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They Will Survive—Again: CLO Resilience Amid the COVID-19 Pandemic

I. INTRODUCTION

Collateralized loan obligations (“CLOs”) have garnered a lot of attention in recent years, from popular news outlets,¹ politicians,² and market observers alike.³ However, this admission is where the consensus ends, as the strengths and shortcomings of CLOs have been fiercely debated in the years following the 2008 financial crisis.⁴ Despite emerging from the last financial crisis largely unscathed,⁵ the asset class has not been permitted to ride the coattails of its successes into the present

1. See Matt Phillips, *Wall Street Loves These Risky Loans. The Rest of Us Should Be Wary.*, N.Y. TIMES (Oct. 19, 2018), <https://www.nytimes.com/2018/10/19/business/economy/clo-corporate-loans.html> [<https://perma.cc/7CZM-CJRK>] (covering CLOs because they have become one of the “hottest investments on Wall Street”).

2. See Letter from Elizabeth Warren, U.S. Sen., to Steven T. Mnuchin, Sec’y of the Treasury, U.S. Dep’t of the Treasury, Joseph Otting, Comptroller, Office of the Comptroller of the Currency, Jelena McWilliams, Chairman, Fed. Deposit Ins. Corp., Jerome Powell, Chairman, Bd. of Governors of the Fed. Reserve Sys., Jay Clayton, Chairman, Sec. and Exch. Comm’n (Nov. 14, 2018), <https://www.warren.senate.gov/imo/media/doc/2018.11.14%20Letter%20to%20Regulators%20on%20Leveraged%20Lending.pdf> [<https://perma.cc/7CZM-CJRK>] [hereinafter Warren Letter] (making specific reference to CLOs in a letter condemning the state of the leveraged loan market).

3. See Stephen Brown & Abraham Salander, *Amid COVID Market Volatility, Are CLOs the Next RMBS?*, LAW360 (Apr. 20, 2020, 6:52 PM), <https://jenner.com/system/assets/publications/19853/original/brown%20salander%20Law360%20April%202020.pdf?1587500081> [<https://perma.cc/6X9L-BB9Y>] (“For the past several years, market observers have warned of risks associated with collateralized loan obligations, or CLOs.”).

4. See Telis Demos, *What We Talk About When We Talk About CLOs*, WALL ST. J. (June 10, 2020, 7:00 AM), <https://www.wsj.com/articles/what-we-talk-about-when-we-talk-about-clos-11591786801> [<https://perma.cc/8T3Q-MBJ3>] (“There were many debates about the risks of CLOs during the debt-market boom of the past few years.”).

5. See YAN CAO ET AL., CORNERSTONE RESEARCH, COLLATERALIZED LOAN OBLIGATIONS IN THE AGE OF COVID-19, at 1 (2020), Westlaw, <https://www.cornerstone.com/Publications/Articles/Collateralized-Loan-Obligations-in-the-Age-of-COVID-19/Collateralized-Loan-Obligations-in-the-Age-of-COVID-19.pdf> [<https://perma.cc/TR8L-ZJE8>] (noting that CLOs escaped the 2008 financial crisis “relatively unscathed”).

day and avoid scrutiny.⁶ Instead, CLOs have been the object of mounting criticism—a reality that is, at least in part, traceable to the meteoric growth of the CLO market.⁷

Today, the CLO market in the United States is valued at just under \$700 billion, more than double its size in 2008.⁸ Although this figure only amounts to roughly one-tenth of the American mortgage market before the 2008 crisis,⁹ it has not stopped critics of the CLO market from comparing CLOs to the infamous collateralized debt obligations that precipitated the last financial collapse.¹⁰ Moreover, critics point to recent trends in the CLO market, namely the securitization of large amounts of poor-quality corporate debt, to suggest that CLOs could pose a risk to the stability of the financial system.¹¹

Prior to 2020, concerns about the risks building in the CLO market were well documented.¹² Nevertheless, even those who pointed

6. See FIN. STABILITY BD., VULNERABILITIES ASSOCIATED WITH LEVERAGED LOANS AND COLLATERALIZED LOAN OBLIGATIONS 1 (2019), <https://www.fsb.org/wp-content/uploads/P191219.pdf> [<https://perma.cc/RVM5-63H6>] (acknowledging that the growth of the leveraged loan and CLO markets has led to greater scrutiny).

7. See Cezary Podkul & Paul J. Davies, *Financial Engineering Made Risky Loans Seem Safe. Now They Face a Huge Test.*, WALL ST. J. (Mar. 20, 2020, 7:00 AM), <https://www.wsj.com/articles/financial-engineering-made-risky-loans-seem-safe-now-they-face-a-huge-test-11584702000> [<https://perma.cc/QL88-Z5UM>] (suggesting that the growth of the CLO and leveraged loan markets “led global regulators to warn of potential instabilities building in the financial system”).

8. See S.P. KOTHARI ET AL., U.S. SEC. AND EXCH. COMM’N, U.S. CREDIT MARKETS INTERCONNECTEDNESS AND THE EFFECTS OF THE COVID-19 ECONOMIC SHOCK 47 (2020), https://www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf [<https://perma.cc/F783-AXTF>] (noting that the CLO market is valued at \$642 billion and providing a graph that tracks the size of the CLO market from 2005 to 2019).

9. Phillips, *supra* note 1.

10. See George Oldfield & John Anthony, *Collateralized Loan Obligations: Subprime Déjà Vu?*, LAW360 (Jan. 28, 2019, 12:29 PM), https://brattlefiles.blob.core.windows.net/files/15427_collateralized_loan_obligations_subprime_dj_vu.pdf [<https://perma.cc/AF9E-TD7Z>] (“[A]larm bells are ringing for some market observers, and some investors, who cite parallels to the subprime mortgage market in the 2004-2008 era.”).

11. See *id.* (citing concerns about the “record volume of low credit quality loans being securitized” in CLOs).

12. See Joe Rennison, *CLOs: The Specialist Loan Vehicles Luring Yield-Hungry Investors*, FIN. TIMES (Jan. 27, 2019), <https://www.ft.com/content/db97c650-1ec6-11e9-b126-46fc3ad87c65> [<https://perma.cc/G82K-UAMM>] (describing concerns about developments in the CLO market); Oldfield & Anthony, *supra* note 10 (discussing the “increased riskiness” of CLOs); *Those \$700B in US CLOs: Who Holds Them, What Risk They Pose*, S&P GLOBAL

to weaknesses in the CLO market acknowledged that the overall strength of the economy might serve to temper concerns and suggested that it would likely take an economic downturn to reveal how problems mounting in the CLO market could damage the economy more broadly.¹³

With this in mind, 2020 should have been the year that proved disastrous for CLOs, effectively bringing critics' warnings home to roost.¹⁴ When the COVID-19 pandemic¹⁵ prompted a nationwide lockdown that rattled the economy, it appeared as though the period of economic stability keeping problems within the CLO market at bay would finally end, leading to damaging losses at best, and a 2008-like banking collapse at worst.¹⁶

While many of the long-term effects of the 2020 downturn will continue to materialize in the years ahead, CLOs so far have weathered the storm.¹⁷ This is not to say that the CLO market did not experience volatility or that it escaped the downturn wholly unscathed: ratings agencies downgraded CLOs, and the leveraged loans that they hold, on a

MKT. INTEL. (June 21, 2019, 11:54 AM), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/leveraged-loan-news/those-700b-in-us-clos-who-holds-them-what-risk-they-pose> [<https://perma.cc/3UTZ-EA79>] [hereinafter *CLOs: Who Holds Them*] (“The flourishing market for collateralized loan obligations has come under increasing scrutiny of late by U.S. lawmakers and regulatory agencies . . .”); Craig Torres & Lisa Lee, *Wider Risk of Leveraged Loans Warrants Scrutiny, Tarullo Says*, BLOOMBERG L. (Oct. 30, 2018, 9:39 AM), https://www.bloomberglaw.com/document/X43T97DS000000?bna_news_filter=banking-law&jcsearch=BNA%252000000166c529d347ad77c7fd2e650000#jcite [<https://perma.cc/99XH-CW86>] (highlighting concerns about the leveraged loans that are packaged into CLOs).

13. See Phillips, *supra* note 1 (suggesting that risks in the CLO market are kept at bay when the economy is strong).

14. See Frank Partnoy, *The Looming Bank Collapse*, THE ATLANTIC (Jul.–Aug. 2020), <https://www.theatlantic.com/magazine/archive/2020/07/coronavirus-banks-collapse/612247/> [<https://perma.cc/8NC9-QY94>] (suggesting that volatility in the CLO market could be detrimental to the market as a whole).

15. See generally *Coronavirus*, WORLD HEALTH ORG., https://www.who.int/health-topics/coronavirus#tab=tab_1 [<https://perma.cc/GW2U-R68Y>] (last visited Jan. 5, 2021) (providing an overview of COVID-19).

16. See Partnoy, *supra* note 14 (presenting a worst-case scenario in which a distressed CLO market could precipitate a collapse of the banking system).

17. See KOTHARI ET AL., *supra* note 8 (suggesting that while the effects of the COVID-19 pandemic and the economic downturn will continue to materialize in the years ahead, CLOs have so far “weathered the storm”).

massive scale.¹⁸ These widespread rating downgrades caused the price of CLO debt to fall, and new CLO issuance slowed considerably.¹⁹ Despite this, the CLO market rebounded well from the downturn that gripped the economy in the earliest months of 2020.²⁰

The experience of CLOs in 2020 seems to suggest that certain weaknesses in the CLO market, while substantiated, might not on their own be capable of destabilizing CLOs in ways that prove disastrous for the economy as a whole.²¹ This Note explores why volatility among CLOs did not damage or upend the market as some critics feared, and it will end by considering what CLO performance during 2020 could mean for the future of the CLO market.²²

This Note proceeds in six parts. Part II provides the necessary background on CLOs by describing what they are and by examining the kinds of entities that hold CLO securities.²³ Part III details specific criticisms of the CLO market.²⁴ Part IV considers the impact of the 2020 downturn by exploring why it should have wreaked havoc on CLOs, but

18. *See id.* (providing an overview of the ways in which COVID-19 and the economic downturn negatively impacted the CLO market).

19. *See* Kristen Haunss, *CLO Issuance Rises Slightly in Second Quarter amid Loan Downgrades*, REUTERS (July 13, 2020, 11:01 AM), <https://www.reuters.com/article/us-clo-20201half/clo-issuance-rises-slightly-in-second-quarter-amid-loan-downgrades-idUSKCN24E200> [<https://perma.cc/5K9K-3YPT>] (reporting that the COVID-19 pandemic led to volatility and low levels of issuance in the CLO market).

20. *See* KOTHARI ET AL, *supra* note 8 (noting that, in light of the 2020 downturn, the CLO market has “fared reasonably well”).

21. *See* Hannah Lang, *Virus Could Deal Blow to Leveraged Loans. What’s That Mean for Banks?*, AM. BANKER (Mar. 11, 2020, 2:26 PM), <https://www.americanbanker.com/news/virus-could-deal-blow-to-leveraged-loans-whats-that-mean-for-banks> [<https://perma.cc/Z72S-YJXM>] (acknowledging weaknesses in the CLO market, but suggesting that the economic impact of COVID-19 is not likely to be “a cataclysmic event” for mounting corporate debt).

22. *See* Lisa Lee & Sarah Husband, *CLOs Fight Back Against Hedge Fund Efforts to Siphon Value*, BLOOMBERG (Sept. 25, 2020, 6:00 AM), <https://www.bloomberg.com/news/articles/2020-09-25/clos-fight-back-against-hedge-fund-efforts-to-siphon-value> [<https://perma.cc/W526-UFBA>] (describing potential changes in the CLO market that could arise in response to the 2020 downturn); *See also* Kristen Haunss, *CLOs Seek to Tie Assets to Loan Index after Missing out on Covid Selloff*, REUTERS (June 26, 2020, 8:28 AM), <https://www.reuters.com/article/clo-loanindex/clos-seek-to-tie-assets-to-loan-index-after-missing-out-on-covid-selloff-idUKL1N2E301N> [<https://perma.cc/VNX6-TG2D>] (presenting one way the CLO market may evolve in response to the 2020 economic downturn).

23. *See infra* Part II.

24. *See infra* Part III.

ultimately did not, and the reasons behind this outcome.²⁵ Part V examines the lasting impact of the 2020 downturn on the CLO market and offers a prediction as to its future.²⁶ Finally, Part VI provides a brief conclusion.²⁷

II. BACKGROUND

A. *An Introduction to CLOs*

A CLO is a structured credit product that, at its most basic level, assembles a pool of loans against which a series of debt obligations are issued.²⁸ With limited exceptions, the loans pooled to serve as collateral for CLO debt are leveraged loans: loans made to corporate borrowers with below investment grade ratings.²⁹ Roughly 90% of a CLO's portfolio is comprised of these loans, which typically receive a single-B rating and are secured by a first-lien claim on assets of the corporate borrower.³⁰

The process of structuring a CLO begins with the CLO Manager, a public or private asset manager employed by the CLO, who assembles the loan portfolio and makes investment decisions on its behalf.³¹ Before the CLO can issue securities to investors, the CLO Manager must do two

25. See *infra* Part IV.

26. See *infra* Part V.

27. See *infra* Part VI.

28. SETH KATZENSTEIN ET AL., ICG CAPITAL MKT. STRATEGIES, AN INTRODUCTION TO COLLATERALIZED LOAN OBLIGATIONS (CLOs) 1 (2020), <https://www.icgam.com/~media/Files/1/ICGAM-V2/documents/20200603-clo-primer.pdf> [<https://perma.cc/P48Y-PXZK>].

29. See Oldfield & Anthony, *supra* note 10 (defining leveraged loans as below investment grade loans made to highly leveraged companies).

30. See JENNIFER JOHNSON, NAT'L ASS'N OF INS. COMM'RS & THE CTR. FOR INS. POLICY AND RESEARCH, COLLATERALIZED LOAN OBLIGATIONS (CLOs) PRIMER 3 (2018), https://www.naic.org/capital_markets_archive/primer_180821.pdf [<https://perma.cc/VTP2-9796>] ("For 'traditional' CLOs, the collateral pool primarily consists of below investment grade, first lien, senior secured broadly syndicated bank loans (usually at least 90% of the portfolio) . . .").

31. See CAO ET AL., *supra* note 5 (describing how CLO Managers are responsible for selecting collateral and for actively managing the CLO portfolio).

things.³² First, the CLO Manager will set up a bankruptcy remote, special purpose vehicle to hold leveraged loans and issue debt and equity securities to CLO investors.³³ Second, the CLO Manager must assemble an initial pool of loans that can be used to market the CLO to potential investors.³⁴ To accomplish this, the CLO Manager will often rely on an arranger—usually a large bank—to provide a loan (a “Warehouse Facility”) that the CLO Manager uses to purchase the leveraged loans that underly the CLO portfolio.³⁵ Once a group of investors interested in purchasing CLO securities is assembled, the special purpose entity issues CLO debt obligations and equity securities.³⁶ The Warehouse Facility is paid down with proceeds from the debt and equity issuance, and any remaining funds are used to purchase additional loans for the CLO portfolio.³⁷

For a period of two to five years after the CLO’s inception, the CLO Manager has discretionary authority to purchase and sell loans with the view of improving the overall credit quality of the portfolio.³⁸ When a loan held by the CLO is downgraded by the ratings agencies or trades at a price below par in the secondary market, the CLO Manager may opt to sell this loan and use the proceeds to purchase a loan with better repayment prospects.³⁹ Alternatively, the CLO Manager may use the reinvestment period to take advantage of volatility in the leveraged loan

32. See, e.g., Oldfield & Anthony, *supra* note 10 (explaining how the CLO Manager establishes a special purpose entity and relies on a warehouse loan to purchase loans for the CLO portfolio).

