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Collateralized Loan Obligations

Key Legal and Business Considerations for Hedge Fund Managers When Purchasing Collateralized Loan Obligation Management Contracts

By Jennifer Banzaca

CLOs, a species of collateralized debt obligation, are special purpose entities that issue senior rated debt securities and junior unrated equity-like securities which provide different levels of exposure to a pool of loans owned, directly or indirectly, by the entity. The principal and interest payments on the securities issued by the CLO generally come from the principal and interest payments made by the borrowers of the loans held by the CLO and, in some cases, from purchases and sales of the underlying loans.

The idea behind issuing multiple classes – or "tranches" in CLO parlance – of CLO securities is to reallocate the risk of underpayment or nonpayment on the underlying loans, and thereby diminish the risk assumed by the senior noteholders. In other words, if a pension fund wanted exposure to a loan used to fund a leveraged buyout in 2006, it might purchase the loan directly, but it would cease receiving principal or interest payments as soon as the borrower stopped making such payments. However, if the pension fund purchased senior notes issued by a CLO that held that same leveraged loan along with other leverage loans, a default by the borrower on that leveraged loan might not cause the pension fund to cease receiving principal and interest payments on the senior CLO note. This is because other leveraged loans in the CLO would, in theory, continue paying principal and interest, thus enabling the CLO to continue making principal and interest payments to its senior notes holders. Also, any underpayment or nonpayment on any of the underlying loans would first be absorbed by holders of the junior or "equity" notes.

What this theory – and the associated AAA ratings of many of the senior notes issued by CLOs – did not take into account prior to 2008 was the possibility that all of the leveraged loans in a CLO could simultaneously stop paying principal and interest. In other words, the high ratings of senior CLO notes and the associated perception of safety was based on the idea that a diversified portfolio of otherwise risky loans to companies in different industries and geographies was considerably safer and less volatile than the individual loans in the portfolio – especially when the initial losses on that diversified portfolio were contractually allocated to other people. But credit markets seized up globally starting in 2008, CLO equity tranches were wiped out and CLO senior notes were revealed as significantly riskier than their coupons suggested. In short, CLOs got a bad name during the credit crisis, and from September 2007 until March 30, 2010 (three days ago), no new CLOs were issued. (On March 30, 2010, Citigroup Inc. priced a new $525 million CLO to be managed by Fraser Sullivan COA, an affiliate of WCAS/Fraser Sullivan Investment Management LLC. Of the $525 million raised, $230 million is expected to be used to partially refinance a CLO that was priced in January 2009.)

However, many CLOs remain in existence and various hedge fund managers currently manage CLOs, have managed CLOs or have the personnel and infrastructure in place to manage CLOs today or with minor adjustments. For example, the skill sets and infrastructure required to manage

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distressed debt or credit hedge funds are similar to those required to manage CLOs. Accordingly, for certain hedge fund managers, purchases of the contracts to manage those existing CLOs may offer a number of attractive features including: (1) an ongoing, reasonably predictable revenue stream; (2) "sticky" investor assets at a time when assets remain difficult to raise and retain; (3) a potential foot in the door with major institutional investors; (4) an asset (the management contract) that may be illiquid, and thus may be obtained at a discount to fair value; (5) forced sellers of management contracts; and (6) an "infrastructure arbitrage" (in the sense that certain larger hedge fund managers may enjoy economies of scale that enable them to manage a CLO at lower cost than smaller managers). For analysis of another situation in which an albatross for one hedge fund manager may be an opportunity for another, see "Will Reported Purchases by D.E. Shaw Hedge Funds of Assets in Other Hedge Funds' Side Pockets Set a Precedent, or Highlight the Fiduciary Duty, Valuation and Other Challenges in Such Transactions?," The Hedge Fund Law Report, Vol. 3, No. 11 (Mar. 18, 2010).

To assist hedge fund managers in evaluating, entering and negotiating the CLO management market, the remainder of this article discusses: the mechanics of CLOs, including features relating to investments, fees, payment priority, ratings and withdrawals; recent precedent transactions involving sales of CLO management contracts; rationales for selling CLO management contracts; rationales for buying CLO management contracts; and key legal considerations in connection with purchases or sales of CLO management contracts, including consent requirements and how to avoid the assumption of liabilities of the prior manager.

