Bloomberg Law

Checklist

Potential Legal Claims Among CLO Participants

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Editor's Note: In the unprecedented fallout and continuing economic devastation of the Covid-19 pandemic, an increase in litigation could soon engulf the recently red-hot world of collateralized loan obligations, or CLOs. These cases may involve claims by CLO participants that the performance of those securities is not merely a byproduct of broader economic misfortune, but rather a consequence of misconduct in the selection and management of the collateral, or a failure to enforce contractual rights, that amounts to a breach of contract or fraud.

As discussed more fully in Part I of this series, CLOs involve a handful of key parties—including the CLO manager, the CLO arranger, the trustee, and the investors (noteholders)—each of which has its own interests, risk tolerance, rights, and obligations. When these complex deal structures are combined with systemic stresses of the type discussed in Part II of this series, a perfect storm for disputes among CLO participants begins to take shape. This checklist will explore potential claims against and among these participants.

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Crisis Management: Claims Involving the Collateral

At its core, the litigation risk in the CLO market arises from the possibility that one or more participants in the transaction fails to fulfill its obligations in such a way that either the collateral becomes impaired or is at greater risk of becoming impaired. CLOs are able to make payments to noteholders as long as their collateral—in this case, leveraged commercial loans—continues to perform.

Even in the best of times, such loans carry risk; CLOs typically compensate for this by overcollateralization, excess spread, and diversification of industries. But as the bottom drops out of the market, a risk emerges that multiple simultaneous adverse events—such as bankruptcies, defaults, or credit rating downgrades—could afflict the collateral. If this occurs, losses could percolate even into the more risk-remote tranches of a CLO.

When nonperforming collateral gives rise to losses, the affected noteholders may be incentivized to examine the conduct of the parties that are in theory most responsible for that collateral: the CLO manager and other parties that establish and administer the security. When assessing potential claims involving these parties, relevant questions might include:

Was the Collateral Properly Selected?

The governing documents of a CLO, such as the indenture, typically set forth criteria for the underlying commercial loans, with an eye to managing the risk presented by such assets. These can include specific criteria that define the characteristics that each loan must possess, such as a minimum rating requirement or leverage ratio. They also typically include aggregate criteria, such as restrictions on the proportion of loans with certain credit ratings (e.g., CCC), within particular industries or business sectors (e.g., construction), or in certain geographical areas. Restrictions on the proportion of "cov-lite" loans—i.e., loans with fewer protective covenants such as required financial maintenance tests, as described in Part II—are also common. To the extent that loans are selected in a way that violates the requirements set forth in the governing documents, parties may attempt to bring claims against the CLO manager.

Has the Collateral Been Properly Managed?

CLOs generally contemplate that their assets will be actively managed; in other words, as explained in more detail in Part I, the CLO manager usually has the ability to move assets (i.e., leveraged loans) into and out of the trust by purchase or sale during the reinvestment period. During this period, the individual and aggregate loan criteria discussed above continue to apply.

The trading of the loans underlying the CLO portfolio must occur within the stipulated reinvestment period. Further, the CLO manager owes fiduciary duties to investors in connection with its management of the trust assets. The CLO manager must therefore remain cognizant of the requirements found in the governing documents throughout the lifetime of the trust and ensure that any investment decisions are made in order to protect or improve the credit quality of the collateral.

If the collateral begins to fail, the party managing that collateral can expect scrutiny of its investment and trading decisions with an eye to determining whether it acted in the best interests of the trust and the noteholders to minimize risk. Individual noteholders may have divergent views about what constitutes proper management, particularly when comparing investors in senior tranches to investors in more junior tranches given differences in how payments and losses are allocated between tranches.

For example, some investors may believe that underperforming collateral should promptly be sold, even if doing so results in a loss to the most junior tranches, to avoid the risk of a further decline in value that may impact more senior tranches. Other investors, such as equity tranche holders (who are the first to suffer any realized losses), may prefer that the collateral be held to avoid or delay realizing a loss upon sale, in the hope that conditions will improve and the collateral will regain its value.