33. See *id.* (describing the process by which the CLO Manager establishes a special purpose entity).

34. See *id.* (explaining how the special purpose entity purchases loans for the CLO portfolio and then issues debt securities to investors).

35. See *id.* (noting that large banks provide warehouse facilities for the purpose of accumulating loans for a new CLO).

36. See FIN. STABILITY BD., *supra* note 6, at 3 (“CLOs are asset-backed securities issued by a special purpose vehicle (SPV). The SPV acquires a portfolio of leveraged loans[,] . . . which it finances through the issuance of securities in the form of bonds (senior and mezzanine tranches) and equity.”).

37. William W. Bratton & Adam J. Levitin, *A Tale of Two Markets: Regulation and Innovation in Post-Crisis Mortgage and Structured Finance Markets*, 2020 U. ILL. L. REV. 47, 99 (2020).

38. JOHNSON, *supra* note 30, at 4.

39. Cf. Oldfield & Anthony, *supra* note 10 (explaining that because CLOs are actively managed, “the CLO issuer may earn additional income by trading loans”).

market.⁴⁰ If a loan trades below par, the CLO Manager can purchase the loan at a discount.⁴¹ In this scenario, the CLO Manager buys the loan based on an assessment of the borrower's long-term repayment prospects.⁴² If the loan price recovers, or if the borrower ultimately repays the loan at par, the CLO stands to recognize returns in excess of what it initially paid to purchase the loan.⁴³

At the end of the reinvestment period, the CLO enters an amortization phase in which it pays down its investors' debt obligations in order of seniority.⁴⁴ During this stage of the CLO life cycle, payments made on the loans underlying the CLO, together with any proceeds from loan sales, must be used to repay the principal of the CLO investors' debt.⁴⁵ Investors holding the senior-most tranches of the CLO are repaid first, followed by junior debtholders.⁴⁶ Equity investors are paid only after the debtholders in the senior and junior tranches are repaid in full.⁴⁷

Investors in a CLO purchase debt according to their individual risk tolerance.⁴⁸ This is possible because CLOs offer different classes of debt to investors in a tranching structure, which consists of highly rated senior debt, junior or subordinated debt, and an unrated equity piece.⁴⁹

40. See KATZENSTEIN ET AL, *supra* note 28, at 2 (explaining that CLOs are actively managed investment vehicles in which a CLO Managers assess credit and respond to changes in the market by substituting loans in the portfolio).

41. See Haunss, *supra* note 22 (explaining how the purchase of discounted loans could boost returns).

42. See *id.* (suggesting that CLO Managers purchase discounted loans because they believe that, in the long term, the loan will recover and repay at par).

43. *Cf. id.* (explaining that CLO Managers want discretionary authority to purchase low-priced loans because they expect some loans to recover in the long term, leading to outsized returns).

44. Bratton & Levitin, *supra* note 37.

45. See KATZENSTEIN ET AL, *supra* note 28, at 7 (providing an overview of the amortization phase in which the CLO manager uses cash flows to repay outstanding CLO debt obligations).

46. See Bratton & Levitin, *supra* note 37 (explaining that cash flows received by the CLO during the amortization period are used to repay investors in order of seniority).

47. See *id.* (explaining that cash flows received by the CLO during the amortization period are used to repay investors in order of seniority).

48. See Phillips, *supra* note 1 ("CLO investors aren't all the same. They get to pick what is important to them: low-risk returns or big payday potential.").

49. The same pool of loans serves as the collateral for each tranche of the CLO. However, investors in each tranche of the CLO have a different priority on the cash flows generated by the underlying loans. The senior tranches, usually rated AAA and AA, have the first and highest claim on payments made to the CLO. The junior tranches, typically rated A, BBB,

Investors looking to be in the safest part of the CLO structure purchase the highest rated notes, often rated AAA or AA, while investors with more tolerance for risk may opt for the junior debt.⁵⁰ The riskiest portion of the CLO structure is the equity piece, which is unrated.⁵¹

Priority in payment is also determined according to where the investor's debt sits within the CLO structure.⁵² Money is distributed to the CLO when corporate borrowers pay interest or principal on the leveraged loans underlying the CLO.⁵³ These payments are then passed on to CLO investors according to a "waterfall" in which the senior-most tranche receives its payment of interest or principal first, followed by the junior tranche, with any remaining funds flowing to equity investors.⁵⁴ The interest payments that CLO investors receive on the securities they purchase vary, as investors in the senior tranche receive a lower rate of interest than investors in the junior, more risky tranches.⁵⁵ Equity investors assume the most risk because they sit at the bottom of the payment waterfall⁵⁶ and are therefore often paid much higher rates of interest.⁵⁷

Certain structural features called credit enhancements exist to reduce risk and protect the investments of CLO debtholders.⁵⁸ The first of these protections, called interest coverage tests ("IC Tests"), seeks to ensure that a CLO has sufficient cash flows to service its debt

and BB, are next in line to claim cash flows of the CLO. Finally, an unrated equity tranche typically receives any excess cash flows. KATZENSTEIN, *supra* note 28, at 3.

50. See KATZENSTEIN ET AL, *supra* note 28, at 7 (describing the risk profile of each tranche in the CLO structure).

51. See JOHNSON, *supra* note 30 (suggesting that investors with the highest tolerance for risk often hold the unrated equity portion of the CLO).

52. See Bratton & Levitin, *supra* note 37 (explaining that payments to CLO debtholders are distributed according to seniority).

53. See Oldfield & Anthony, *supra* note 10 (explaining that a CLO satisfies its debt obligations by passing on the cash it receives from borrowers when they make payments on their loans).

54. See, e.g., KATZENSTEIN ET AL, *supra* note 28, at 3 (outlining the process by which payments are made to CLO debt and equity holders).

55. See CAO ET AL, *supra* note 5, at 2 (explaining how holders of senior CLO debt are paid lower rates of interest than holders of junior debt and equity).

56. See KATZENSTEIN ET AL, *supra* note 28, at 3 (noting that equity investors have a claim on cash flows only after all debt obligations of the CLO have been paid in full).

57. See CAO ET AL, *supra* note 5, at 2 (reporting that equity investors recognize a greater rate of return than CLO debtholders).

58. KATZENSTEIN ET AL, *supra* note 28, at 4.

obligations.⁵⁹ IC Tests are conducted regularly and, in order to pass, the interest income generated by the CLO's underlying loans must exceed the interest it owes to its debtholders.⁶⁰ Any excess interest paid to the CLO is distributed to its equity investors.⁶¹

CLOs are also subject to overcollateralization tests ("OC Tests"), which require the principal value of the loans underlying the CLO to exceed the value of its outstanding debt obligations.⁶² When proceeds from the underlying loans are paid to the CLO, the CLO must satisfy its OC Tests before passing payments on to its debtholders.⁶³ For instance, a CLO that must return \$500 million in principal to its debt investors might be required to purchase \$625 million of leveraged loans to serve as collateral for the CLOs debt.⁶⁴ In this example, the overcollateralization ratio would be 1.25, and the CLO would have to demonstrate its compliance with this requirement at the time it seeks to distribute payments to investors.⁶⁵

OC Tests are designed to protect the investments of CLO debtholders, especially those who invest in the senior tranches of the CLO structure.⁶⁶ A CLO that fails its OC Test will cut off payments to its junior debtholders and equity investors in order to direct all cash flows to holders of the senior-most debt.⁶⁷ Moreover, any proceeds generated by the CLO's underlying loans will be redirected to repay the principal, not

59. JOHNSON, *supra* note 30.

60. *Id.*

61. See KATZENSTEIN ET AL., *supra* note 28, at 3 (explaining that equity investors have a claim on excess cash flows after all debtholders are paid).

62. FIN. STABILITY BD., *supra* note 6, at 14.

63. See JOHNSON, *supra* note 30, at 4 (explaining how the CLO structure must pass certain performance-based tests on payment dates).

64. See SCOTT MINERD ET AL., GUGGENHEIM, UNDERSTANDING COLLATERALIZED LOAN OBLIGATIONS 3 (2019), <https://www.guggenheiminvestments.com/cmspages/getfile.aspx?guid=4510f36e-7ed3-4af3-98c5-6b667d7464e9> [<https://perma.cc/898C-6SCH>] (providing a concrete example of how OC Tests operate in order to ensure that the CLO has sufficient collateral to service its obligations to its debt investors).

65. *Id.*

66. See FIN. STABILITY BD., *supra* note 6, at 14 (describing how a CLO that fails its OC Test will divert payments to the senior tranche to guarantee the investments of more senior investors at the expense of investors in other parts of the CLO structure).

67. *Id.* at 14.

simply the interest of senior debtholders.⁶⁸ In this instance, the CLO effectively reduces the value of its outstanding debt obligations and can bring itself back into compliance with its OC Test requirements.⁶⁹ Ultimately, the protections for senior debtholders embedded within the CLO structure⁷⁰ are designed to ensure that they receive what they paid for—an investment security that promises low-risk and stable returns.⁷¹

B. *Who Holds CLO Securities?*

CLO securities are held by a wide variety of investors, ranging from banks and insurance companies to various institutional investors like mutual funds, hedge funds, and pension funds.⁷² The rapid growth of the CLO market has spurred efforts to identify who holds CLO securities.⁷³ While it is true that the sizeable amount of CLO exposure held outside of the regulated banking sector makes the inquiry more complicated, existing data is sufficient to identify the holders of CLO securities with some particularity.⁷⁴

Insurance companies are the largest holders of CLOs,⁷⁵ and their exposure to the market has grown considerably since 2016.⁷⁶ As of 2018, insurance companies held \$122 billion in CLO securities,⁷⁷ and this

68. *Id.*

69. *Id.*

70. *See, e.g.,* KATZENSTEIN ET AL., *supra* note 28, at 4 (describing the kinds of credit enhancements embedded within the CLO structure that exist to protect investors).

71. *See* JOHNSON, *supra* note 30, at 3–4 (explaining how senior debtholders assume the least amount of risk and are first to be paid according to the payment “waterfall”).

72. KOTHARI ET AL., *supra* note 8, at 43.

73. *See* FED. RESERVE BD., FED. NOTES, WHO OWNS U.S. CLO SECURITIES? (2019) [hereinafter WHO OWNS U.S. CLO SECURITIES?] (noting the growth of the leveraged loan and CLO markets and highlighting the importance of identifying who holds CLOs).

74. *See CLOs: Who Holds Them, supra* note 12 (“While full transparency on a private credit market such as leveraged loans can be difficult to obtain, a window into who is holding those CLOs is possible . . .”).

75. Lisa Lee & Katherine Chiglinsky, *A \$158 Billion CLO Bet is Putting the Insurance Industry at Risk*, BLOOMBERG (July 30, 2020, 6:00 AM), <https://www.bloomberg.com/news/articles/2020-07-30/a-158-billion-clo-bet-is-putting-the-insurance-industry-at-risk> [https://perma.cc/K7C5-WG25].

76. *CLOs: Who Holds Them, supra* note 12.

77. JENNIFER JOHNSON, NAT’L ASS’N OF INS. COMM’RS & THE CTR. FOR INS. POLICY AND RESEARCH, U.S. INSURANCE INDUSTRY’S EXPOSURE TO COLLATERALIZED LOAN OBLIGATIONS AS OF YEAR-END 2018, at 7 (2019),

exposure grew to \$158 billion by the end of 2019.⁷⁸ Life insurance companies are the predominant players, accounting for 77% of all CLO exposure among insurance companies.⁷⁹ However, despite their increasing exposure, insurance companies invest only a small portion of their total assets—about 2%—in CLO securities.⁸⁰

Banks located in the United States and abroad also invest in the CLO market.⁸¹ Depository institutions in the United States hold roughly \$94 billion in CLOs,⁸² accounting for about 18% of the market.⁸³ Wells Fargo & Company is the largest holder of CLOs among U.S. banks, with a reported \$34.6 billion in holdings, or about 2% of its total assets.⁸⁴ JPMorgan Chase & Co. and Citigroup Inc. are the next largest holders, with \$20.5 billion and \$18.1 billion of exposure, respectively.⁸⁵ European and Japanese banks are the most significant holders among foreign depository institutions, with European banks holding roughly \$35 billion of CLO exposure and Japanese banks holding about \$113 billion in CLO securities.⁸⁶

An array of institutional investors are active in the CLO market, as pension funds, mutual funds, hedge funds, and asset managers have sizeable CLO exposures.⁸⁷ While full transparency into these private credit markets is difficult to achieve, piecing together available data provides a workable picture.⁸⁸ As of December 2018, mutual funds held roughly \$61 billion in CLO securities, and pension funds held just over

https://www.naic.org/capital_markets_archive/special_report_190618.pdf
[<https://perma.cc/HJ2R-A9LN>].

78. Lee & Chiglinsky, *supra* note 75.

79. JOHNSON, *supra* note 77.

80. *Id.* at 1.

81. *CLOs: Who Holds Them*, *supra* note 12.

82. *CLOs: Who's Holding (for the Long-Term)?*, LOAN SYNDICATIONS & TRADING ASS'N (Sept. 12, 2019), <https://www.lsta.org/news-resources/clos-whos-holding-for-the-long-term/> [<https://perma.cc/GHB2-K2BH>].

83. See Lee & Chiglinsky, *supra* note 75 (providing a chart which reflects the portion of the CLO market held by banks).

84. *CLOs: Who Holds Them*, *supra* note 12.

85. *Id.*

86. *CLOs: Who's Holding (for the Long-Term)?*, *supra* note 82.

87. See WHO OWNS U.S. CLO SECURITIES?, *supra* note 73 (“Institutional investors, including . . . mutual funds (16%), and pension funds (10%) held roughly half of Cayman-issued CLOs at year-end 2018.”).

88. *CLOs: Who Holds Them*, *supra* note 12.

\$22 billion.⁸⁹ Funds or other investment vehicles, which includes hedge funds, held more than \$20 billion in CLOs in December of 2018.⁹⁰

Apart from understanding who holds CLOs, it is equally important to know what kinds of CLO exposure they hold—specifically, whether banks, insurance companies, and other types of institutional investors hold mostly senior debt, junior tranches, or CLO equity.⁹¹ This is because exposure type dictates priority of payment,⁹² and if large, systemically important institutions—like some of the bank holding companies mentioned—run the risk of nonpayment, this could lead to greater systemic risk.⁹³

A desire among depository institutions for low-risk investments with stable returns has led banks to invest almost exclusively in the senior tranches of the CLO structure.⁹⁴ Roughly 95.4% of CLO holdings among depository institutions are concentrated in the most highly rated CLO debt, while bank holdings in junior and equity tranches are limited to 3.6% and 1%, respectively.⁹⁵ CLO exposure among insurance companies is more dispersed: roughly half of all holdings among insurance companies are concentrated in senior tranches, with the remaining half invested in the heightened risk, higher-yielding portion of the CLO structure.⁹⁶ However, while insurance companies do hold CLO securities outside of the safest AAA tranche, 81% of their holdings are rated BBB or higher.⁹⁷

89. FED. RESERVE BD., FED. NOTES, WHO OWNS U.S. CLO SECURITIES? AN UPDATE BY TRANCHE (2020) [hereinafter WHO OWNS U.S. CLO SECURITIES? AN UPDATE BY TRANCHE].

90. *Id.*

91. *See CLOs: Who Holds Them*, *supra* note 12 (suggesting that the interest in understanding who owns CLOs is rooted in concerns about the risk that CLOs may pose to the broader financial system).

92. KATZENSTEIN ET AL., *supra* note 28, at 3 (explaining that payments are made to CLO investors according to their seniority within the structure).

93. *See Lang*, *supra* note 21 (suggesting that the stability of the banking system is critical to the functioning of financial markets).

