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CLOs – Lessons Learned

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Until the financial crisis brought CLO issuance to a virtual halt, CLOs were among the largest and fastest growing structured products in the marketplace, representing approximately 60% of institutional participation in syndicated loans in 2006. While the long-term impact of the Dodd-Frank risk retention rules on CLOs remains uncertain, the short-term outlook for new CLO issuance is promising. As spreads on the triple-A rated tranches of CLOs have continued to tighten, the arbitrage on CLO collateral has become increasingly attractive in recent months. For the first time since the onset of the financial crisis, CLOs are showing signs of a sustained revival.

Although CLOs generally withstood the financial crises, the economic pressures brought to bear on CLO and CDO market participants tested the documentation utilized for these programs to an unprecedented degree. The controversies surrounding the proper interpretation of critical provisions of CLO documentation that arose during the market meltdown are too numerous to discuss in a single article. This article will therefore seek to address a representative sample of these issues, which generally fall into two categories: (1) provisions that need to be clarified or corrected for the benefit of all CLO market participants, and (2) provisions that warrant close scrutiny, but will ultimately need to be crafted to reflect the negotiated intent of the relevant CLO participants. As the CLO industry moves into its next phase, it is essential that the next generation of CLO documentation evolve to reflect the lessons learned from the worst market crisis since the Great Depression.

Common Ground

The financial crisis exposed an array of CLO provisions that market participants would, with the benefit of hindsight, generally agree should be drafted differently. In order to avoid disputes and market uncertainty, these provisions should be addressed with greater precision in the CLO documentation for new issuances.

Conflicts in the Application of CLO Proceeds

The CLO waterfall, which is intended to govern the priority in which cash flows are applied to the payment of amounts due to the various classes of noteholders and to the CLO service providers over the life of the CLO, has proven in a number of instances to be difficult to reconcile with the CLO subordination provisions, which are intended to codify the subordination of the junior noteholders to the senior noteholders with respect to cash flows during the continuance of an event of default. As a consequence, CLO trustees, who are tasked with applying CLO cash flows to the various transaction participants in accordance with the CLO documentation, have too often found themselves caught in the crossfire between investors with conflicting interpretations of these critical provisions.

Trustees have commonly responded to these disagreements by holding the disputed cash flows in escrow pending resolution among the affected parties in court or otherwise. Had the waterfall and subordination provisions in these transactions been clearly aligned, such measures could have been avoided.

Trade and Settlement Date Accounting

Among the most fundamental protections granted to cash flow CLO investors are the provisions that restrict trading by the CLO collateral manager of the underlying CLO assets or trigger the amortization of CLO liabilities if the CLO fails to meet certain benchmarks regarding anticipated CLO cash flows or the overall quality of the collateral. Significant among these benchmarks are the CLO's overcollateralization (OC) tests, which require the vehicle to maintain a minimum cushion between potential available cash flows from the CLO collateral and the principal payments owed to CLO investors. Compliance with the OC tests and other collateral metrics is typically calculated periodically as of a specified date of measurement, commonly referred to as a determination date.

Uncertainty has arisen when CLO documentation is either unclear or inconsistent as to whether trading of CLO collateral should be measured as of the date on which the CLO enters into a commitment to purchase or sell an asset (i.e., the trade date) or as of the settlement date. This trade date/

settlement date distinction can be of significant concern to CLO investors and collateral managers, particularly when assets are being traded in an effort to cure or avoid a test failure in close proximity to a determination date.

Administrative Expense Caps

The fees, out-of-pocket expenses and other amounts due to CLO service providers (such as trustees, independent accountants and rating agencies) fall under the general umbrella of CLO administrative expenses. In general, administrative expenses are payable under the CLO waterfall up to a specified cap prior to the payment of amounts owed to CLO investors. Administrative expenses in excess of the cap are generally payable after the payment of amounts owed to CLO investors.