Were Overcollateralization Tests Run Properly?

As noted in Part I, a common credit enhancement feature of CLOs is overcollateralization, or ensuring that the total balance of the collateral exceeds the total amount of principal promised to the noteholders by a certain amount. Governing documents typically prescribe when and how the CLO manager must perform these tests. CLO managers can expect scrutiny from other participants of decisions made in connection with overcollateralization tests, including whether collateral that was added or removed from the trust was valued accurately.

What Representations Were Made in Connection with the Collateral?

Though CLOs are offered by private placement rather than publicly, potential noteholders are generally furnished with an offering memorandum that makes representations regarding the quality of the collateral, the requirements and limitations for management, and other aspects of the overall transaction. This information is generally prepared or provided by the CLO arranger.

Further, after the transaction has closed, noteholders receive regular reports on the status of the collateral that detail a variety of information including income from the collateral, the delinquency rate of the same, and the results of any performance tests or calculations that are performed on the trust.

For example, CLO managers run the overcollateralization tests discussed above. To the extent that any representations are untrue or misleading, or if any reports or tests were falsified or manipulated to achieve a certain result, CLO managers, CLO arrangers, or any other parties involved in making representations could face claims for common law or securities fraud.

Were There Any Conflicts of Interest?

Some private equity firms are involved in both the business of originating leveraged loans and the business of CLO management. In other words, the same firms that offer leveraged loans to below-investment-grade enterprises may find it attractive to then package those same loans into CLOs in order to generate liquidity and diversify assets; indeed, some CLOs are composed primarily of loans originated by the manager itself.

Assuming full disclosure, there is not necessarily an issue when the same party originates and securitizes loans. It is even possible that this arrangement reduces risk, as the CLO manager may have superior insight into the nature of the underlying loan collateral. At the same time, this arrangement seems to echo the originate-to-distribute or conduit models that were once common among other asset-backed securities like residential mortgage-backed securities, or RMBS.

Such models faced significant scrutiny and allegations of self-dealing and other misconduct from both private parties and government regulators in the fallout of the last economic crisis. Similar arrangements in the context of CLOs may cause investors to raise an eyebrow if the underlying assets poorly perform. Further, some CLO managers may have a financial incentive to maximize returns to the equity tranche due to incentive fees based on the rate of return of equity notes.

In both of these situations, CLO managers must naturally still exercise the same fiduciary duties with respect to the trust and the noteholders, regardless of whether they originated the collateral or receive additional compensation based on the performance of certain tranches.

Events of Default: The Role of the Trustee

As previewed in Part II of this series, the indenture that governs a CLO typically sets forth one or more triggers for an event of default. While EOD triggers vary between deals, these triggers generally focus on the status of the collateral. EOD triggers could include whether the collateral is performing, has experienced any ratings downgrades, or is meeting overcollateralization targets.

Further, the transaction documents can provide for an EOD when a threshold delinquency rate is reached for the underlying loans or when noteholders do not receive all of their promised payments. When an EOD occurs, the trustee takes center stage, supplanting the CLO manager.

During an EOD, the role of the trustee is to preserve the collateral for the benefit of the noteholders. While a CLO trustee's duties are normally limited, one consequence of an event of default is that it may trigger additional powers—and in some cases, obligations—of the trustee in order to respond to the default.

Such powers and obligations may be triggered by the default itself, or by notice and direction of a majority of senior noteholders following the default. The powers typically vested in the trustee to this effect include liquidating the collateral or accelerating the maturity of the notes. In the exercise of these powers, the trustee must be guided by its fiduciary duty to the trust and to the noteholders. But in the complex, multi-party world of CLOs, hewing to that duty may be easier said than done, potentially opening the trustee up to liability.