94. *See WHO OWNS U.S. CLO SECURITIES? AN UPDATE BY TRANCHE*, *supra* note 89 (providing that 95.4% of bank CLO holdings are rated AAA).

95. *Id.*

96. *See id.* (providing that CLO holdings among insurance companies are divided between the senior, junior, and equity portions of the CLO structure).

97. JOHNSON, *supra* note 77.

CLO holdings among pension funds and mutual funds are similarly dispersed throughout the CLO structure.⁹⁸ Like banks and insurance companies, the majority of exposure among these funds is concentrated in the highest rated CLO debt.⁹⁹ As of 2018, pension funds held about \$16.9 billion of senior debt, \$4.9 billion of junior debt, and \$240 million in CLO equity securities.¹⁰⁰ Conversely, mutual funds held \$7.4 billion in CLO equity in December of 2018.¹⁰¹ However, the majority of mutual fund holdings were also confined to junior and senior CLO tranches, totaling \$12.5 billion and \$39.4 billion, respectively.¹⁰²

Exposure to the riskiest parts of the CLO structure is held almost entirely outside of the banking sector, as asset managers, hedge funds, and other investment vehicles are the largest holders of subordinated debt and CLO equity.¹⁰³ In 2018, hedge funds and other investment vehicles held roughly two-thirds of their total CLO exposure in junior tranches and CLO equity.¹⁰⁴ Moreover, private equity funds, credit opportunity funds,¹⁰⁵ and CLO managers are the primary holders of CLO equity;¹⁰⁶ and while a lack of disclosure requirements among these private players makes obtaining concrete numerical data difficult, S&P estimated in 2019 that 80% of all CLO equity was held by asset managers.¹⁰⁷

98. See WHO OWNS U.S. CLO SECURITIES? AN UPDATE BY TRANCHE, *supra* note 89 (reflecting the CLO holdings among pension funds and mutual funds).

99. See *id.* (providing that mutual funds and pension funds invest 66.4% and 76.6% of their holdings in senior CLO debt, respectively).

100. See *id.* (reflecting pension fund exposure to CLO securities, of which roughly 76% are concentrated in senior tranches, 22% in junior tranches, and about 1% in CLO equity).

101. See *id.* (evidencing that mutual funds maintain 12.5% of all their CLO holdings in equity tranches, as of year-end 2018).

102. See WHO OWNS U.S. CLO SECURITIES? AN UPDATE BY TRANCHE, *supra* note 89 (pointing to the fact that mutual funds concentrate 66.4% of all their CLO holdings in senior tranches and 21% in junior tranches).

103. See *CLOs: Who Holds Them*, *supra* note 12 (“[I]n 2018, asset managers made up about 40% of the equity buyers, while hedge funds made up closer to 20% and structured credit funds 25%.”).

104. WHO OWNS U.S. CLO SECURITIES? AN UPDATE BY TRANCHE, *supra* note 89.

105. See generally, Richard Parkus, *Introduction to Credit Opportunity Funds*, DEUTSCHE BANK 1–21 (2007), http://www.globalsecuritisation.com/07_intro/db07_015_021_db_co.pdf [<https://perma.cc/HF2L-FXQV>] (providing an overview of credit opportunity funds).

106. See WHO OWNS U.S. CLO SECURITIES? AN UPDATE BY TRANCHE, *supra* note 89 (identifying market participants who hold the largest amounts of CLO equity).

107. *CLOs: Who Holds Them*, *supra* note 12.

C. *Historical Performance and the Market Today*

CLOs entered the market in the late 1980s,¹⁰⁸ but their performance during the 2008 financial crisis seems to be what many remember most about CLOs.¹⁰⁹ While other structured finance securities—namely, collateralized debt obligations—proved catastrophic to the security of the financial system in 2008, CLOs escaped the crisis largely unscathed.¹¹⁰ During the last financial crisis, no CLO debt rated AA or AAA ever defaulted,¹¹¹ and default rates among junior tranches were infinitesimal, amounting to less than 0.01%.¹¹² This history of low default rates among CLOs is especially notable when considered in the context of the leveraged loan default rates during the recession, which peaked at just under 11%.¹¹³

The CLO market looks markedly different today than it did in its earliest days, especially in size.¹¹⁴ The value of outstanding CLOs doubled between 2007 and 2018, reaching \$600 billion,¹¹⁵ and estimates suggest that the U.S. CLO market surged to \$642 billion in 2020.¹¹⁶ Nevertheless, default rates have remained low: the rating agency S&P calculated a 0.41% default rate among 6,100 ratings it issued on over

108. Laila Kollmorgen & Stephen Oh, *Seeing Beyond the Complexity: An Introduction to Collateralized Loan Obligations*, PINEBRIDGE INVS. (Sept. 19, 2019), <https://www.pinebridge.com/en/investor-types/default/> [<https://perma.cc/QNF6-7MS3>].

109. See Joe Rennison, *Coronavirus Sell-Off Puts Faith in CLOs to the Test*, FIN. TIMES (Apr. 23, 2020), <https://www.ft.com/content/ed2dc3a9-c004-4c37-a5e3-715c1d05a2e6> [<https://perma.cc/TJ6S-2HSW>] (“People tend to look backward in history saying CLOs survived the last financial crisis.”).

110. See JOHNSON, *supra* note 30, at 1–2 (comparing CLOs to CDOs and referring to CLOs as “survivors” of the 2008 financial crisis).

111. A CLO indenture will define what constitutes a default. A default may occur, for example, if a CLO fails to make a payment due on its senior debt obligations, or if the CLO fails to meet its overcollateralization requirements. Brown, *supra* note 3.

112. Sally Bakewell & Lisa Lee, *CLO Engineering Is No Match for Covid-19 as Payments Get Cut-Off*, BLOOMBERG (Apr. 20, 2020, 10:59 AM), <https://www.bloomberg.com/news/articles/2020-04-30/clo-engineering-is-no-match-for-covid-19-as-payments-get-cut-off> [<https://perma.cc/3F3X-J3XP>].

113. See *CLOs: Who Holds Them*, *supra* note 12 (reporting that the leveraged loan default rate peaked at 10.81% in November 2009).

114. See Rennison, *supra* note 12 (explaining that the CLO market has experienced significant growth since the 2008 financial crisis).

115. *Id.*

116. KOTHARI ET AL., *supra* note 8, at 47.

1,100 CLO transactions.¹¹⁷ This represents just over four tranches for every 1,000 rated.¹¹⁸ Moreover, the annual default rate among leveraged loans has remained low,¹¹⁹ with a 2.93% historical average that even dropped to 1% for a period in 2019.¹²⁰

III. CRITICISMS

In recent years, the modest praise that CLOs received for their success in weathering the last financial crisis has largely taken a backseat to the mounting concerns over the \$700 billion asset class.¹²¹ Criticism directed towards CLOs can be reduced to two interrelated ideas. First, CLOs are often blamed for encouraging unsustainably high levels of corporate debt.¹²² Second, CLO demand for leveraged loans has purportedly fostered a leveraged lending environment in which issuers can secure loans on terms that are increasingly adverse to lenders.¹²³

117. From mid-1990 until 2014, the credit rating agency S&P issued more than 6,100 ratings on over 1,100 U.S. CLO transactions. In 2014, S&P evaluated the performance of all the CLO tranches they rated and concluded that default rates were notably low. *S&P: CLOs Show Strong Historic Performance with Few Defaults*, S&P GLOBAL MKT. INTEL. (Jan. 31, 2014, 7:02 PM) <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/leveraged-loan-news/sp-report-clos-show-strong-historic-performance-with-few-defaults> [<https://perma.cc/GG9W-DUNM>].

118. *Id.*

119. The CLO market is inextricably tied to the health of the leveraged loan market. CLOs satisfy their debt obligations by passing on payments received from leveraged loan borrowers whenever they pay down their loan. If leveraged loan borrowers default on their obligations, CLOs may not have the cash to make payments on their outstanding debt. Therefore, low default rates among leveraged loan borrowers ultimately benefit the CLO market. See FIN. STABILITY BD., *supra* note 6, at 3–6.

120. *Despite Aging Credit Cycle, Near-Term Spike in Leveraged Loan Defaults Unlikely*, S&P GLOBAL MKT. INTEL. (June 10, 2019, 9:00 AM), <https://www.spglobal.com/marketintelligence/en/> [<https://perma.cc/HK6C-7DAP>].

121. See Phillips, *supra* note 1 (acknowledging that CLOs performed well during the last financial crisis but focusing predominantly on the threats that CLOs pose to the health of the financial system).

122. See Warren Letter, *supra* note 2 (calling out CLOs for their role in fueling unsustainably high levels of corporate debt).

123. See Podkul & Davies, *supra* note 7 (“[A]s CLOs competed for loans to invest in, borrowers were able to . . . demand looser terms . . .”).

A. *CLO Demand Fuels Massive Corporate Debt*

Perhaps the most obvious measure of the increase in demand for CLOs is the growth of the market since 2008.¹²⁴ The amount of CLOs outstanding has more than doubled compared to its pre-crisis peak of \$256 billion.¹²⁵ This demand has been driven, at least in part, by historically low interest rates.¹²⁶ Both CLOs and the leveraged loans they hold are floating rate instruments that offer yield-hungry investors a spread above a base rate.¹²⁷ Historically, the base rate has been the London Interbank Offered Rate (“LIBOR”).¹²⁸ Spreads above LIBOR on leveraged loans can range from 1.75% to as high as 7%.¹²⁹ CLOs offer spreads above LIBOR that increase in lockstep with the amount of risk a CLO investor assumes.¹³⁰ For instance, investors who hold CLO debt in the subordinated part of the structure will be paid a spread above LIBOR that is greater than the spread paid to investors with exposure to the highest rated AAA tranche.¹³¹ However, regardless of the exact amount of spread, CLOs often provide investors with higher returns,¹³² especially as compared to similarly rated assets.¹³³ Therefore, in low interest rate environments, the higher-yielding assets of the CLO market are especially attractive to yield-hungry investors.¹³⁴

124. See FIN. STABILITY BD., *supra* note 6, at 7 (explaining that the CLO market has doubled in size since the 2008 financial crisis).

125. See *US CLO Issuance Hits All-Time Record, Topping \$125B*, S&P GLOBAL MKT. INTEL. (Dec. 18, 2018), <https://www.spglobal.com/marketintelligence/en/https://perma.cc/6LM9-D37Q> (reporting that the CLO market peaked at \$256 billion before the 2008 financial crisis and has since grown to become a \$600 billion market).

126. See *id.* (suggesting that historically low interest rates have driven investors towards the higher-yielding CLO market).

127. CAO ET AL., *supra* note 5, at 2.

128. LIBOR has historically served as the base rate. However, it is expected that LIBOR will be discontinued by the end of 2021 and will be replaced with an alternative reference rate to serve as a benchmark. *Id.* at 2, 4.

129. See Aaron Weinman, *Spreads Widen in Choppy US Leveraged Loan Market*, REUTERS (Sept. 20, 2019, 9:28 AM), <https://www.reuters.com/article/usloans-spreads-idUSL2N26B0FV> [https://perma.cc/DN9Z-EZG5] (highlighting the fact that spreads on leveraged loans can be as low as 175 basis points or, in some cases, as high as 700 basis points).

130. See CAO ET AL., *supra* note 5, at 2 (“The spread decreases with the relative seniority of a note within the CLO capital structure.”).

131. See *id.* (explaining that AAA-rated CLO debt pays a lower rate of interest as compared to the higher interest rates paid to investors in the junior tranche).

CLO demand is relevant because it has fueled, or at least reinforced, the growth of the leveraged loan market.¹³⁵ CLOs purchase approximately 60% of all leveraged loans and are thus the largest buyer of below investment grade corporate debt.¹³⁶ When demand for CLOs increases, the demand for leveraged loans follows suit, as leveraged loans are the bedrock of the CLO structure.¹³⁷ In recent years, demand for leveraged loans among CLOs afforded corporate borrowers easy access to a loan market teeming with eager investors.¹³⁸ As a result, borrowers have been able to incur large amounts of debt that could ultimately prove difficult to repay.¹³⁹ The roughly \$1.3 trillion of outstanding corporate debt financed by leveraged loans—and fueled by CLO demand—contributes to a persistent fear that business debt is approaching unsustainable levels.¹⁴⁰

132. According to data from Wells Fargo, collected as of March 25, 2020, AAA-rated CLO notes paid spreads above benchmarks in the mid-to-high 300 basis point area, meaning an extra 3 percentage points in return. A similarly rated corporate bond paid about 142 basis points more than its benchmark on the same date. Sally Bakewell, *Why Leveraged Loans, CLOs Feed Worries in Virus Slump*, BLOOMBERG (Apr. 3, 2020, 5:38 PM), <https://www.bloomberg.com/news/articles/2020-04-03/why-leveraged-loans-clos-feed-worries-in-virus-slump-quicktake> [<https://perma.cc/8PAH-YEND>].

133. See *US CLO Issuance Hits All-Time Record, Topping \$125B*, *supra* note 125 (suggesting that yields in the CLO market have historically been higher as compared to other similarly rated assets).

134. See *id.* (suggesting that investors in low-interest rate environments flock to the higher-yielding CLO market).

135. See Warren Letter, *supra* note 2 (criticizing the growth of the leveraged loan market and suggesting that CLOs have enabled the expansion).

136. *CLOs: Who Holds Them*, *supra* note 12.

137. Cf. Bratton & Levitin, *supra* note 37, at 98 (highlighting the fact that the CLO and leveraged loan markets move in “lockstep”).

138. See Brown & Salander, *supra* note 3 (referencing strong investor demand and a “borrower-friendly” market).

139. See Podkul & Davies, *supra* note 7 (“[A]s CLOs competed for loans to invest in, borrowers were able to take on more debt per dollar of earnings . . .”).

140. See Jerome Powell, Chair, Bd. of Governors of the Fed. Reserve Sys., *Business Debt and Our Dynamic Financial System* (May 20, 2019), <https://www.federalreserve.gov/newsevents/speech/powell20190520a.htm> [<https://perma.cc/H2YY-BV7X>] (“Business debt has clearly reached a level that should give businesses and investors reason to pause and reflect. If financial and economic conditions were to deteriorate, overly indebted firms could well face severe strains.”).

B. *CLO Demand Leads to a Deterioration in Underwriting Standards*

Concerns about high levels of corporate debt are almost inevitably coupled with warnings about the quality of the loans extended to borrowers.¹⁴¹ CLOs factor prominently in this discussion because CLO demand for leveraged loans is largely seen as a driving force behind deteriorating underwriting standards.¹⁴² The erosion of lending standards is best reflected in the rise of covenant-lite loans and in the proliferation of aggressive provisions in loan documentation (“Credit Agreements”).¹⁴³

1. Covenant-Lite Loans

Loans are considered covenant-lite when they lack requirements compelling borrowers to meet certain performance criteria on a monthly or quarterly basis; failure to meet these requirements can place a borrower in default.¹⁴⁴ Maintenance covenants, while onerous for borrowers, offer insights as to a borrower’s ability to repay its loans.¹⁴⁵ Thus, the lack of covenants in a Credit Agreement is often seen as a benefit to borrowers granted at the expense of lenders.¹⁴⁶ Prior to the 2008 financial crisis,

141. See Joy Wiltermuth & Kristen Haunss, *Yellen Warns of Corporate Distress, Economic Fallout*, REUTERS (Feb. 27, 2019, 11:55 AM), <https://www.reuters.com/article/us-yellen-distressed/yellen-warns-of-corporate-distress-economic-fallout-idUSKCN1QG2CZ> [<https://perma.cc/R3DV-B3ZR>] (“At the same time corporate buyout leverage [increased], . . . lender protections weakened . . .”).

142. See Podkul & Davies, *supra* note 7 (“As CLOs competed for loans to invest in, borrowers were able to take on more debt per dollar of earnings at lower rates, and to demand looser terms, known as covenants.”).