Mechanics of CLOs

Structure, Choice of Entity and Regulatory Exemptions

As indicated, CLOs generally are bankruptcy-remote, special purpose entities that issue various tranches of debt and equity, the proceeds of which are used to purchase leverage loans and other bank debt. Oftentimes, the CLO is organized in an offshore jurisdiction and issues interests to non-U.S. investors in reliance on Regulation S under the Securities Act of 1933 (Securities Act). Alternatively, the CLO may be organized as a Delaware limited partnership or limited liability company and may offer its interests in reliance upon Rule 144A under the Securities Act, which provides a safe harbor from registration of securities offered to "Qualified Institutional Buyers" (generally, entities with at least $100 million under management). In this sense, domestic CLOs generally employ the same entity types as hedge funds, but rely on a different safe harbor to avoid registering offerings of their interests. The chief difference between Rule 144A interests and those issued under Regulation D (the safe harbor relied upon by most domestic hedge funds) is that Rule 144A interests are significantly more liquid.

Domestic CLOs, like many hedge funds, generally rely on Section 3(c)(7) of the Investment Company Act of 1940 (Investment Company Act) to avoid registration as an investment company. Generally, a CLO organized outside of the U.S. falls outside of the jurisdiction of the Investment Company Act, so long as it does not make a "public offering" in the U.S. Similarly, many CLO managers avoid registration under the Investment Advisers Act of 1940 (Advisers Act) based on the "private adviser" exemption provided in Section 203(b)(3) of that Act. However, the "Restoring American

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Financial Stability Act of 2010," sponsored by Senate Banking Committee Chairman Chris Dodd (D-CT) and recently passed by the Banking Committee (Dodd Bill), would rescind the private adviser exemption. That Dodd Bill will be introduced on the Senate floor in the coming weeks. See The Hedge Fund Law Report's Regulatory & Legislative Database.

Tranches, Ratings and Investor Base

CLOs generally issue various tranches of debt, from the safest and most senior tranche at the top of the capital structure to the most risky "equity" tranche at the bottom. (Though termed "equity," the junior-most tranche may consist of preferred stock or subordinated notes.) All tranches except the equity are rated by a rating agency (e.g., Standard & Poor's, Moody's, Fitch), with ratings reflecting the likelihood of payment of principal and interest. The senior debt tranches generally pay a lower coupon, reflecting their presumed lower risk (e.g., LIBOR plus 25 basis points), while the junior debt tranches generally pay higher coupons, reflecting their presumed incrementally higher risk (e.g., LIBOR Plus 150 basis points). The equity tranche generally does not pay a coupon, but rather receives residual cash flows, that is, cash flows left over after the principal and interest on the senior tranches has been paid in full. Generally, senior notes comprise a majority of CLO notes by face amount.

Attaching ratings to the more senior tranches is important because certain institutional investors, by the terms of their investment guidelines, are only permitted to invest in debt with certain ratings. Interests in hedge funds, by contrast, are not rated. Therefore, although a CLO and a debt hedge fund may invest in the same loans and produce similar economic returns gross of fees, they would fall into different categories under the asset allocation guidelines of many institutional investors, such as pension funds. Accordingly, William Lutkins, Managing Director and Senior Portfolio Manager of Aladdin Capital Management LLC's CLOs and Flexible Investment Fund, noted that institutional investors whose investment policies only permit investments in debt at or above certain ratings, such as pension funds and banks, comprise a significant proportion of the investors in senior CLO notes. Historically, hedge funds have been noteworthy buyers of CLO equity tranches, in addition to serving, in many cases, as CLO managers.

Grant Buerstetta, a Partner at Blank Rome LLP, noted that "one of the key differences between CLOs and hedge funds is that CLOs are issuing debt securities as well as equity securities. The debt securities tend to be a significant portion of the securities offered. Debt securities are typically rated, which means you have a rating agency looking over the structure, ensuring that their criteria are being complied with and that particular provisions are included in the documentation to satisfy their requirements. Because you are issuing debt securities, you also have a trustee who has responsibility for collecting and paying out money, and they will have an interest in making sure that the various terms of the documentation suit their needs."

Ramp Up, Reinvestment and Amortization

Generally, a CLO operates in three stages: ramp up, reinvestment and amortization. During the ramp up period, which usually lasts three to six months starting on the day of closing of the CLO, the CLO uses the proceeds of its note issuance to purchase loans, which then serve as the "collateral" for the notes. (Alternatively, the manager may arrange with the CLO underwriter to purchase the loan collateral prior to issuance of the notes, then to transfer the collateral to

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the CLO in exchange for the proceeds of the note issuance – a process known as "warehousing.") Once the CLO is fully invested, the CLO reinvests cash and other proceeds from the loan portfolio in new loans. This is known as the "reinvestment" or "revolving" period, and usually lasts three to five years. Finally, during the amortization period, the CLO uses cash and other proceeds from the loan portfolio to pay off or retire the various tranches of notes issued by the CLO. During all these periods, a CLO must continue to meet certain tests, including tests relating to average maturity, concentration, minimum average ratings, portfolio diversity, over-collateralization and interest coverage.