The core problem facing the CLO trustee in an EOD is balancing the competing incentives and interests of multiple parties, each of whom is owed a fiduciary duty, and each of whom could potentially sue if they feel that the trustee has not properly exercised that duty. As detailed in Part I, the CLO is divided into different tranches, which have different payment priorities based on the waterfall structure.

The noteholders are thereby stratified into a gradient of risk appetites, from the highest risk (and greatest economic upside when the CLO performs) to the most risk-remote classes of noteholders (which are the last to suffer losses if it does not). Accordingly, different classes of noteholders might stand to gain or lose different amounts based on actions that the trustee could take during an EOD, which could be difficult for the trustee to square with its fiduciary duties to all noteholders. Also, as noted above, different noteholders may have different preferences with respect to collateral management decisions.

In an attempt to resolve the competing interests of different noteholders and provide guidance to the trustee's exercise of its fiduciary duties, CLO governing documents often provide for noteholder control of the trustee during an EOD. These provisions generally require a majority or even a supermajority of noteholders to provide formal written direction to the trustee to exercise its powers over the collateral.

But even with such provisions, noteholders that are not part of the controlling majority may feel frozen out or aggrieved, especially if the controlling class directs a liquidation or other disposition of assets that does not benefit all classes equally. In turn, litigation could develop over whether the conditions were met for a controlling class of noteholders to provide direction or, if so, whether such class followed the proper formalities associated with directing the trustee.

Finally, if a noteholder majority fails to coalesce, the trustee will be left without guidance and may have to act on its own judgment. CLO governing documents generally provide that in the absence of direction, the trustee must at least collect the proceeds of the collateral and make distributions pursuant to the indenture, to the extent possible. But beyond such basic management activities, experience has shown that trustees in similarly structured asset-backed securities (ABS) are often reluctant to act on their own initiative.

Indeed, other ABS trustees have not always taken an active role in asserting what some investors may see as valid claims against other parties to the transaction and have instead tended to wait to receive direction from a controlling class. Some trustees have sought an undertaking from the directing noteholders in case the trustee is later challenged for having brought such litigation or having resolved it on terms that were not acceptable to certain noteholders.

Given the increased likelihood that event of default provisions will be triggered in the current economic environment, CLO participants should be attuned to the triggers of an event of default as well as their rights and obligations once an event of default has occurred. Since some rights and remedies may be time-sensitive, parties should be familiar with these provisions and their ramifications well in advance of when they might be triggered.

Remedies and Recovery: Payouts to Investors

Like other forms of asset-backed securities, CLO governing documents typically include a "no action" clause that acts as a significant impediment to the assertion by individual noteholders of contract-based claims in connection with the CLO. Thus, such claims must generally be brought by the trustee on investors' behalf—subject to the various legal and practical limitations on the trustee discussed above.

If the trustee pursues claims and obtains a recovery in litigation over a CLO, the damages award or settlement would be paid to the trust and distributed to noteholders indirectly, likely based on the same waterfall payment structure that governs ordinary payments to noteholders. In the RMBS context, suits arose among investors involving disputes over how settlement payments should be allocated and distributed to various tranches. Because CLOs also have a complex structure that prioritizes certain classes above others, similar disputes over waterfall distributions of damages or settlement payments could arise in the CLO context.

Conclusion

If losses begin to mount within CLOs, litigation will likely be close behind. While common-law fraud and/or fiduciary duty claims will be available in some circumstances, experience with other asset-backed securities has shown that contract claims are likely to take center stage.

We have also seen from RMBS litigation that even comparably structured deals can include distinct provisions that impact available claims and remedies. Thus, it would behoove any participant in a CLO to acquaint itself now with the indenture and other governing documents and not to wait until the crisis deepens.

Given numerous overlapping legal and economic issues in these structured finance transactions, attorneys and consultants with experience in the deluge of RMBS disputes over the past decade will be well-positioned to provide advice on the complicated legal and factual issues that will arise in litigation concerning CLOs.