143. See Kristen Haunss, *Regulators Concerned About Material Loosening in Leveraged Loan Market*, REUTERS (Oct. 24, 2018, 2:37 PM), <https://www.reuters.com/article/regs-loans/regulators-concerned-about-material-loosening-in-leveraged-loan-market-idUKL2N1X41JA?edition-redirect=ca> [<https://perma.cc/7GDL-CTXS>] (discussing covenant-lite loans and the incorporation of aggressive Credit Agreement provisions that pose risks to lenders).

144. ERIC GOODISON & MARGOT WAGNER, COVENANT-LITE LOANS: OVERVIEW 1, 5 (2019), https://www.paulweiss.com/media/3978887/goodison_wagner_practicallaw_aug2019_update.pdf [<https://perma.cc/QS95-FDT6>].

145. See *id.* (explaining covenants as beneficial to lenders because of their ability to alert lenders before a borrower defaults on their loan).

146. See FIN. STABILITY BD., *supra* note 6, at 8 (suggesting that covenant-lite loans are a benefit to borrowers and a detriment to lenders).

covenant-lite loans represented only a small fraction of the market.¹⁴⁷ By contrast, roughly 80% of leveraged loans today are covenant-lite.¹⁴⁸ Competition among CLO investors for leveraged loans has effectively allowed borrowers to market covenant-lite credit facilities without the risk that lenders will demand more traditional lender protections or refuse to lend altogether.¹⁴⁹

2. Aggressive Provisions in Credit Agreements

Amidst a backdrop of surging demand for leveraged loans and CLOs, traditional lender protections in Credit Agreements have been eroded by terms that give borrowers greater flexibility.¹⁵⁰ Regulators and market participants identified three specific areas in Credit Agreements where new, more borrower-friendly terms threaten to undermine the protections that secured lenders have long relied on when providing loans to below investment grade corporate borrowers.¹⁵¹ First, Credit Agreements have incorporated provisions—incremental facilities—that allow borrowers to incur additional debt, often without consulting existing lenders.¹⁵² This ability to tack on additional debt is especially

147. See Sam Goldfarb & Avantika Chilkoti, *Regulators, Investors Zero in on Corporate Debt Market*, WALL ST. J. (May 28, 2019, 10:14 AM), <https://www.wsj.com/articles/regulators-investors-zero-in-on-corporate-debt-market-11558958401> [<https://perma.cc/B47Y-HBWQ>] (reporting that in 2006 only 6% of loans were covenant-lite); *Covenant-Lite Leveraged Loans: After Default, Whither Recoveries?*, S&P GLOBAL MKT. INTEL. (July 23, 2018), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/leveraged-loan-news/covenant-lite-leveraged-loans-default-whither-recoveries> [<https://perma.cc/LFV8-VJ23>] (noting that in 2007 only 29% of the leveraged loan market was considered covenant-lite).

148. Phillips, *supra* note 1 ("So-called covenant lite loans now account for roughly 80 percent of the new leveraged loans on the market.").

149. See FIN. STABILITY BD., *supra* note 6, at 8 ("[D]eals have experienced looser covenants, likely driven by high availability of funding and competition for loan mandates by arrangers.").

150. See *id.* at 7–8 (describing the erosion of traditional lender protections in Credit Agreements and attributing this development to a competitive market).

151. See Haunss, *supra* note 143 (describing some of the borrower-friendly terms being incorporated into Credit Agreements).

152. See Gary L. Storck & Mark D. Sheely, *Leveraged Lending: Evolution, Growth and Heightened Risk*, in 16 SUPERVISORY INSIGHTS 10, 15 (2019), <https://www.fdic.gov/regulations/examinations/supervisory/insights/sifall19/si-fall-2019.pdf> [<https://perma.cc/N7H9-A4XF>] ("[M]any credit agreements allow borrowers the right to

detrimental in the context of below investment grade borrowers because, as indicated by their low credit rating, these borrowers already carry large debt loads.¹⁵³ In the event of a downturn, these highly indebted borrowers will likely have little cash on their balance sheets to repay creditors.¹⁵⁴ Second, under most Credit Agreements, a borrower may take certain actions—like incur debt—only if it can establish that it is in compliance with ratios that measure its debt to earnings.¹⁵⁵ However, many Credit Agreements now contain provisions that allow a borrower to artificially inflate its earnings by adding back certain expenses or anticipated cost savings.¹⁵⁶ Research indicates that these adjustments often overstate a borrower’s earnings and thus understate its debt to earnings ratio,¹⁵⁷ allowing borrowers greater flexibility to take actions that would otherwise be prohibited under their loan agreements.¹⁵⁸ Finally, many Credit Agreements now allow corporate borrowers to transfer assets outside the credit group¹⁵⁹ thus diluting the collateral that can be claimed

obtain additional debt without the current lender’s approval, an ability known as incremental facilities.”).

153. *See id.* at 10–11 (explaining that leveraged borrowers typically have high levels of debt and below investment grade credit ratings).

154. *See id.* at 10 (“[H]igh debt levels coupled with lower levels of liquidity may reduce businesses’ flexibility to respond to changes in economic conditions.”).

155. *See* GOODISON & WAGNER, *supra* note 144, at 2 (providing that many Credit Agreements allow borrowers to incur an unlimited amount of debt if the borrower meets an incurrence test, like a maximum leverage ratio).

156. *See* Aaron Weinman, *US Investors Sound Alarm over Projected Add-Backs*, REUTERS (May 9, 2019, 2:56 PM), <https://www.reuters.com/article/investors-addbacks/us-investors-sound-alarm-over-projected-add-backs-idUSL2N22L1MK> [<https://perma.cc/Z2ZE-EPYQ>] (“Borrowers . . . have in recent years ramped up their usage of add-backs, or projected cost savings . . . in a bid to make leverage calculations more palatable to both investors and regulators.”).

157. FIN. STABILITY BD., *supra* note 6, at 9 (explaining how add-backs can artificially increase earnings and thus understate a borrower’s debt to earnings ratio).

158. *See The Arc of the Covenants*, LOAN SYNDICATIONS & TRADING ASS’N (Jan. 18, 2018), <https://www.lsta.org/news-resources/the-arc-of-the-covenants/> [<https://perma.cc/9URG-SJ9V>] (suggesting that the impact of add-backs “cascade” through other credit agreement provisions, making many of the activities governed by leverage ratios easier to undertake).

159. A borrower may transfer assets away from secured lenders who have a claim on those assets by moving them to an entity called an unrestricted subsidiary. Unrestricted subsidiaries, unlike restricted subsidiaries, are not parties to the Credit Agreement. This means that unrestricted subsidiaries are not subject to the limitations imposed on borrowers under the Credit Agreement, and these unrestricted subsidiaries can be used to protect assets from seizure in the event a borrower cannot repay their loan. Brad Cheek, Note, *Tearin’ Up*

by lenders in the event of default.¹⁶⁰ The vast majority of Credit Agreements contain carve-outs that permit borrowers to transfer assets to subsidiaries that are not a party to the Credit Agreement, up to a stated amount.¹⁶¹ Individually, these borrower-friendly provisions undermine the safety of lender investments.¹⁶² However, taken together, these terms amplify the risk lenders assume when extending credit to below investment grade corporate borrowers.¹⁶³ CLO demand for leveraged loans has allowed borrowers to incorporate some or, in some cases, all of these provisions into their Credit Agreements.¹⁶⁴

C. *The Regulatory Landscape*

The fact that demand from unregulated investors—like CLOs—prompted massive growth in the leveraged loan market and the deterioration of underwriting standards did not go unnoticed by federal regulators.¹⁶⁵ In 2013, the Office of the Comptroller of the Currency (“OCC”), the Board of Governors of the Federal Reserve System (“Federal Reserve”), and the Federal Deposit Insurance Corporation (“FDIC”) jointly issued Interagency Guidance on Leveraged Lending (“Guidance”).¹⁶⁶ The Guidance was designed to provide agency-

iHeart: The Recent Trend with Troubled Companies and The Unrestricted Subsidiary Transfer Tactic, 23 N.C. Banking Inst. 271, 273–74 (2019).

160. See Joe Rennison & Colby Smith, *Debt Machine: Are Risks Piling up in Leveraged Loans?*, FIN. TIMES (Jan. 21, 2019), <https://www.ft.com/> [<https://perma.cc/ZP46-JBN6>] (describing how an increasing number of credit agreements come with “few of the lender protections that were once standard,” and explaining how recent loan documentation often includes the ability to “move assets out of the reach of lenders.”).

161. See *id.* (“Of the top 20 private equity-sponsored loan deals in 2018 approximately 80 per cent contained a loophole that could see loan investors’ claim on collateral diluted . . .”).

162. See FIN. STABILITY BD., *supra* note 6, at 7–11 (examining the weaknesses in credit documentation and explaining how these weaknesses can disadvantage lenders).

163. *Id.* at 7–11.

164. See Rennison, *supra* note 12 (“[S]trong demand from CLOs has helped to shred many of the investor protections that were once routinely embedded in loan documents . . .”).

165. See Joint Press Release, Fed. Reserve Bd., Agencies Issue Updated Leveraged Lending Guidance (Mar. 21, 2013), <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20130321a.htm> [<https://perma.cc/Z8NQ-TW4S>] (announcing the release of updated leveraged lending guidance in response to the deterioration of loan underwriting standards).

166. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766, 17766 (Mar. 22, 2013).

supervised institutions with “high-level principles related to safe and sound leveraged lending activities.”¹⁶⁷ Specifically, the Guidance urged regulated lenders not to extend loans that could not be repaid within five to seven years, and to avoid financing any loan that would elevate a borrower’s debt to earnings ratio above six times.¹⁶⁸ While the Guidance may have curtailed leveraged lending among banks for a short time,¹⁶⁹ it was ultimately an imperfect attempt to stymie the growth of the leveraged loan market and enforce stricter lending standards among banks.¹⁷⁰

The Guidance was incapable of influencing underwriting standards in the long-term because federal regulators backed away from the Guidance¹⁷¹ after it was challenged in 2017 and subsequently reviewed by the Government Accountability Office (“GAO”).¹⁷² According to the GAO, the Guidance constituted a rule that needed to comply with the Congressional Review Act (“CRA”) before it could be made effective.¹⁷³ Rather than reissue the Guidance to conform with the requirements under the CRA, federal regulators took the opposite approach.¹⁷⁴ In September of 2018, the Federal Reserve, in collaboration with four other agencies, issued an Interagency Statement Clarifying the

167. *Id.*

168. *See id.* at 17773, 17775 (explaining the agency’s view of what constitutes “adequate repayment capacity” and suggesting that corporate leverage above six times “raises concerns”).

169. *See* Sooji Kim et al., *Did the Supervisory Guidance on Leveraged Lending Work?*, FED. RES. BANK N.Y. (May 16, 2016), <https://libertystreeteconomics.newyorkfed.org/2016/05/did-the-supervisory-guidance-on-leveraged-lending-work.html> [<https://perma.cc/4GVS-46PU>] (reporting a decline in leveraged lending among banks after the passage of the Guidance).

170. *See* Kristen Haunss, *Regulatory Crackdown Unlikely in US Leveraged Loan Market*, REUTERS (Mar. 15, 2019, 11:25 AM), <https://www.reuters.com/article/regulatory-crackdown-unlikely-in-us-leve/regulatory-crackdown-unlikely-in-us-leveraged-loan-market-idUSL1N2120Q6> [<https://perma.cc/3242-KDXB>] (suggesting that the Guidance had an “insufficient effect” on tightening underwriting standards in the leveraged loan market).

171. *See* Warren Letter, *supra* note 2 (criticizing federal regulators from backing away from the Guidance instead of building upon it).

172. *See* U.S. GOV’T ACCOUNTABILITY OFFICE, B-329272, *APPLICABILITY OF THE CONGRESSIONAL REVIEW ACT TO INTERAGENCY GUIDANCE ON LEVERAGED LENDING* (2017) (noting that the GAO reviewed the Guidance at the request of Senator Pat Toomey).

173. *Id.*

174. *See* Hannah Lang et al., *6 Policy Responses to Leveraged Lending Fears*, AM. BANKER (June 6, 2019, 9:00 PM), <https://www.americanbanker.com/list/6-policy-responses-to-leveraged-lending-fears> [<https://perma.cc/4JCP-DU3K>] (“The regulators could have resubmitted the guidance, but they did not take that road.”).

Role of Supervisory Guidance (“Clarifying Statement”).¹⁷⁵ The Clarifying Statement established that supervisory guidance—like the 2013 Interagency Guidance on Leveraged Lending—does not have the force of law and confirmed that no enforcement actions would be taken based on guidance alone.¹⁷⁶ Moreover, in November of 2020, the OCC proposed a rule to codify the Clarifying Statement.¹⁷⁷ With this, the Guidance was effectively nullified and therefore incapable of addressing concerns about underwriting standards in the leveraged loan market.¹⁷⁸

The CLO market was more directly impacted by federal regulation in 2014 when the Securities and Exchange Commission (“SEC”) and the Federal Reserve each issued a Credit Risk Retention Rule (“Risk Retention Rule”).¹⁷⁹ Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), the SEC and federal banking agencies were authorized to prescribe regulations requiring securitizers of asset-backed securities (“ABS”) to retain at least 5% of the credit risk in assets that they transferred, sold, or conveyed to a third-party.¹⁸⁰ Under the Risk Retention Rule, CLO Managers were classified as securitizers.¹⁸¹ This designation required CLO Managers to retain a 5% interest in the CLOs that they managed.¹⁸² While the Risk Retention Rule was implemented to align the interests of investors and

175. FED. RESERVE BD., SR 18-5/ CA 18-7, INTERAGENCY STATEMENT CLARIFYING THE ROLE OF SUPERVISORY GUIDANCE (Sept. 12, 2018) [hereinafter CLARIFYING STATEMENT].

176. *See id.* (“Unlike a law or regulation, supervisory guidance does not have the force and effect of law, and the agencies do not take enforcement actions based on supervisory guidance.”).

177. Role of Supervisory Guidance, 85 Fed. Reg. 70512, 70512 (proposed Nov. 5, 2020).

178. *See* Lang et al., *supra* note 174 (explaining how the Guidance was never implemented as a rule and was thus, “effectively nullified”).

179. *See* Credit Risk Retention (Regulation RR), 12 C.F.R. § 244.1 (2020) (providing the Federal Reserve’s regulation to implement credit risk retention as required by Dodd-Frank); Credit Risk Retention, 17 C.F.R. § 246.1 (2020) (providing the SEC’s regulation to implement credit risk retention as required by Dodd-Frank).

180. Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 941(b), 15 U.S.C. 78o-11(c), (g)-(h) (2018).

181. *See* Credit Risk Retention, 79 Fed. Reg. 77602, 77650–51, 77653, 77659 (Dec. 24, 2014) (“[T]he agencies believe that CLO managers are clearly included within the statutory definition of ‘securitizer’ . . .”).

182. *Id.* at 77651.

securitizers,¹⁸³ it had another important effect on the CLO market: smaller CLO managers without the capital required to retain the mandatory 5% interest were forced out of the market.¹⁸⁴

Ultimately, the impact of the Risk Retention Rule on the CLO market was short-lived.¹⁸⁵ In 2018, federal regulation of the CLO market was significantly curtailed pursuant to a successful lawsuit brought by the Loan Syndications and Trading Association (“LSTA”).¹⁸⁶ The U.S. Court of Appeals for the District of Columbia sided with the LSTA in their suit against the SEC and the Federal Reserve, which challenged the Risk Retention Rule as applied to CLO Managers.¹⁸⁷ The court held that CLO Managers are not in fact securitizers under Section 941 of Dodd-Frank, and this finding exempted CLO Managers from the requirements of the Risk Retention Rule.¹⁸⁸ The 2020 downturn, therefore, materialized after federal regulation of the leveraged loan and CLO markets—in the form of the Guidance and the Risk Retention Rule—had been significantly scaled back.¹⁸⁹

183. See Elliot Gantz & Phillip Black, *CLO Risk Retention: A Case Study in Regulatory Indiscretion*, 24 N.C. BANKING INST. 75, 75 (2020) (explaining the “potential conflict of interest” between loan originators and investors in the ABS market).