Like hedge funds, the types of investments a CLO can make are governed by the CLO documentation as well as the management contract between the manager and the CLO. However, the discretion of the manager of a CLO usually is significantly more restricted than the discretion of a hedge fund manager. Paul Watterson, a Partner in the New York office of Schulte Roth & Zabel LLP and Chair of the firm's Structured Products & Derivatives Group, explained that "CLOs have a very defined set of investment guidelines – the eligibility and reinvestment criteria – that are legally binding. In any one deal there may be 40 to 45 of them and they really restrict the types of loans the manager can buy and the sales the manager can make of those loans."

Even during the reinvestment period, a CLO manager is restricted in the types of loans it can buy or sell and the circumstances in which it can do so. "Once a CLO is fully invested, the manager can reinvest the cash collections as they come in for three to five years," Watterson noted. "There are very strict limits on what they can buy. If there is an event of default on the notes they have to stop reinvesting. During the reinvestment period they can turn over the portfolio maybe 10 to 15 percent per year. In addition, the manager can sell loans which have had a significant improvement or decline in credit quality." Buerstetta similarly explained that "you can't turn over a portfolio in a CLO the way you would in a hedge fund. There are limitations on how much trading you can do in any 12-month period, with exceptions for selling assets that have deteriorated in credit quality and things of that nature."

CLO Management Contracts

Geoffrey Goldman, a Partner in Shearman & Sterling LLP's Asset Management Group, noted that "the CLO documentation itself will typically have an indenture that sets forth the terms of the securities that are issued and will say what the CLO can do and not do in terms of purchasing and selling assets. The management agreement requires the manager to comply with those restrictions."

Buerstetta added that CLO management contracts generally dictate the terms by which the investment manager will operate, set the parameters within which the manager may buy or sell assets, establish the standard of care under which the manager must operate, set forth the criteria for terminating the manager and include key person provisions. See "Key Person Provisions in Hedge Fund Documents: Structure, Consequences and Demand from Institutional Investors," The Hedge Fund Law Report, Vol. 2, No. 37 (Sep. 17, 2009).

Manager Fee Structure

CLO managers receive fees according to a complex "waterfall" structure. Generally, the manager may receive three categories of fees: a senior management fee, a subordinated management

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fee and an incentive fee. The senior management fee has high priority, the subordinated management fee generally ranks below principal and interest payments to senior noteholders and the incentive fee is only earned if certain investments targets or hurdles are achieved.

Watterson explained the typical waterfall principles in more detail, as follows: "Every quarter there is a senior management fee, which is paid before the investors get anything. There is also a subordinated management fee. The CLO issues multiple classes of rated notes and usually one equity class that may be subordinated notes or preferred shares. The rated notes have stated interest rates, typically LIBOR plus a spread. So, the manager doesn't get his subordinated management fee until all those rated notes have gotten their interest payment and all over-collateralization and interest coverage tests have been passed. Then the manager gets his subordinated fee and the equity class – or subordinated notes, as they're usually called – gets their equity distribution. At some point, when certain thresholds, targets rates or hurdles are hit, the manager starts getting an incentive fee alongside the equity class. It's almost like a complicated private equity fund waterfall."

Shearman's Goldman added with respect to management fees, "There is a priority of payments for every distribution. For example, the subordinated management fee typically comes below the interest on the rated CDO debt. If for some reason for that quarter the cash flow from the assets was not enough to pay the interest on the rated debt, the manager wouldn't receive the subordinated fee. Whether you get paid depends on whether the deal can pay everyone who is above you in the priority of payments. The incentive fee often has a hurdle that has to be met before the manager gets paid."

Term and Withdrawals

Unlike a hedge fund, which is conceptually perpetual, the term of a CLO is finite, and generally limited to the duration of the longest-term notes issued by the CLO. (In practice, most hedge funds have a limited life despite their theoretically indefinite term.)