When CLOs experienced an unprecedented wave of OC test failures during the financial crisis—causing interest proceeds from CLO portfolios that would normally be applied to the payment of administrative expenses in excess of the cap to be diverted to the amortization of principal on the senior notes—this two-tier priority of payment structure resulted in CLO service providers being insufficiently compensated, sometimes for extensive periods of time. Adding an additional layer of controversy, CLO documentation in certain cases neither provided guidance as to the relative entitlement of these service providers to available proceeds, nor afforded the collateral manager a right to allocate these proceeds among the service providers in its reasonable discretion. As a result, undue tension was often created among critical transaction parties—namely service providers and collateral managers—and the timely performance of critical administrative services was in some cases unnecessarily jeopardized.

Deep Discount Dilemma

At a time when management of CLO portfolio risk was of paramount importance, many collateral managers found their hands tied by provisions which, although initially designed to protect portfolio quality, during the financial crisis served to disincentivize collateral managers from making portfolio-improving asset substitutions. CLO provisions governing so-called "deep discount" loans are a prime example of this problem. While the par value of a loan was generally used in CLO documentation for the purpose of computing OC test compliance, deep discount loans—loans that were purchased below a designated percentage of par, typically 80% to 85%—were valued at their purchase price, thereby reducing the theoretical CLO collateral cushion as it related to the principal amount owed to CLO investors.

Under normal market conditions it was assumed that a deeply discounted purchase price was indicative of a distressed loan; however, in the depths of the financial crises, when performing loans were trading at historic lows, even the highest quality loans were, by the narrow terms of cash flow CLO documentation, deep discount loans. As a result, collateral managers would often refrain from substituting a loan of rapidly deteriorating credit quality that did not constitute a deep discount loan at the time of purchase (and therefore was valued at par for purposes of the OC tests) for a higher-quality deep discount loan due to the negative impact the trade would have on OC test compliance. In a number of instances during the financial crisis, collateral managers attempted to amend the CLO indenture to allow (or increase, in those cases where the CLO indenture permitted a small "bucket" of deep discount substitutions) such substitutions, but were often confronted with substantial resistance from senior noteholders. Going forward, industry participants should consider the merits of providing a mechanism in the CLO documentation to permit a loan with deteriorating credit quality to be substituted for a higher-quality deep discount loan without the correspondingly punitive effect on the OC tests, so long as the credit quality of the CLO portfolio is improved or maintained by the substitution.

Equity Securities

As the financial crisis gathered steam, CLO assets were increasingly exchanged for assets that failed to meet the strict parameters for eligible CLO collateral in connection with bankruptcy or workout proceedings in respect of the related borrowers. CLO documentation typically required the collateral manager to dispose of these "equity securities" within a relatively brief period of time following receipt, regardless of the collateral manager's reasonable perception of their potential future value. Perhaps more troubling, unless the CLO documentation contemplated the establishment of an issuer subsidiary to hold equity securities as necessary to avoid potential adverse tax consequences, certain of these equity securities were technically not permitted to be held by

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the CLO vehicle at all. Consequently, CLO managers were at times compelled to trade out of potentially valuable distressed credits prior to a restructuring in order to avoid the receipt of equity securities.

In the future, it may be advisable for CLO documentation to allow equity securities to be retained in circumstances where immediate liquidation is not in the CLO's best interest. In addition, all CLO documentation should permit the formation of tax subsidiaries to allow for the retention of equity securities which would otherwise be required to be disposed of if held by the CLO.

Solutions May Differ

A second category of CLO provisions warranting close attention do not lend themselves to a one-size-fits-all solution, and will therefore need to be specifically addressed to reflect the intent of the transaction parties.

Note Cancellation

OC test failures have the practical effect of diverting the payment of interest on the junior tranches of CLO notes to the payment of principal on the senior notes. Faced with the prospect of watching from the sidelines as dwindling cash flows were being applied solely to senior note amortization, certain CLO investors devised a unique approach to freeing the flow of cash to the most subordinate (commonly known as equity) tranche—they sought to cure OC test failures by purchasing mezzanine notes on the open market at a deep discount, and tendering these mezzanine notes to the trustee for cancellation.