184. See *Risk Retention Could Hurt CLO Investors by Increasing Correlation, Decreasing Diversity*, LOAN SYNDICATIONS & TRADING ASS’N (July 27, 2016), <https://www.lsta.org/news-resources/risk-retention-could-hurt-clo-investors-by-increasing-correlation-decreasing-diversity/> [<https://perma.cc/E3V9-6PJS>] (explaining that the risk retention requirement is likely to reduce CLO formation, especially among smaller managers without sufficient capital to purchase and retain 5% of the notes of new CLOs).

185. See Kristen Haunss, *CLO Risk Retention Now Just a Memory as Final Appeal Deadline Passes*, REUTERS (May 11, 2018, 12:22 PM), <https://www.reuters.com/article/us-clos-supremecourt/clo-risk-retention-now-just-a-memory-as-final-appeal-deadline-passes-idUSKBN1IC21S> [<https://perma.cc/2L8F-ZC5J>] (reporting that CLO Managers “are now completely free” from the requirements imposed by the Risk Retention Rule).

186. See *Loan Syndications & Trading Ass’n v. Securities & Exch. Comm’n & Bd. of Governors of the Fed. Reserve Sys.*, 882 F.3d 220, 229 (D.C. Cir. 2018) (holding that CLO Managers are not subject to the Risk Retention Rule).

187. *Id.*

188. *Id.* at 222.

189. See *Loan Syndications & Trading Ass’n*, 882 F.3d 220 (holding that CLO Managers are not subject to the requirements of the Risk Retention Rule); CLARIFYING STATEMENT, *supra* note 175 (explaining that supervisory guidance does not have the force of law).

IV. CLO PERFORMANCE DURING THE 2020 DOWNTURN

A. *The CLO Response to the 2020 Downturn*

In light of the criticism directed towards the CLO market, the economic downturn wrought by the COVID-19 pandemic should have been disastrous for CLOs—and some predicted that it would be.¹⁹⁰ The pandemic ended the longest economic expansion in United States history¹⁹¹—a prosperity that may have sanctioned inaction with respect to longstanding concerns about the CLO and leveraged loan markets.¹⁹² In response to the spread of COVID-19 and the nationwide lockdown, many businesses closed their doors, flights and vacations were cancelled, and life seemed to come to a rapid halt.¹⁹³ As a result, the pandemic caused material damage to businesses and companies across almost all corporate sectors.¹⁹⁴ For many corporate borrowers, revenue shortfalls, supply chain disruption, and reduced demand were commonplace when lockdown measures took effect.¹⁹⁵ Speculative-grade corporate borrowers, whose high debt loads become difficult to repay when

190. See Partnoy, *supra* note 14 (discussing the potential for a bank collapse caused by distress in the CLO market).

191. See, e.g., Elizabeth Schulze, *The Coronavirus Recession is Unlike any Economic Downturn in US History*, CNBC (Apr. 8, 2020, 12:33 PM), <https://www.cnbc.com/2020/04/08/coronavirus-recession-is-unlike-any-economic-downturn-in-us-history.html> (explaining that, prior to the pandemic, GDP had expanded for a record 126 months, unemployment was at a fifty-year low, economic growth was steady at around 2%, and stock markets were at record highs).

192. See Phillips, *supra* note 1 (suggesting that there are many reasons to be concerned about the CLO market but that, because the economy is strong, there has been less incentive to take them seriously).

193. See Podkul & Davies, *supra* note 7 (describing the broad impact of the COVID-19 pandemic across industries).

194. See Hannah Zhang, *Leveraged Finance: U.S. Leveraged Finance Q2 2020 Update: Recovery Ratings Maintain Social Distance from Credit Impact of COVID-19 Pandemic*, S&P GLOBAL RATINGS (July 23, 2020, 2:59 PM), <https://www.spglobal.com/ratings/en/research/articles/200723-leveraged-finance-u-s-leveraged-finance-q2-2020-update-recovery-ratings-maintain-social-distance-from-credit-11577544> [<https://perma.cc/SE6D-5VF2>] (“[T]he pandemic has caused material damage to the business and creditworthiness of companies in almost all corporate sectors . . .”).

195. See Micah Maidenberg, *Fewer Products, Localized Production—Companies Seek Supply-Chain Solutions*, WALL ST. J. (Apr. 26, 2020, 5:30 AM), <https://www.wsj.com/articles/coronavirus-disrupted-supply-chains-that-companies-are-still-fixing-11587893401> [<https://perma.cc/Y9MQ-4G2U>] (reporting on supply chain disruptions and a decline in earnings among businesses as a result of the COVID-19 pandemic).

revenues decline,¹⁹⁶ unfortunately bore the brunt of the pandemic-induced economic damage.¹⁹⁷

Due to their reliance on corporate debt repayment, the leveraged loan and CLO markets did experience volatility, especially in the earliest months of the lockdown.¹⁹⁸ Specifically, in the leveraged loan market, the COVID-19 pandemic catalyzed three troubling trends: downgrading of loans, increased default rates, and trading price decreases.¹⁹⁹ First, a staggering number of leveraged loans were downgraded by ratings agencies, which generally reflected concerns that leveraged borrowers would be unable to repay their debt.²⁰⁰ Between March and July, the rating agency S&P downgraded more than 900 corporate borrowers.²⁰¹ Moreover, from March through May, the pace of loan downgrades at S&P outpaced upgrades by a rate of 43:1, prompting fears that a wave of corporate defaults would soon materialize.²⁰² Ultimately, default rates among leveraged loan borrowers did increase—albeit not catastrophically—during the earliest months of the year, marking the second strain on the leveraged loan market induced by the COVID-19

196. See Lang, *supra* note 21 (“Highly leveraged companies that either experience a disruption in their supply chains or reduced demand because of the coronavirus could have difficulty repaying their loans . . .”).

197. See Zhang, *supra* note 194 (suggesting that below investment grade corporate borrowers “bore the brunt” of the pandemic-induced economic damage).

198. See Haunss, *supra* note 19 (“[A]s coronavirus began to spread around the world, market volatility hit the CLO and loan asset classes.”).

199. See CAO ET AL., *supra* note 5, at 1 (highlighting the decline in leveraged loan prices instigated by the COVID-19 pandemic); Rachele Kakouris, *In Grim Sign, US Leveraged Loan Defaults Set Record in April*, S&P GLOBAL MKT. INTEL. (May 6, 2020), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/in-grim-sign-us-leveraged-loan-defaults-set-record-in-april-58437664> [<https://perma.cc/NR5J-T9D3>] (reporting a record number of defaults in April of 2020); Yoruk Bahceli, *U.S. Leveraged Loan Downgrade Ratio Five Times Worse Than 2008-09*, REUTERS (June 4, 2020, 11:20 AM), <https://www.reuters.com/article/us-health-coronavirus-leveraged-loans-gr/u-s-leveraged-loan-downgrade-ratio-five-times-worse-than-2008-09-idUSKBN23B2H8> [<https://perma.cc/7LN4-79ZS>] (describing a spike in leveraged loan downgrades).

200. See Bahceli, *supra* note 199 (describing the record level of leveraged loan downgrades as a response to pandemic-induced stress in the loan market).

201. Zhang, *supra* note 194.

202. See Rachele Kakouris, *US Leveraged Loan Downgrade Ratio Hits Staggering 43:1 as Pandemic Stalls Market*, S&P GLOBAL MKT. INTEL. (June 4, 2020), [<https://perma.cc/7J3F-RLJV>] <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/us-leveraged-loan-downgrade-ratio-hits-staggering-43-1-as-pandemic-stalls-market-58928285> (“As a leading indicator, rising downgrades also typically precede a period of increased defaults.”).

pandemic.²⁰³ In April, the total number of defaults reached eleven, which surpassed the previous monthly record of ten set in October 2009.²⁰⁴ Finally, the price of leveraged loans trading in the secondary market fell dramatically between February and March.²⁰⁵ For instance, leveraged loan issuer Cirque du Soleil saw the price of its loan tumble to 69.5 cents on the dollar—down from 92.5 cents in February—when it was forced to cancel shows due to the pandemic.²⁰⁶ Falling loan prices can affect CLO managers trying to trade out of nonperforming loans, as they may be forced to sell at a significant discount.²⁰⁷ This can negatively impact the outstanding value of the debt that CLOs hold for purposes of meeting the overcollateralization requirements imposed by their OC Tests.²⁰⁸

The impact of the COVID-19 pandemic and resultant economic downturn was also felt directly in the CLO market.²⁰⁹ In response to largescale ratings downgrades in the leveraged loan market, the three major credit rating agencies turned their attention to the CLOs holding these loans and placed roughly 2,400 CLO debt obligations under review for possible downgrade.²¹⁰ In addition, some CLOs failed their internal performance tests in response to widespread loan downgrades and market volatility.²¹¹ Notably, a CLO triggered its senior OC Test for the first

203. See Kakouris, *supra* note 199 (highlighting an increase in defaults among borrowers during the month of April but acknowledging that the default rate remains below the historical average).

204. *Id.*

205. CAO ET AL., *supra* note 5, at 1.

206. Podkul & Davies, *supra* note 7.

207. See Adam Tempkin, *Over 10% of CLOs Fail Collateral Tests, Putting Payouts at Risk*, BLOOMBERG (Apr. 23, 2020, 4:50 PM), <https://www.bloomberg.com/news/articles/2020-04-23/over-10-of-clos-fail-collateral-tests-putting-payouts-at-risk> [https://perma.cc/V5TY-RLB2] (explaining how loans sold at a discount can reduce the value of the CLO portfolio).

208. *Id.*

209. See Cezary Podkul, *Expected Surge of CLO Downgrades Slow to Arrive*, WALL ST. J. (Aug. 28, 2020, 6:31 PM), <https://www.wsj.com/articles/expected-surge-of-clo-downgrades-slow-to-arrive-11598653875> [https://perma.cc/2VSN-GNX5] (noting that CLO debt obligations were placed under review for downgrade by ratings agencies in response to economic volatility caused by the COVID-19 pandemic).

210. See *id.* (“After the coronavirus pandemic shut many businesses this spring, the three major credit-ratings firms placed about 2,400 bonds tied to pools of corporate loans on review for possible downgrades.”).

211. See Tempkin, *supra* note 207 (reporting that, according to one analysis, 13% of roughly 750 CLOs failed their junior OC Tests in April).

time since 2008.²¹² Finally, new CLO issuance decreased substantially, especially as compared to prior years.²¹³ In the first three months of 2020, there was just \$15.2 billion of new issuance, which was \$14.1 billion short of the \$29.3 billion issued during the same quarter in 2019.²¹⁴ The CLO market freeze reflected investor concerns tied to falling loan prices and large-scale corporate downgrades.²¹⁵

Despite experiencing a bout of volatility in the earliest months of the year, CLOs and the leveraged loan market rebounded well.²¹⁶ The wave of potential CLO downgrades that seemed likely at the beginning of the year largely failed to materialize.²¹⁷ Ultimately, many CLO securities had their ratings affirmed or were otherwise downgraded only one notch.²¹⁸ On the new issue front, volume gradually picked back up, with \$3.9 billion of CLOs issued in April, \$6 billion in May, and \$8.2 billion in June.²¹⁹ Moreover, Wells Fargo adjusted its 2020 U.S. CLO issuance forecast to \$65 billion, up from the \$50 billion it estimated in May.²²⁰ Finally, the leveraged loan space also saw a gradual recovery²²¹

212. Alexander Saeedy, *For 1st Time Since 2008, a CLO Triggers its Senior Overcollateralization Test*, S&P GLOBAL MKT. INTEL. (Apr. 17, 2020), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/for-1st-time-since-2008-a-clo-triggers-its-senior-overcollateralization-test-58047116> [https://perma.cc/H6PR-QEEL].

213. See Kristen Haunss, *CLO Issuance Falls 48% as Rush of Loan Downgrades Threatens Investor Distributions*, REUTERS (Apr. 17, 2020, 9:55 AM), <https://www.reuters.com/article/cloissuance-ccc/clo-issuance-falls-48-as-rush-of-loan-downgrades-threatens-investor-distributions-idINL1N2C50BG> [https://perma.cc/56SK-9RBL] (describing how CLO issuance slowed in the earliest months of 2020 in response to the economic impact of the COVID-19 pandemic).

214. *Id.*

215. *See id.* (suggesting that the CLO market froze due to falling loan prices and a wave of corporate downgrades).

216. *See* KOTHARI ET AL., *supra* note 8, at 47 (explaining that CLO issuance has “rebounded” to almost pre-outbreak levels and suggesting that the leveraged loan market has stabilized).

217. Podkul, *supra* note 209.

218. *Id.*

219. Haunss, *supra* note 19.

220. *Id.*

221. *See* Jonathan Hemingway, *US Leveraged Loan Issuance Rebounds in Q3 after Pandemic-Induced Slump*, S&P GLOBAL MKT. INTEL. (Sept. 30, 2020), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/us-leveraged-loan-issuance-rebounds-in-q3-after-pandemic-induced-slump-60534463> [https://perma.cc/4V4D-46LM] (“Issuance in the U.S. leveraged loan market rebounded in

in a move that was important for the health of the CLO market.²²² After tumbling in the early months of 2020, loan prices ultimately rebounded,²²³ and new issuance ticked back up, even if in fits and starts.²²⁴ After leveraged loan issuance bottomed out at a four-year low of \$44.5 billion in the second quarter, the market recovered, with new issuance totaling \$71 billion in the third quarter of 2020.²²⁵

While it may be years before the CLO market is as active as it was before the COVID-19 pandemic, it appears as though CLOs have emerged, yet again, as “survivors”²²⁶—only this time in reference to their handling of the 2020 economic downturn.²²⁷ At the very least, CLOs did not catalyze the next banking crisis or severely destabilize the U.S. financial system,²²⁸ as some feared.²²⁹ The reason why CLOs—in spite of the criticisms they face—survived the volatility of the 2020 downturn without damaging the financial market is twofold. First, government intervention in the form of the Term Asset-Backed Securities Loan Facility (“TALF”) helped to reinvigorate the CLO market after it froze in the earliest months of the year.²³⁰ However, the impact of TALF was

the third quarter, as stabilizing conditions and increasing investor demand have drawn borrowers off the sidelines.”).

222. See generally FIN. STABILITY BD., *supra* note 28 (“[T]he leveraged loan and CLO markets include direct and indirect forms of interconnectedness Direct interconnectedness arises from . . . origination and distribution of leveraged loans to securitization by CLO managers . . .”).

223. See KOTHARI ET AL., *supra* note 8, at 48 (discussing the rebound in leveraged loan prices).

224. See Hemingway, *supra* note 221 (noting the \$71 billion of loans issued in the third quarter of 2020 and suggesting that this increase reflects a rebound in the leveraged loan market).

225. *Id.*

226. See JOHNSON, *supra* note 30, at 1 (highlighting that CLOs were deemed survivors of the last financial crisis).

227. See KOTHARI ET AL., *supra* note 8, at 48 ([W]hile the COVID-19 economic shock initially halted new CLO issuance, the market appears headed for recovery.”).

228. See *id.* at 49 (explaining that CLOs performed well when confronted with the COVID-19 induced economic downturn).

229. See Partnoy, *supra* note 14 (suggesting that weaknesses in the CLO market could lead to a financial collapse reminiscent of the 2008 financial crisis).

