representing the positive arbitrage between the interest on the loan portfolio and the interest on the senior loans.

The manner in which net carry is computed is of critical importance. Most significantly, the first loss provider should seek to require that net carry be computed based upon all interest accrued on the loan portfolio – not merely interest actually paid during the warehouse period – while also seeking

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to resist, to the extent feasible, any efforts by the senior lender and the CLO manager to reduce the net carry computation by certain stipulated warehouse expenses. Another heavily negotiated issue concerns whether net warehouse trading gains and losses should be allocated to the CLO or the first loss provider.

Conclusion

U.S. CLO issuance remains robust, and CLO equity continues to represent an attractive investment opportunity for private funds. As this article illustrates, there are a number of critical issues that warrant the close attention of CLO equity investors, both at the warehouse stage and in respect of the definitive CLO documentation. Committing to an anchor equity stake affords an investor significant leverage to shape these issues.

Greg B. Cioffi is co-head of Seward & Kissel LLP's Asset Securitization and CLO Practice Group. Cioffi has extensive experience with a broad range of asset-backed, market value, cash flow and synthetic transactions. Cioffi regularly represents virtually all of the participants in CLO transactions, including issuers, arrangers, collateral managers, trustees and investors.