



KRIEGER KIM & LEWIN LLP

RMBS Redux? Navigating the Impending CLO Crisis

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In light of the considerable economic challenges facing multiple sectors of the economy, collateralized loan obligations (“CLOs”) may soon become a significant source of litigation and criminal and regulatory scrutiny. Market participants should therefore take stock now of their potential exposure and/or the claims to which they may be entitled.

The CLO Market

CLOs are securities backed by pools of debt, typically bank loans to below-investment grade companies. The debt is purchased by a special-purpose vehicle, known as a CLO issuer, using funds received from investors. The investors receive notes in the CLO, which are organized into a series of distinct tranches, each with its own risk/return profile. The CLO portfolio is managed by a collateral manager, and the investors’ interests are intended to be protected by a trustee.

CLOs are similar to the collateralized debt obligation (“CDO”) and residential mortgage-backed security (“RMBS”) products that fueled the 2008 financial crisis, except that CLOs bundle leveraged loans to troubled businesses in place of subprime mortgages to low-credit home buyers. The CLO market is currently estimated to be worth more than the subprime-mortgage CDO market was at its height.

Just as the collapse of the housing market across multiple geographies precipitated the last financial



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crisis and the ensuing RMBS-related litigation, so too could widespread, cross-sector distress trigger corporate loan defaults, which in turn would lead to distress in the CLO market. The risks associated with this are heightened by the fact that a significant majority of the loans underlying CLOs are “covenant-lite,” meaning that they include relatively weak covenants that provide only minimal protection to the lenders and, by extension, the CLO investors.

Anticipated CLO-Related Disputes and Investigations

The last financial crisis prompted a slew of RMBS-related litigation, leaving few major financial institutions unscathed. Indeed, there appears now to be a resurgence of such litigation in the wake of the pandemic. But, just as this current crisis is spawning renewed RMBS litigation, several potential areas of CLO-related disputes are likely to emerge in the coming months as well.

Claims challenging managers’ investment decisions and/or valuations: As default rates rise and CLO losses accumulate, noteholders or trustees may bring suit against collateral managers, challenging their investment decisions and alleging that they failed to comply with contractual obligations to meet specified investment eligibility criteria. Similarly, noteholders or trustees may bring claims against managers for allegedly taking steps to manipulate or overstate the value of the underlying collateral in order to remain in compliance with applicable fund requirements. Analogous claims were brought following the last financial crisis, and such claims may arise in future litigation.

Claims challenging representations regarding the structure of CLO funds and the quality and risk profile of the underlying debt: Noteholders or trustees may bring suit against the entities that originally created the CLO issuer and marketed the fund, alleging that such entities misrepresented – or made material omissions regarding – the structure of the fund and/or the quality and risk profile of the debt to be purchased by the CLO.

Claims contesting prioritization of payments or distribution of settlement proceeds: As cash flows dissipate, disputes may emerge among noteholders regarding the proper prioritization of payments, or regarding when and how the fund should proceed with liquidation of the underlying collateral. Similarly, if and when settlements are reached in connection with any combination of the other claims discussed herein, litigation regarding the distribution of settlement proceeds may soon follow.

Regulatory and/or criminal enforcement actions:

Many CLO-related claims – particularly those predicated on allegations of misrepresentations, omissions, and/or manipulated valuations – may draw scrutiny from regulatory and criminal authorities.

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Market participants should assess the extent to which they may face exposure to some combination of these claims – or the extent to which they may have an opportunity to bring such claims themselves.

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