230. See *id.* (explaining that TALF will have a modest, but positive, impact on the CLO market).

largely symbolic,²³¹ and the survival of the CLO market can be mostly attributed to something else—the strength of the CLO structure.²³² In the midst of the 2020 downturn, protections embedded in the CLO structure worked as intended; the OC Tests designed to safeguard the investments of AAA investors deployed properly²³³ and protected the investments of banks—whose losses could have spelled financial trouble.²³⁴

B. The Modest Impact of TALF on the CLO Market

In response to the economic hardship brought on by the pandemic, the Federal Reserve exercised its power under Section 13(3) of the Federal Reserve Act²³⁵ to revive TALF.²³⁶ The first iteration of TALF, launched in 2008, responded to the financial crisis by providing loans to investors that could be used to purchase eligible asset-backed securities (“ABS”).²³⁷ When it was reintroduced in March of 2020, TALF again sought to encourage the issuance of ABS,²³⁸ which

231. See Lisa Lee, *CLOs, Leveraged Loans Get Partial Lifeline in Fed’s TALF Changes*, BLOOMBERG (May 12, 2020, 5:14 PM), <https://www.bloomberg.com/news/articles/2020-05-12/clos-leveraged-loans-get-partial-lifeline-in-fed-s-talf-changes> [https://perma.cc/EG9N-4NNU] (suggesting that TALF’s impact on the CLO market will be fairly limited).

232. See KOTHARI ET AL., *supra* note 8, at 10 (suggesting that CLOs structures are designed to absorb risk).

233. See Saeedy, *supra* note 212 (reporting that a CLO triggered its senior OC Test, which redirects cash flows from junior debtholders to more senior investors).

234. See Lang, *supra* note 21 (suggesting that banks will be largely insulated from losses stemming from their CLO holdings, which is important for the overall health of financial markets).

235. Federal Reserve Act, Pub. L. No. 63-43, 38 Stat. 251 (1913) (codified at 12 U.S.C. § 343 (2020)).

236. *Term Asset-Backed Securities Loan Facility*, FED. RES. BD. (Dec. 11, 2020) <https://www.federalreserve.gov/monetarypolicy/talf.htm> [https://perma.cc/NUN6-ECMW].

237. See *Federal Reserve Establishes Term Asset-Backed Securities Loan Facility (TALF)*, DECHERT LLP (March 26, 2020) <https://www.dechert.com/knowledge/onpoint/2020/3/federal-reserve-establishes-term-asset-backed-securities-loan-fa.html> [https://perma.cc/L4R2-BTPP] (“During the 2008 financial crisis, the Fed created the Legacy TALF Program to stimulate the securitization markets by providing financing to third party investors in highly rated ABS . . .”).

238. See Press Release, Fed. Reserve Bd., *Federal Reserve Announces Extensive New Measures to Support the Economy* (Mar. 23, 2020) (on file with author) (explaining that TALF will enable the issuance of ABS).

facilitated access to credit among U.S. consumers and businesses.²³⁹ The Federal Reserve committed \$100 billion to fund loans to buyers of highly rated ABS like, for example, AAA-rated CLO debt.²⁴⁰ Ultimately, the passage of TALF had important implications for the CLO market because it provided buyers of the highest rated CLO securities access to federal funding.²⁴¹

In its initial guidance, the Federal Reserve placed several restrictions on the kinds of borrowers that were eligible to receive TALF funds (“Eligible Borrowers”) and on the nature of CLO debt that could serve as collateral for a TALF loan (“Eligible CLO”).²⁴² However, TALF was ultimately amended multiple times in response to feedback coming from the ABS market.²⁴³ In its final form, TALF’s impact on the CLO market was modest at best, as an important limitation on Eligible Collateral curtailed the utility of the program as applied to the CLO market.²⁴⁴ Ultimately, two specific revisions allowed TALF to have a

239. See *Term Asset-Backed Securities Loan Facility (“TALF”) Funds Resources*, DECHERT LLP <https://www.dechert.com/knowledge/hot-topic/coronavirus-business-impact/term-asset-backed-securities-loan-facility---talf---funds-resour.html> [<https://perma.cc/7QT5-2JLA>] (last visited Jan. 5, 2021) (“TALF supports the flow of credit to consumers and businesses by allowing the investment fund borrower to buy AAA-rated ABS with significant leverage from the Fed.”).

240. See Matt Wirz, *Fed Aid Could Restart the CLO Market by June*, WALL ST. J. (Apr. 10, 2020, 1:19 PM), <https://www.wsj.com/articles/fed-aid-could-restart-clo-market-by-june-11586539170> [<https://perma.cc/2FBW-T3UF>] (“The Fed earmarked up to \$100 billion . . . to help investors buy asset-backed debt, including the highest-quality bonds of certain types of CLOs . . .”).

241. *Id.*

242. See CHRISTOPHER DESMOND ET AL., DECHERT LLP, CLOS AND TERM ASSET-BACKED SECURITIES LOAN FACILITY (TALF)— WE’RE NOT THAT DESPERATE (YET) 1 (2020), [https://info.dechert.com/10/14115/uploads/clos-and-term-asset-backed-securities-loan-facility-\(talf\)--we-re-not-that-desperate-\(yet\).pdf](https://info.dechert.com/10/14115/uploads/clos-and-term-asset-backed-securities-loan-facility-(talf)--we-re-not-that-desperate-(yet).pdf) [<https://perma.cc/5KKV-R23B>] (referencing the restrictions contained in the first iteration of TALF and explaining subsequent revisions to the program).

243. See FRBNY, *Yet Again, Revises the TALF 2.0 Frequently Asked Questions*, DECHERT LLP (June 18, 2020),

<https://www.dechert.com/knowledge/onpoint/2020/6/frbny--yet-again--revises-the-talf-2-0-frequently-asked-question.html> [<https://perma.cc/72GG-TJDK>] (noting the number of revisions that have been made to TALF since its inception).

244. See Lee, *supra* note 231 (acknowledging that TALF will impact the CLO market, but suggesting that its effect will be limited due to the requirement that Eligible CLOs must be static).

limited practical impact, but the overall effect of the initiative on the CLO market was largely symbolic.²⁴⁵

Under TALF, Federal funds could only be employed to purchase AAA-rated debt in static CLOs, effectively rendering the lending program impractical for most of the CLO market.²⁴⁶ Static CLOs do not permit CLO managers to actively trade the loan portfolio during the life of the CLO and represent only a small fraction of the CLO market.²⁴⁷ For instance, static CLOs represented a mere 2% of new deals launched in 2017 and only 5% in 2019.²⁴⁸ This limitation, which was not scaled back in any subsequent revision of TALF, served to meaningfully limit the utility of the program to the CLO market.²⁴⁹ Nevertheless, two subsequent changes to TALF made the program more useful to the CLO market, although only to a limited extent.²⁵⁰

All of the revisions to TALF sought to align the program more closely with established practices within the CLO industry.²⁵¹ However, the two most important updates to TALF were a clarification that Eligible CLOs could contain loans issued *or refinanced* after January 1, 2019,²⁵² and an update that allowed up to 65% of loans in Eligible CLOs to be

245. See CHRISTOPHER DESMOND ET AL., *supra* note 242 (suggesting the limited utility of TALF as applied to the CLO market); Lee, *supra* note 231 (explaining how TALF was revised to allow refinanced loans to serve as Eligible Collateral); Matt Wirz, *Fed TALF Revision Could Help Clear CLO Logjam*, WALL ST. J. (May 13, 2020, 4:26 PM), <https://www.wsj.com/articles/fed-talf-revision-could-help-clear-clo-logjam-11589383995> [<https://perma.cc/S3AZ-YSDH>] (noting the revision to TALF which relaxed the requirement that loans have covenants).

246. See Lee, *supra* note 231 (explaining how the static CLO requirement under TALF will serve to limit the utility of the program).

247. *Id.*

248. Wirz, *supra* note 240.

249. See CHRISTOPHER DESMOND ET AL., *supra* note 242 (“[T]he requirement[] that CLOs be static . . . will further undercut the utility of the program in terms of facilitating the flow of credit to U.S. businesses through CLOs.”)

250. See sources cited *supra* note 245.

251. See CHRISTOPHER DESMOND ET AL., *supra* note 242 (acknowledging that certain revisions to TALF aligned the program more closely with existing standards within the CLO market).

252. In the initial TALF term sheet, Eligible CLOs included only CLOs whose underlying leveraged loans were originated on or after January 1, 2019. TALF was revised to allow Eligible CLOs to hold loans that were refinanced on or after January 1, 2019. This change was important, as it allowed loans sitting in warehouses to serve as collateral in TALF Eligible CLOs. See *id.* at 3.

covenant-lite.²⁵³ The update permitting Eligible CLOs to hold a significant amount of covenant-lite loans was important given the fact that roughly 80% of all leveraged loans are covenant-lite.²⁵⁴ Moreover, the percentage of covenant-lite loans in existing CLOs portfolios is often between 60% and 70%.²⁵⁵ By aligning TALF more closely with the realities of the CLO market, the Federal Reserve ensured that TALF funds could be used more effectively by CLO market participants.²⁵⁶

The TALF revision allowing Eligible CLOs to hold loans issued or refinanced after January 1, 2019, had important practical implications for the CLO market because it allowed CLO managers to finish deals that were initiated prior to the pandemic.²⁵⁷ Before the downturn, many CLO Managers relied on Warehouse Facilities from banks to purchase portfolios of loans.²⁵⁸ Problematically, some of these loans were never formally packaged into CLOs and sold to investors before market conditions deteriorated, so when the CLO market froze \$15 to \$20 billion of loans were left sitting in warehouses.²⁵⁹ Under TALF these existing loans could be pooled in new CLOs that Eligible Borrowers could invest in.²⁶⁰ As revised, TALF ultimately benefited the CLO market by facilitating the issuance of CLOs that were initiated prior to the COVID-19 pandemic.²⁶¹ TALF was also important for banks because the sale of

253. *See id.* (indicating that up to 65% of the loans in Eligible CLOs could be covenant-lite); Wirz, *supra* note 245 (“Previous TALF guidance generally limited assistance to CLOs that invested in new corporate loans with strong investor protections, called covenants.”).

254. *See* Phillips, *supra* note 1 (reporting that covenant-lite loans account for about 80% of new leveraged loans).

255. *See* CHRISTOPHER DESMOND ET AL., *supra* note 242, at 3 (providing a table to show that covenant-lite loans constitute 60% to 70% of existing CLO portfolios).

256. *See id.* (noting that the clarification regarding new issue loans could have a modest positive impact on the CLO market); Wirz, *supra* note 245 (suggesting that CLO market participants will be able to use TALF funds more effectively in light of the revisions to TALF).

257. *See* Wirz, *supra* note 245 (suggesting that revisions to TALF will help CLO Managers finish deals that began prior to the COVID-19 pandemic).

258. Robert Smith & Joe Rennison, *Big Banks Left Hanging after ‘Disaster’ in Risky Loan Market*, FIN. TIMES (Mar. 30, 2020), <https://www.ft.com/content/49ee0c64-cd97-4342-9f03-fec019963fef> [<https://perma.cc/U6AB-3KHX>].

259. Wirz, *supra* note 245.

260. *See id.* (reporting that TALF may help CLO Managers close outstanding CLO transactions that were initiated prior to the COVID-19 pandemic).

261. *See* CHRISTOPHER DESMOND ET AL., *supra* note 242 (explaining how revisions to TALF allows loans sitting in warehouses to serve as collateral in TALF eligible CLOs).

CLO debt obligations is what allows a CLO Manager to repay its Warehouse Facility with the bank.²⁶² When the CLO market stalls, banks get stuck holding the risk of this credit extension on their balance sheet.²⁶³ Therefore, the opportunity that TALF afforded CLO Managers—to close CLO transactions and repay Warehouse Facilities—was also a net positive for banks.²⁶⁴

While the practical effect of TALF on CLOs was relatively limited given its narrow application to static CLOs, government intervention nevertheless had a symbolic impact on the CLO market.²⁶⁵ First, the Federal Reserve announcement regarding the launch of TALF sparked a rally in credit markets.²⁶⁶ This effect was especially significant given the nature of the CLO market, which reacts to shifts in the price of leveraged loans²⁶⁷ and relies on investor confidence to drive new issuance.²⁶⁸ Second, in its many revisions of TALF, the Federal Reserve seemed to signal both the importance of the CLOs and a willingness to meet the realistic needs of the market.²⁶⁹ The objective of TALF, according to the Federal Reserve, was to facilitate the flow of credit and “to support the longer-term, market-based financing that is critical to economic activity.”²⁷⁰ In tailoring TALF to work for the CLO market in practice, not simply in theory, the Federal Reserve implied that CLOs are

262. Wirz, *supra* note 245 (explaining that CLOs sell securities to investors in order to pay off obligations incurred under their warehouse facilities).

263. Smith & Rennison, *supra* note 258.

264. *See* Wirz, *supra* note 245 (describing how TALF allows CLO Managers and investment bankers to finish deals that have been “stuck in limbo” since the beginning of the pandemic).

265. *See* Wirz, *supra* note 240 (highlighting positive sentiment coming from a CLO Manager in response to the TALF announcement).

266. *Id.*

267. *See* Podkul & Davies, *supra* note 7 (providing an example of how the CLO market reacts to swings in the price of leveraged loans).

268. *See* Haunss, *supra* note 19 (noting that CLO issuance picked up in April and May because investor confidence returned).

269. *See* Lee, *supra* note 244 (reporting that the Federal Reserve appeared to consider the more detailed aspects of how the CLO market actually works when it announced revisions to TALF).

270. *The Quarterly CARES Act Report to Congress: Hearing Before the S. Banking, Hous. and Urban Affairs Comm.*, 116th Cong. 4 (2020) (statement of Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System), <https://www.banking.senate.gov/imo/media/doc/Powell%20Testimony%205-19-20.pdf> [<https://perma.cc/WA9Y-PKML>].

a vital mechanism through which credit critical to economic activity is extended.²⁷¹ Moreover, when it revised TALF to allow covenant-lite loans to comprise 65% of an Eligible CLO's portfolio, the Federal Reserve symbolically conformed to the industry standard²⁷² over and against the crusade against covenant-lite loans in popular discourse.²⁷³ This is important because, when presented with an opportunity to affirmatively signal its disapproval of covenant-lite loans, the Federal Reserve backed away from its principles²⁷⁴ and deferred to market custom.²⁷⁵ Therefore, while the practical effect of TALF on CLOs may have been limited at best, the program's symbolic impact served to fortify the CLO market in the midst of the 2020 economic downturn.²⁷⁶

C. *The Structural Strength of the CLO*

The primary reason why CLOs will be seen as survivors of yet another economic downturn is hardly novel.²⁷⁷ Even as concerns about ballooning corporate debt and poor credit quality mounted in the years leading up to 2020,²⁷⁸ the resilience of the CLO structure was often

271. See Lee, *supra* note 231 (describing how a revision to TALF made the program more useful to CLO market participants); Wirz, *supra* note 245 (explaining how a subsequent change to TALF increased its utility in the context of the CLO market).

272. CHRISTOPHER DESMOND ET AL., *supra* note 242, at 3 (providing a table to show that 60% to 70% of loans in a typical CLO are covenant-lite).

273. See Warren Letter, *supra* note 2 (expressing concern over the trend towards covenant-lite loans); Kristen Haunss, *Regulators Sound Alarm About Leveraged Loan Market*, REUTERS (Oct. 30, 2018, 12:39 PM), <https://www.reuters.com/article/regulators-sound-the-alarm-about-leverag/regulators-sound-the-alarm-about-leveraged-loan-market-idUSL8N1XA7MH> [<https://perma.cc/PFN6-5ZUC>] (citing concerns about the prevalence of covenant-lite loans).