CLO investors generally do not individually have periodic redemption rights, as do hedge fund investors. However, investors in subordinated CLO notes often have the right, upon the vote of a specified percentage of subordinated noteholders by face amount, to require the CLO manager to sell certain loans and distribute the net proceeds, so long as the net proceeds are sufficient to retire any rated notes at par plus accrued interest (plus, in some cases, a call premium payable to the rated noteholders). As Watterson explained, "there are provisions that a specified majority (usually two-thirds) of the owners of the subordinated notes can get together and call all of the rated notes at par. There is usually a non-call period of three to five years, but then they can exercise this call option. So, if they think the portfolio has gone up greatly in value and they'd rather get the manager to sell the portfolio and pay off the rated debt and take a big distribution to themselves, they can do that."

Cash Flow CLOs versus Market Value CLOs

The distinction between "cash flow" CLOs and "market value" CLOs generally relates to the degree of trading permitted in the CLOs. Broadly, market value CLOs permit more trading and cash flow CLOs permit less. Accordingly, market value CLOs generally have: slightly higher management fees; slightly fewer or less restrictive investment guidelines and tests (such as less onerous over-collateralization

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tests); payments made to noteholders based in part on gains from portfolio transactions, rather than just from principal and interest on loans held in the portfolio; mark-to-market valuation of portfolio collateral; and revolving credit facilities to facilitate trading.

Sales of CLO Management Contracts: Precedent Transactions

Since the start of this year, there have been a number of noteworthy sales of CLO management contracts, including the following:

- In January 2010, Babson Capital Management announced the assumption of contracts to manage five CLOs with collective assets under management of $1.7 billion. Babson assumed the role of collateral manager from Jefferies Capital Management, a subsidiary of Jefferies Group, with respect to: Victoria Falls CLO, Diamond Lake CLO, Clear Lake CLO, Summit Lake CLO and St. James River CLO.

- Also in January 2010, GSO/Blackstone Debt Funds Management LLC, a business unit of GSO Capital Partners LP, which is an affiliate of The Blackstone Group LP, acquired collateral management agreements for nine CDO and CLO funds formerly managed by Callidus Capital Management LLC. Total assets within the Callidus funds are approximately $3.2 billion, consisting chiefly of leveraged loans and high yield bonds.

- In February 2010, ING Alternative Asset Management LLC, a registered investment adviser, announced that it had been appointed as the successor collateral manager for three CLOs previously managed by Avenue Capital Management II, LP: Avenue CLO IV, Ltd., with $378 million in assets; Avenue CLO V, Ltd., with $622 million in assets; and Avenue CLO VI, Ltd., with $472 million in assets.

- Also, press reports in February 2010 noted that Stanfield Capital was considering sales of the management contracts for 11 CLOs with approximately $4.3 billion under management.

"In these transactions where you see the CLO manager changing, there are two fundamental types of transactions," Watterson noted. "In some of them the manager has gone out and asked other managers if they want to take over the contracts. There may be some compensation to the former manager in return. There are also situations where the manager is being fired or is resigning. In a few transactions, two successful managers are combining their operations."

In such transactions, the purchaser generally acquires the obligation to manage the CLOs and the right to the associated fee revenue streams. The seller generally receives upfront consideration based on the anticipated future revenue streams, and in some cases an earnout if certain hurdles are achieved. In practice, the sellers in many of these transactions are in challenging negotiating positions, and so the revenue assumptions used to calculate deal consideration frequently, since the start of this year, have favored buyers.

Rationales for Sales of CLO Management Contracts

The chief rationale for sales of CLO management contracts has been a precipitous decline in subordinated management fees. Generally, CLO managers only earn subordinated

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management fees if the CLO continues to pass over-collateralization and other tests. However, during the credit crisis and since, many CLOs have failed their over-collateralization tests and thus their managers have not earned subordinated fees. Since subordinated fees generally comprise the majority of expected management fees (often around 60 percent of gross fees), not earning subordinated fees can greatly diminish the value of a management contract.

Also, such declines in fees hit smaller managers harder than larger managers because larger managers generally have economies of scale in CLO management. For example, a manager of 10 CLOs can spread the cost (as a practical if not an accounting matter) of a CLO management software across those 10 CLOs, while a manager of one CLO would not be able to spread the cost. Another rationale would be a basic change in strategy: some managers simply want to exit the CLO management business and enter a different business. Yet another rationale would be winding up – a desire to exit the CLO business without entering a different business.

As Watterson explained, "Since September 2007 until January of this year there really haven't been any new issues of CLOs. The managers have continued to get the senior fees but many of the managers stopped getting the subordinated fees because CLOs were failing at least one of the (over-collateralization) tests. You had smaller managers which either didn't have a big enough fee base and couldn't raise more money on the CLO market or who made a strategic decision that the CLO market had gone away for two years and it was going to be tough to compete in it once it came back and they went out to the market, hiring an investment banker, and went to bigger CLO managers and either got them to bid to buy the management company or bid to acquire the CLO management agreement."