In a highly distressed marketplace, this strategy made economic sense in instances where the value of the payments received by the equity notes after the curing of the OC test failure together with the increased future residual value of the equity notes resulting from the note cancellation would exceed the nominal cost to the equity investors of purchasing the notes to be tendered for cancellation. If implemented, however, this strategy would have had the consequent effect of extending the average life of the senior notes, potentially increasing their expected losses. The prospect of these potential cancellations thus put CLO trustees in a bind: the documentation neither contemplated nor prohibited such cancellations, and if the trustee acceded to the equity holders' wishes, senior noteholders could be adversely effected.

The issue of note cancellation was adjudicated in a court of law based on a fact pattern involving a commercial real estate CDO vehicle. The tenets of the Delaware Supreme Court ruling in *Concord Real Estate CDO 2006-1, Ltd. v. Bank of America N.A., as Trustee*—broadly, that absent an express prohibition in the underlying documentation to the contrary, junior noteholders are entitled to tender their notes for cancellation—would seem equally applicable to CLOs. However, there is no guarantee that courts will apply the *Concord* ruling to CLOs and CDOs with transaction documents governed by the laws of other jurisdictions. Regardless, the subject of note cancellation should be expressly addressed in the definitive CLO documentation going forward. If the CLO documentation does not expressly prohibit such cancellations, the CLO offering materials should adequately disclose the related risks.

No Petition Covenants

The financial crisis has magnified the importance of provisions relating to the power of certain classes of noteholders to direct a liquidation of the CLO portfolio following an event of default. CLOs that require the direction of only a requisite percentage of the senior-most "controlling" class of noteholders in order to liquidate present significant risks that junior noteholders will not be made whole in tumultuous market environments where loan assets are being sold in bulk, often at fire sale prices.

However, even in circumstances where the documentation requires a requisite percentage of multiple classes of notes to direct a liquidation, circumstances have arisen in the CDO context where the controlling class has taken the position that the documentation's "no petition" covenants can be read to afford senior noteholders the right to petition the CDO into bankruptcy. If successful, these noteholders would effectively be side-stepping the CDO's liquidation mechanics and voting rights, the latter of which are typically heavily negotiated at the outset of the transaction. In the future, careful attention must be paid to these no petition provisions in the CLO context to ensure that they properly reflect the intent of the parties.

Flexibility to Cure OC Test Failures

In certain circumstances, cash flow CLO investors may wish to afford their collateral managers increased flexibility to avoid or cure OC test failures. There are numerous ways in which CLO documentation can enhance a collateral manager's ability to maintain compliance with, or cure failures of, OC tests and other CLO collateral quality metrics, including the following:

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- permitting the CLO's equity holders to contribute additional cash to the CLO vehicle;
- allowing the issuance of additional CLO equity under certain enumerated circumstances; and
- basing test compliance not upon each individual substitution of assets, none of which would avoid or cure a test failure if measured individually, but upon a basket of trades executed within a finite window of time that would avoid or cure such failure when measured collectively.

While these are but a few examples, the breadth and scope of the tools at a particular collateral manager's disposal will be tailored to the objectives and risk profiles of the relevant CLO investors.

Conclusion

While it remains to be seen whether CLO industry initiatives will succeed in convincing regulators to distinguish CLOs from other securitization structures under the Dodd-Frank risk retention regime, the near-term future of CLO issuance shows promise. As the short-term environment for CLO issuance improves, it is crucial for the documentation for new CLO issuances to incorporate provisions reflecting the many lessons learned from the financial crisis. With the benefit of hindsight, CLO market participants have the opportunity to improve documentation going forward in order to avoid the various pitfalls and disputes that have befallen transaction parties in the past.

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