274. See Haunss, *supra* note 273 (highlighting concerns among present and former Federal Reserve officials regarding the proliferation of covenant-lite loans).

275. See CHRISTOPHER DESMOND ET AL., *supra* note 242, at 3 (highlighting the fact that an Eligible CLO under TALF may contain covenant-lite loans in an amount equal to 65% of the total portfolio).

276. See Lee, *supra* note 231 (acknowledging the positive, but limited, impact of TALF on the CLO market).

277. See FIN. STABILITY BD., *supra* note 6, at 2 (suggesting that resilient CLO structures may mitigate losses during periods of instability).

278. See Thomas Franck, *Former Fed Chair Yellen Says Excessive Corporate Debt Could Prolong a Downturn*, CNBC (Dec. 10, 2018, 10:40 PM), <https://www.cnbc.com/2018/12/11/janet-yellen-says-excessive-corporate-debt-could-prolong-a-downturn.html> [<https://perma.cc/7QCE-KGN2>] (citing the concerns of former

recognized as a factor that could serve to mitigate the systemic risk posed by CLOs in the event of a downturn.²⁷⁹ In 2020, as the economy stumbled, businesses closed, and loans defaulted, CLOs were afforded an opportunity to finally prove that speculations as to the strength of their structure were not speculative at all.²⁸⁰

CLOs survived 2020 without crippling or severely destabilizing the financial system because CLO structures held up to provide investors with the level of protection they were promised upon making their original investment.²⁸¹ The banks that invested in the highest-rated AAA tranches received the protections they expected, and therefore banks did not suffer losses capable of destabilizing the financial system.²⁸² The subordinated debt and equity investors—who will likely experience losses²⁸³—also got exactly what they were promised when they invested in the riskiest portion of the CLO structure.²⁸⁴ Ultimately, CLOs were survivors of the economic downturn because they delivered on the promises they made to investors²⁸⁵ and because CLO investors were situated in tranches best suited to accommodate their tolerance for risk.²⁸⁶

Federal Reserve Chair Janet Yellen regarding increasing amounts of low quality corporate debt).

279. See FIN. STABILITY BD., *supra* note 6, at 2 (acknowledging that resilient CLO structures may mitigate losses in a downturn).

280. See KOTHARI ET AL, *supra* note 8, at 43, 47–48 (describing the challenges wrought by the COVID-19 pandemic and highlighting the structural protections embedded within CLOs that are designed to reduce risks to investors).

281. See *id.* at 48 (explaining that investors in both the highest-rated CLO tranches and the more junior tranches are unlikely to experience losses despite the pandemic-induced economic downturn).

282. See *id.* (predicting that the AAA-rated tranches, which banks most often hold, will not experience losses).

283. See *id.* at 49 (“Market pricing of the CLO tranches today suggests that the market expects most losses would be borne by the equity layer and some by the lower rated CLO tranches.”); Lisa Lee, *Battered CLO Investors Are About to Get a Look at Their Losses*, BLOOMBERG (Apr. 20, 2020, 10:27 AM), <https://www.bloomberg.com/news/articles/2020-04-20/clo-reckoning-arrives-downgrade-wave-tests-700-billion-market> [<https://perma.cc/CN9F-NK5Q>] (explaining that equity investors and subordinated debtholders will be the first to experience losses).

284. See JOHNSON, *supra* note 30, at 5 (“Investors with . . . a higher tolerance for risk invest in the equity (first-loss) tranche.”).

285. See KOTHARI ET AL, *supra* note 8, at 48 (providing that investors in the highest-rated parts of the CLO structure are not expected to experience losses); Lee, *supra* note 283 (indicating that investors in the riskiest parts of the CLO structure are likely to suffer losses).

286. See *id.* at 46 (suggesting that risks posed by the CLO market are reduced by the diversity of investors that hold CLO securities).

1. The CLO Structure Worked as Intended in the Face of Market Volatility

The tranching CLO structure allows investors to purchase securities commensurate with their individual tolerance for risk.²⁸⁷ Investors who opt for lower-yielding AAA debt accept lower returns in exchange for the protection afforded by a CLOs OC Tests.²⁸⁸ Conversely, subordinated debt and equity investors knowingly trade this protection for larger returns.²⁸⁹ Thus, the OC Tests that a CLO must pass to distribute payments to its various tranches are structural features that do not purport to mitigate losses equally across the CLO structure.²⁹⁰ When conditions in the leveraged loan market deteriorate, a CLO's OC Tests serve as protective shields that prioritize payments to the AAA and AA tranches.²⁹¹

In the midst of the 2020 downturn, CLOs tripped their OC Tests, diverting payments away from equity investors and some subordinated debtholders in order to repay the principal of AAA investors.²⁹² In April 2020, it was reported that more than 10% of U.S. CLOs risked cutting cash payments, and by May 2020, 21% of roughly 900 CLOs cut payments to investors holding securities in the riskiest tranches of the CLO structure.²⁹³ Moreover, for the first time since 2008, a CLO tripped its senior OC Test.²⁹⁴

287. See KATZENSTEIN ET AL., *supra* note 28, at 6 (“CLOs offer institutional investors access to the senior secured loan market with tailored risk-adjusted return profiles. By purchasing CLOs, banks and insurance companies can obtain exposure to the senior secured loan market while benefitting from structural protections....”).

288. See JOHNSON, *supra* note 30, at 3–4 (explaining that highly rated CLO tranches receive lower rates of interest, but also highlighting the fact that AAA rated debt benefits from structural protections).

289. See *id.* at 3, 5 (explaining that investors with a greater tolerance for risk invest in the higher-yielding subordinated debt and equity tranches of the CLO structure).

290. See CAO ET AL., *supra* note 5, at 3 (explaining the process by which cash flows are diverted from junior to senior CLO tranches in the event that a CLO fails its OC Test).

291. *Id.* at 3.

292. Tempkin, *supra* note 207.

293. *Id.*

294. Saeedy, *supra* note 212.

While reports of CLO performance during the 2020 downturn seem to suggest that CLOs performed poorly in the midst of volatility,²⁹⁵ these accounts actually serve to prove that CLOs performed exactly as intended.²⁹⁶ Volatile market conditions tripped CLO OC Tests, and a protective shield was extended to safeguard the investments of senior debtholders.²⁹⁷ Ultimately, the AAA investors who opted for smaller returns in exchange for more robust protection got what they paid for,²⁹⁸ as payments were diverted to guarantee the safety of their investments.²⁹⁹ Conversely, the junior debtholders and equity investors who assumed more risk hoping to win the lottery will likely be reminded of the inherent risk in their investment³⁰⁰ after years of impressive returns.³⁰¹

2. CLO Investors Hold CLO Securities Well-Tailored to Their Appetite for Risk

While CLOs survived 2020 due to their structural strength, the protections embedded within the CLO structure were especially meaningful when considered in the context of *who* they protected.³⁰² The type of investor that occupied each tranche of the CLO structure was

295. See Sally Bakewell & Lisa Lee, *CLO Engineering Is No Match for COVID-19 As Payments Get Cut Off*, BLOOMBERG (Apr. 30, 2020, 10:59 AM), <https://www.bloomberg.com/news/articles/2020-04-30/clo-engineering-is-no-match-for-covid-19-as-payments-get-cut-off> [<https://perma.cc/P5RM-9QWF>] (“Loans are getting downgraded and their value is dropping, which is triggering protections designed to protect the safest securities issued by CLOs, those rated AAA.”).

296. See KOTHARI ET AL, *supra* note 8, at 48 (reporting that AAA-rated CLO tranches are not expected to experience losses).

297. See Bakewell & Lee, *supra* note 295 (“Loans are getting downgraded and their value is dropping, which is triggering protections designed to protect the safest securities issued by CLOs, those rated AAA.”)

298. See JOHNSON, *supra* note 30, at 3 (explaining that holders of senior CLO debt receive less interest but are afforded greater security in the CLO structure).

299. See KOTHARI ET AL, *supra* note 8, at 48 (reporting that AAA-rated CLO tranches are not expected to experience losses).

300. See Lee, *supra* note 283 (predicting that investors in the high-risk, high-yield portion of the CLO structure will experience losses due to the 2020 downturn).

301. *Why CLO Equity*, EAGLE POINT CREDIT CO., <http://www.eaglepointcreditcompany.com/why-clos> [<https://perma.cc/C5JV-LXB9>] (last visited Jan. 5, 2021) (“[Ninety-six percent] of U.S. CLOs issued between 2002 and 2011 had a positive return on the equity tranche, with only 4% returning less than the original invested capital.”).

302. See KOTHARI ET AL, *supra* note 8, at 49 (explaining that losses confined to the equity tranche have a limited macroeconomic impact).

ultimately an important factor that allowed CLOs to weather the 2020 downturn without prompting systemic financial instability.³⁰³

The stability of the financial system largely depends on the vitality of banks, so in moments of economic peril, it is important that banks have the capacity to withstand losses and continue lending.³⁰⁴ By cabining 95.4% of their holdings in the senior-most tranches of the CLO structure³⁰⁵ banks sacrifice high returns for structural protections that allow them to avert major losses.³⁰⁶ In 2020, when economic volatility forced CLOs to cut payments to investors, CLOs made good on their promise to protect bank investments, as there were no defaults on AAA-rated debt.³⁰⁷ Moreover, according to an analysis from Moody's, CLO OC Tests will continue to protect bank investments even in the event of a protracted economic downturn, as it would take a cumulative loan default rate in excess of 80% to impair AAA securities.³⁰⁸ Fitch Ratings' year-end default forecast suggests a cumulative leveraged loan default rate of 5% to 6% in 2020 and 8% to 9% in 2021.³⁰⁹

While it was important for the stability of the financial system in 2020 that banks invested in the senior tranches of the CLO structure, it was equally as important that asset managers, hedge funds, and other privately managed funds held the riskiest CLO securities.³¹⁰ This is because a CLO's protective shields are only effective in thwarting instability if losses are confined to investors capable of shouldering the

303. *See id.* at 43, 49 (predicting that losses will be confined to equity tranches, which are often held by asset managers, pension funds, and other private funds).

304. *See* Lang, *supra* note 21 (highlighting the importance of stable banks to the safety of the financial system and suggesting that bank losses contribute to systemic instability).

305. WHO OWNS U.S. CLO SECURITIES? AN UPDATE BY TRANCHE, *supra* note 89.

306. *Cf.* KATZENSTEIN ET AL., *supra* note 28, at 6 (providing that banks benefit from structural protections due to the nature of their investment in CLOs).

307. *See* KOTHARI ET AL, *supra* note 8, at 48 (“[T]he AAA-rated senior tranches will not incur losses unless economic conditions worsen dramatically.”).

308. *See* Brian Chappatta, Opinion, *First ETF for CLOs is Ultra-Safe. No, Seriously.*, BLOOMBERG (Sept. 10, 2020, 5:00 AM), <https://www.bloomberg.com/opinion/articles/2020-09-10/first-etf-for-clos-is-ultra-safe-no-seriously> [<https://perma.cc/PSY7-Q9LG>] (“[T]he cumulative collateral default rate would have to reach 70% to 80% before double-A CLOs would be impaired The triple A tranche is even further out of reach.”).

309. *Credit: 2020 Hindsight*, LOAN SYNDICATIONS & TRADING ASS'N (July 30, 2020), <https://www.lsta.org/news-resources/credit-2020-hindsight/> [<https://perma.cc/WT7M-UD6U>].

310. *See* KOTHARI ET AL, *supra* note 8, at 43, 49 (indicating that losses will be confined to CLO equity tranches held by asset managers and private funds).

burden.³¹¹ Importantly, the investors that hold the high-yielding, riskiest pieces of the CLO structure are those with the highest tolerance for big swings in performance.³¹² Market volatility and losses negatively affect subordinated debt and equity holders, but only to a limited extent because the market “is not held by weak hands.”³¹³ In 2018, for instance, equity investors ended the year with losses of 11.4%, and no large-scale financial instability ensued.³¹⁴ The story of 2020 will be largely similar, as losses will likely be confined to the equity investors that are better positioned to withstand losses.³¹⁵

V. THE FUTURE OF THE CLO MARKET

CLOs have evolved in the years since their inception, and CLOs today are notably different than those that first entered the market in the late 1980s.³¹⁶ In response to the 2008 financial crisis, the structure of post-crisis CLOs changed in order to make senior tranches safer and more attractive.³¹⁷ The passage of Dodd-Frank in 2010 also incited change, as CLOs refashioned themselves into vehicles that banks could invest in without violating the Volcker Rule.³¹⁸ Considering this history of evolution, it is fair to ask whether CLOs might change in response to the

311. *See id.* at 49 (explaining that losses borne by the equity layer present little macroeconomic risk); Lang, *supra* note 21 (suggesting that bank losses could lead to widespread disruption in financial markets).

312. *See* Rennison, *supra* note 12 (reporting that the riskiest parts of the CLO structure are held by those with a high tolerance for market volatility).

313. *See id.* (quoting a CLO equity investor, “[w]hen the market falls and you have to mark down your portfolio 10 per cent that hurts but it doesn’t create forced sellers. This market is not held by weak hands.”).

314. *See id.* (suggesting that equity investors are able to withstand large losses without disrupting financial markets).

315. *See* KOTHARI ET AL, *supra* note 8, at 49 (predicting losses will be realized exclusively among equity investors); *see also* CLOs: Not So Opaque, LOAN SYNDICATIONS & TRADING ASS’N (June 20, 2019), <https://www.lsta.org/news-resources/clos-not-so-opaque/> [<https://perma.cc/8U4M-3RRP>] (explaining that asset managers are well positioned to assume greater risk).

316. *See* Bratton & Levitin, *supra* note 37, at 100 (describing the evolution of the CLO structure in response to market changes).

317. *Id.* at 100–01.

318. *Id.* at 101.

economic downturn of 2020.³¹⁹ So, how will CLOs evolve in light of the economic slowdown? In short, CLOs may change modestly, but not monumentally in the aftermath of 2020.³²⁰ It is possible that in a post-2020 landscape characterized by increased corporate defaults, CLOs may be permitted to hold larger amounts of distressed loans or equity received as part of a restructuring.³²¹ However, apart from these potential developments, the CLO market after 2020 is unlikely to look much different from the market that preceded it.³²²

A. *Post-2020 CLOs May Hold More Distressed Assets and Equity*

CLOs are limited in the kinds of assets they are permitted to hold.³²³ While a large majority of loans in any given CLO portfolio are rated B, CLO Managers are typically allowed to hold a limited number of loans with a CCC rating—usually in an amount constituting 7.5% of the portfolio.³²⁴ Other restrictions include an inability to purchase loans trading below 60 to 65 cents on the dollar³²⁵ and a prohibition against injecting new capital into a distressed borrower whose loan is part of the CLO's underlying collateral.³²⁶ Finally, while CLOs are generally permitted to hold equity received in connection with a restructuring,

319. See *id.* at 100 (describing the evolution of the CLO structure in response to market changes).

320. See Haunss, *supra* note 22 (suggesting a way in which the CLO market may evolve in response to the 2020 economic downturn); Lee & Husband, *supra* note 22 (describing potential changes in the CLO market that could arise in response to the 2020 downturn).

321. See Lee & Husband, *supra* note 22 (noting that some CLO Managers are amending the terms of their CLOs to allow the CLO greater flexibility to participate in restructurings).

322. See *Credit: 2020 Hindsight*, *supra* note 309 (reporting that investor demand for leveraged loans is strong and that deal documents appear to be no more lender-friendly than they were prior to the pandemic).

323. See JOHNSON, *supra* note 30, at 4 (“CLOs are structured with specific investment limitations . . . which aim to protect investors from potential losses.”)

324. *Id.* at 4.