Rationales for Purchases of CLO Management Contracts

As indicated above, hedge fund managers may purchase CLO management contract for various reasons, including the following:

1. A reasonably predictable, ongoing revenue stream. The revenue stream is reasonably predictable because, unlike hedge fund investors, CLO investors generally do not have a redemption right and therefore the assets under management of the CLO decline at a predictable rate. Of course, such predictions can be complicated if the subordinated note holders exercised their call right, but that call right generally requires a supermajority vote.

2. "Sticky" investor assets at a time when assets remain difficult to raise and retain. CLO investments are resilient for at least two reasons. Most notably, most CLO investors generally do not have a right of redemption. However, even where they have a limited right of redemption (e.g., via exercising a call right), CLO investors tend to have longer-term investment horizons and investment goals driven in large part by their liabilities. Pension funds are the paradigmatic example of this: they conduct significant due diligence ex ante, then stick around.

3. A potential foot in the door with major institutional investors. Taking over a CLO management contract can be an interesting avenue of "backdoor" marketing. Many investors in CLOs are among the more coveted categories of hedge fund investors – pension funds, banks, insurance companies and other institutional investors with significant assets and long horizons. A manager that does

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a reasonably competent job managing the CLO will have a much "warmer" call with a current pension fund CLO investor about a potential hedge fund investment than with a pension fund not invested in any of the manager's products. Similarly, managing a CLO may enable a hedge fund manager to obtain capital that can only be allocated to "rated" investments, as are senior CLO notes. Thus, a hedge fund manager that also manages a CLO may offer different products to the same institutional investor for different asset allocation categories of that investor. Moreover, allocation of investment opportunities concerns would be muted (though not eliminated) because of the limited investment guidelines of CLOs relative to hedge funds.

4. Many potential sellers of CLO management contracts are in some degree of distress, and there are not many eligible buyers for such contracts. Therefore, such contracts generally may be purchased with an illiquidity discount.

5. Since larger managers may have economies of scale in CLO management, they may be able to derive greater revenue per unit of input than a smaller manager. This is the cost-spreading argument mentioned above.

Key Legal Considerations When Selling or Assigning CLO Management Contracts

Consent Requirements

If the manager of a CLO is a registered investment adviser, the management contract is subject to Section 205(a)(2) of the Advisers Act, which generally requires that an advisory contract prohibit assignments absent client consent. In the case of a CLO (as in the case of a hedge fund), the client for Advisers Act purposes is the CLO itself, rather than its investors. For CLOs structured as companies in the Cayman Islands and other jurisdictions that require a board of directors, a majority of the independent directors generally can consent to the assignment of the management contract.

However, CLO management contracts often contain contractual consent requirements that go beyond the requirements of the Advisers Act and analogous offshore law. According to Buerstetta, such provisions typically state that to effectuate a valid assignment, the manager must obtain the approval of a majority of the senior noteholders and a majority of the subordinated noteholders. Moreover, the manager must obtain confirmation from the relevant rating agency that an assignment of the management contract will not cause the ratings of any of the notes to be reduced. Where majority consent is required and obtained, dissenting investors generally do not obtain a special withdrawal or appraisal right.

The CLO management contract may also require the selling and buying managers to obtain "non-objection letters" from the banks that made the underlying loans. Non-objection letters do not provide affirmative consent to an assignment but merely the absence of objection (similar to SEC no-action letters).

Avoiding Assumption of Liabilities

Generally, the new manager can avoid assumption of liabilities of the prior manager through an indemnity given by the prior manager; non-contractual claims of liability (or subrogation) available to the new manager against the prior manager; or back-to-back management agreements.
On the first two points, Watterson explained that "typically, the replacement management agreement will say clearly and it will be disclosed to investors, both in the original CLO

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offering and at the time of replacement, that the new manager has no responsibility for the former manager's work. The former manager, even though it has been replaced, typically either gives an indemnity to the CLO for its gross negligence or is going to be liable through some non-contractual theory of liability for gross negligence or willful misconduct that happened before it was replaced."

And on the back-to-back approach, Buerstetta added, "There would be some kind of negotiation between the outgoing investment manager and the incoming investment manager to allocate any hangover risk related to that transfer. One of the ways I've seen it done is to structure a termination of a manager which would terminate the original contract and the new incoming manager would then execute a new management contract."