325. Haunss, *supra* note 22.

326. Lisa Lee & Sally Bakewell, *Hedge Funds Exploit CLO Weakness Laid Bare by Corporate Distress*, BLOOMBERG (June 22, 2020, 6:00 AM), <https://www.bloomberg.com/news/articles/2020-06-22/hedge-funds-exploit-clo-weakness-laid-bare-by-corporate-distress> [<https://perma.cc/PVY7-T22M>].

holding large amounts of equity might negatively impact a CLO's ability to meet its various performance tests.³²⁷

As a result of the COVID-19 pandemic and the economic downturn, leveraged loan prices fell,³²⁸ ratings agencies downgraded many B-rated loans to CCC³²⁹ and corporate bankruptcies surged.³³⁰ In this new economic landscape, the constraints designed to protect CLO investors may ultimately prove too rigid.³³¹ For instance, limitations on equity holdings and a prohibition on providing new money to a borrower in bankruptcy may frustrate a CLO Manager's effort to recoup value on a distressed loan in its portfolio.³³² In some cases, hedge funds have taken advantage of CLO limitations and have opportunistically cut CLOs out of deals during the restructuring process.³³³ Moreover, based on current limitations in CLO governing documents, CLO Managers that see long-term value in loans trading below 60 cents on the dollar are precluded from purchasing these assets, potentially causing CLO investors to lose out on significant returns when the loans recover and repay investors at par.³³⁴

327. *See id.* ("While they're allowed to receive equity in exchange for struggling loans in restructurings, it can be unappealing because of the impact on crucial compliance tests used to determine CLO investor payouts.")

328. *See* Joe Rennison, *US Leveraged Loan Prices Slump to Lowest Since Financial Crisis*, FIN. TIMES (Mar. 17, 2020), <https://www.ft.com/content/7e81b818-683a-11ea-800d-da70cff6e4d3> [<https://perma.cc/MTY8-NSVZ>] (reporting that the average leveraged loan price sunk to 84 cents on the dollar, its lowest level since August 2009).

329. *See Amid Record Leveraged Loan Downgrades, B- Debt Swells, CCC Loans Test CLO Limits*, S&P GLOBAL MKT. INTEL. (Apr. 8, 2020), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/amid-record-leveraged-loan-downgrades-b-8211-debt-swells-ccc-loans-test-clo-limits-57959048> [<https://perma.cc/GER9-LB7F>] (highlighting that the share of the S&P/LSTA Index rated CCC or lower rose to 7.48% in March, which represented a 1.67% increase since February).

330. *See* Patrick Mathurin et al., *Pandemic Triggers Wave of Billion -Dollar US Bankruptcies*, FIN. TIMES (Aug. 21, 2020), <https://www.ft.com/content/277dc354-a870-4160-9117-b5b0dece5360> [<https://perma.cc/RJ9Y-YTY4>] (reporting that 157 companies with liabilities of more than \$50 million have filed for bankruptcy as of August 2020).

331. *See* Lee & Bakewell, *supra* note 326 (explaining how CLO limitations are making it difficult for CLOs to take advantage of opportunities emerging in the market).

332. *See id.* (explaining how limitations on holding equity and injecting capital are forcing some CLOs to sell distressed assets to a depressed market, which often leads to lower recoveries).

333. *See id.* (providing specific examples of how CLOs are being deliberately cut out of bankruptcy deals that convert the debt of a distressed borrower to equity).

334. Haunss, *supra* note 22 (describing the restrictions that prevent CLO Managers from purchasing loans priced below a certain threshold and explaining why some CLO Managers are pushing back against such limitations).

Two solutions have emerged to provide CLO Managers with more flexibility to respond to market changes prompted by the COVID-19 pandemic.³³⁵ First, certain CLO Managers have amended their governing documents to permit CLOs to hold more distressed assets, and some are considering new ways that CLOs might be able to provide new capital in corporate restructurings.³³⁶ The second proposal suggests that loan prices be tied to an index—rather than a set price—that can account for market volatility.³³⁷ In this scenario, CLO Managers would have the ability to purchase loans that trade below 60 cents on the dollar.³³⁸

While it is enticing to believe that greater flexibility for CLO Managers is a categorically positive development, opponents suggest that these changes could allow CLO Managers to make risky investments that jeopardize the returns of investors.³³⁹ For investors in the senior AAA-rated tranche, low and stable returns are preferable to the unpredictability of risky distressed debt plays.³⁴⁰ In a typical CLO, senior debtholders constitute 60% of the structure,³⁴¹ so there is good reason to doubt that the majority of CLOs will eagerly adopt changes that allow CLO Managers greater flexibility.³⁴² Nevertheless, it is likely that some CLOs will adapt to the post-pandemic economic landscape by granting CLO Managers greater discretion to maximize returns on distressed assets.³⁴³

335. *See id.* (reporting on a proposal to tie leveraged loan prices to an index); Lee & Husband, *supra* note 2 (explaining how CLO Managers are responding to the limitations in their governing documents which have hindered CLO Managers in their attempt to recoup distressed investments).

336. Lee & Husband, *supra* note 22 (explaining how CLO Managers are responding to the limitations in their governing documents which have hindered CLO Managers in their attempt to recoup the value of distressed investments).

337. *See* Haunss, *supra* note 22 (“CLO managers are now looking to tie the price at which a loan can be purchased to an index to account for market volatility rather than a set price.”).

338. *See id.* (explaining how the proposal to tie loan prices to an index would allow CLO Managers to take advantage of volatility in the leveraged loan market).

339. *See* Lee & Husband, *supra* note 22 (describing how debt investors might push back against giving more flexibility to CLO Managers to purchase distressed assets).

340. *See* JOHNSON, *supra* note 30, at 5 (suggesting that investors in the senior portion of the CLO structure have a lower risk tolerance than those in the bottom tranches).

341. *See CLOs: Who Holds Them*, *supra* note 12.

342. *See* Lee & Husband, *supra* note 22 (highlighting the potential for push back from senior debtholders in the CLO structure).

343. *See id.* (providing examples of CLO Managers that have already begun to amend their governing documents to give managers more flexibility).

B. *The CLO Market Will Remain Largely Unchanged After 2020*

After the 2008 financial crisis, the CLO market experienced a slowdown that gradually ebbed as the economy recovered.³⁴⁴ The same scenario is likely post-2020 as the CLO market licks its wounds from the economic downturn wrought by the COVID-19 pandemic.³⁴⁵ However, unlike the aftermath of 2008—which saw the evolution of the CLO structure³⁴⁶—CLOs and the CLO market post-2020 will likely remain unchanged.³⁴⁷ Specifically, demand for CLOs will continue to yield Credit Agreements with few lender protections³⁴⁸ and the prevalence of covenant-lite loans in the market will remain the industry standard.³⁴⁹

The Federal Reserve’s decision to keep interest rates low for the foreseeable future³⁵⁰ suggests that the forces which drove investors to the CLO market prior to the downturn will be just as strong after 2020.³⁵¹ In

344. See Bratton & Levitin, *supra* note 37, at 98 (noting that the CLO market experienced low levels of new issuance and an investor sell-off following the financial crisis but highlighting the recovery of the market).

345. See Haunss, *supra* note 19 (describing the decrease in CLO issuance during the earliest months of the pandemic and suggesting that new issuance is beginning to rebound).

346. See Bratton & Levitin, *supra* note 37, at 100 (detailing the evolution of the CLO structure).

347. See *Credit: 2020 Hindsight*, *supra* note 309 (highlighting the fact that longstanding complaints about the poor credit quality of leveraged loans remain prevalent despite the volatility caused by the 2020 downturn).

348. See *id.* (reporting that despite modest improvement in the earliest months of the pandemic, recent Credit Agreements suggest a return to pre-pandemic borrower-friendly terms).

349. See Brian Chappatta, Opinion, *The ‘Cov-Lite’ Fight in Leveraged Loans is Lost*, BLOOMBERG (Feb. 18, 2020, 6:00 AM) https://www.bloomberg.com/opinion/articles/2020-02-18/the-cov-lite-fight-in-leveraged-loans-is-lost?utm_source=google&utm_medium=cpc&utm_campaign=dsa&utm_term=&gclid=Cj0KCQiAoab_BRCxARIsANMx4S7nOdawmLT45S2zFtgGgVeiFsNoxoZd8SStyg9PacU6cyhVTGtIgZkaAtNMEALw_wcB [<https://perma.cc/R5QQ-6SSC>] (suggesting that covenant-lite loans are the new industry standard).

350. See Press Release, Fed. Reserve Bd. (Sept. 16, 2020) (on file with author) (“The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range”); see also James Politi & Colby Smith, *Fed Signals Rock-Bottom Rates Until at Least End of 2023*, FIN. TIMES (Sept. 16, 2020), <https://www.ft.com/content/827302da-4257-4bbc-a0fa-9bc98f65d661> [<https://perma.cc/HV5B-PPYT>] (reporting that the Federal Reserve projected no interest rate increases until 2023).

351. See Oldfield & Anthony, *supra* note 10 (explaining how the “hunt for better yields” led many investors to the CLO market).

low interest rate environments, CLOs provide investors with attractive returns relative to similarly rated assets.³⁵² Therefore, investor demand for CLOs is likely to remain robust as the economy recovers from the 2020 downturn.³⁵³ Strong investor demand for CLOs in the lead up to 2020 did, however, lend to the deterioration of lender protections in Credit Agreements.³⁵⁴ This trend will continue well past 2020 as demand prompts investors to compete for leveraged loans.³⁵⁵ Because widespread downgrades and borrower defaults in 2020 did little to scale back borrower-friendly terms in Credit Agreements, investors should not expect a shift towards greater lender protections in the future.³⁵⁶

Even before the 2020 downturn, some suggested that the ship had sailed on covenant-lite loans and that the fight to bring fully covenanted loans³⁵⁷ back to the market was lost.³⁵⁸ To the extent the ship may have been lingering in the port, 2020 was the wind that finally set the vessel free.³⁵⁹ In revising TALF to allow Eligible CLOs to hold covenant-lite loans in an amount equal to 65% of the portfolio, the Federal Reserve implied its acceptance of the industry standard.³⁶⁰ A TALF program that

352. See CAO ET AL., *supra* note 5, at 3 (explaining that CLOs have attractive risk-return profiles, especially as compared to similarly rated securities in the market).

353. See *supra* note 350 and accompanying text; see also Oldfield & Anthony, *supra* note 10 (describing how the search for higher yields in low interest rate environments leads investors to the CLO market).

354. Oldfield & Anthony, *supra* note 10 (“[S]trong investor demand has allowed CLO managers to loosen controls over investment quality such as to allow increases in permitted exposures to riskier loans.”).

355. See *Credit: 2020 Hindsight*, *supra* note 309 (“[W]ith supply actually running below demand, investor appetite for acceptable deals is solid.”)

356. See *id.* (suggesting that terms in Credit Agreements have returned to normal after moving slightly towards increased lender protections in the earliest months of the COVID-19 pandemic).

357. Loans with traditional covenants, as opposed to covenant-lite loans, have protective mechanisms built into the Credit Agreement for the safety and benefit of lenders. For instance, a borrower might be required to remain in compliance with a financial maintenance covenant that measures the debt service capabilities of the borrower. James Chen, *Covenant-Lite Loan Definition*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/covenant-lite-loans.asp> [<https://perma.cc/XW26-G7LV>] (last updated Dec. 1, 2020).

358. See Chappatta, *supra* note 349 (arguing, even before the onset of the pandemic, that covenant-lite loans are the new industry standard).

359. See KOTHARI ET AL., *supra* note 8, at 12 (providing that 85% of loans that underly CLO portfolios are covenant-lite).

360. See Wirz, *supra* note 245 (reporting that TALF was revised to allow Eligible CLOs to hold more covenant-lite loans).

restricted the ability of Eligible CLOs to hold covenant-lite loans would have reflected the concerns of regulators,³⁶¹ but it would have proven unworkable in a market where the vast majority of loans are covenant-lite.³⁶² Ultimately, the Federal Reserve prioritized the goal of making TALF useful to the CLO market, indicating a tacit acceptance of covenant-lite loans as a significant part of the CLO market.³⁶³

VI. CONCLUSION

CLOs were survivors of the 2008 financial crisis.³⁶⁴ However, the praise CLOs received for successfully weathering the turmoil of 2008 was short-lived.³⁶⁵ From a post-crisis trough of \$263 billion,³⁶⁶ the CLO market surged to become the more than \$600 billion market it is today,³⁶⁷ and with this meteoric growth came spirited criticism.³⁶⁸ In recent years, CLO demand has purportedly caused corporate debt to reach unsustainable levels and has brought about a decline in underwriting standards.³⁶⁹ Prior to 2020, critics warned that in the event of a downturn, the outstanding \$1.3 trillion of poor-quality corporate loans could prove ruinous to the CLOs that held them.³⁷⁰ In 2020, the economic downturn

361. See Joy Wiltermuth & Kristen Haunss, *Yellen Warns of Corporate Distress, Economic Fallout*, REUTERS (Feb. 27, 2019, 11:55 AM) <https://www.reuters.com/article/us-yellen-distressed/yellen-warns-of-corporate-distress-economic-fallout-idUSKCN1QG2CZ> [<https://perma.cc/VJJ4-X36L>] (discussing former Federal Reserve Chair Janet Yellen's concerns regarding the proliferation of covenant-lite loans).

362. See *supra* note 359 and accompanying text.

363. See Wirz, *supra* note 245 (reporting that TALF was revised to allow Eligible CLOs to hold more covenant-lite loans).

364. JOHNSON, *supra* note 30 at 1.

365. Cf. Brown & Salander, *supra* note 3 (“For the past several years, market observers have warned of risks associated with collateralized loan obligations, or CLOs.”).

366. Bratton & Levitin, *supra* note 37.

367. See KOTHARI ET AL, *supra* note 8.

368. See, e.g., Phillips, *supra* note 1 (“[T]op Federal Reserve policymakers cited the surging growth of this market as a reason to ‘remain mindful of vulnerabilities’ and possible risks to the financial system.”).

369. See *supra* Part III.

370. See Sally Bakewell, *CLO Machine is Approaching Full-Tilt, and Credit Quality Suffers*, BLOOMBERG (May 25, 2018, 6:00 AM), <https://www.bloomberg.com/news/articles/2018-05-25/clo-machine-is-approaching-full-tilt-and-credit-quality-suffers> [<https://perma.cc/7VWW-HNJL>] (“[A] lot of CLOs have been stuffed with weaker credits. A downturn, if and when that happens, will uncover these weaknesses.”).

caused by the COVID-19 pandemic was the kind of destabilizing event that critics of CLOs feared, yet CLOs escaped this financial instability relatively unscathed.³⁷¹

In spite of the many criticisms they faced prior to the 2020 downturn, CLOs did not suffer the kinds of losses capable of sending shock waves through the economy.³⁷² Ultimately, government support in the form of TALF and the structural strength of the CLO emerged as the primary reasons why CLOs were capable of weathering the volatility of 2020.³⁷³ When the dust from the 2020 downturn finally settles, the CLO market may look modestly different as CLO Managers lobby for more flexibility to invest strategically in the post-pandemic market.³⁷⁴ However, monumental change is not likely to grip the CLO market, as demand for CLOs will continue to encourage corporate borrowing and will produce the same borrower-friendly Credit Agreements that were predominant prior to the downturn.³⁷⁵

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371. See KOTHARI ET AL, *supra* note 8, at 41, 48 (explaining that the CLO market weathered the 2020 downturn and suggesting that the market is “headed for recovery”).

372. See *supra* note 371 and accompanying text.

373. See *supra* Part IV.B; *supra* Part IV.C.

374. See *supra* Part V.

375. See *Credit: 2020 Hindsight*, *supra* note 309 (suggesting that demand among investors remains strong and that, as of July 2020, Credit Agreements are continuing to incorporate the borrower-friendly terms that were common prior to the downturn).

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