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Editor’s Note

Time to put a fork in 2020. It’s done—maybe even overdone. Anyone else pass the time by consuming boxes of cookies and/or boxes of wine, or just me? It’s been that kind of year. But also, some unexpected moments of grace. Our industry stayed busy, the work was robust and kept a lot of us happily focused on deals and growth rather than … well, everything else. Anyway, here’s to more silver linings in 2021, health, deal flow, and seeing our colleagues and clients again in person, hopefully to break bread and drink wine (from a bottle, not a box). From all of us at Alston & Bird, our very best wishes for a peaceful, healthy, and prosperous New Year.

Aimee Cummo
Partner, Finance

Another Brick in the Safe Harbor Wall: Section 546(e) Protection in Constructive Fraudulent Conveyance Actions

Continuing a strong trend within the Second Circuit of broadly interpreting the safe harbor defense of Section 546(e) of the Bankruptcy Code, Judge Stuart Bernstein, in *SunEdison Litigation Trust v. Seller Note LLC, et al. (In re SunEdison Inc.)* (Bankr. S.D.N.Y. Nov. 2, 2020), recently dismissed a constructive fraudulent conveyance action brought by the SunEdison Litigation Trust to recover the value of transfers made by affiliates of SunEdison Inc. in connection with SunEdison's acquisition of the renewal energy company First Wind Holdings LLC 15 months before SunEdison and numerous affiliates filed for Chapter 11.

Like almost everything about SunEdison, the facts of the underlying transaction are complicated. In essence, in November 2014, SunEdison and certain of its affiliates entered into a purchase and sale agreement (PSA) with D.E. Shaw Composite Holdings LLC (and certain of its affiliates) and Madison Dearborn Capital Partners, IV L.P. and certain of its affiliates (collectively, the "seller defendants") to acquire the equity interests (the "First Wind equity interests") of the seller defendants in First Wind Holdings LLC and in certain of its affiliates. A portion of the purchase price consisted of $350 million of exchangeable notes to be issued to the seller defendants by a SunEdison special purpose vehicle, Seller Note LLC, pursuant to an indenture with Seller Note, as issuer, and Wilmington Trust, as exchange agent, registrar, paying agent, and collateral agent. The closing of the sale of the First Wind equity interests, including the issuance of the exchangeable notes to the seller defendants, occurred in January 2015 and was effectuated pursuant to two sequential transfers that ultimately became the subject of the litigation. First, a wholly-owned subsidiary of SunEdison, SunEdison Holdings, capitalized Seller Note by transferring to it certain shares of stock and LLC membership units (the "securities") in certain of SunEdison's companies (the "step one transfer"). Second, Seller Note pledged the securities to Wilmington Trust to hold for the benefit of the seller defendants as collateral for the payment of the exchangeable notes (the "step two transfer").

In April 2016, SunEdison, SunEdison Holdings, and numerous other affiliates filed for Chapter 11 relief in the Bankruptcy Court for the Southern District of New York. In July 2017, the bankruptcy court confirmed a Chapter 11 plan of reorganization for SunEdison and its affiliated debtors, and

the plan of reorganization became effective in December 2017. Under the plan of reorganization, all the affiliated debtors' litigation claims and causes of action were vested in the SunEdison Litigation Trust, and the Litigation Trust was authorized, as a designated representative of the debtors' bankruptcy estates, to pursue such claims and causes of action on behalf of the debtors' creditors.

In April 2018, the Litigation Trust commenced litigation in the bankruptcy court against Seller Note and the seller defendants seeking to avoid, as a "constructive fraudulent" conveyance, the transfer of the securities and to recover the value of the securities from the seller defendants. The Litigation Trust's complaint asserted that (1) purchase of the First Wind equity interests occurred when the SunEdison entities were insolvent or undercapitalized; and (2) the value of the First Wind equity interests transferred by the seller defendants to SunEdison was less than "reasonably equivalent value" for the seller defendants' receipt, through Wilmington Trust, of a security interest in the securities to secure payment of the exchangeable notes.

Section 546(e), however, creates a safe harbor for an avoidance action defendant, including a defendant in a constructive fraudulent conveyance action, by providing that a prepetition transfer of a debtor's property may not be avoided if the challenged transfer was "made by or to (or for the benefit of) a … financial institution … in connection with a securities contract…." Relying on this provision, and focusing on the step two transfer, the seller defendants moved to dismiss the Litigation Trust's complaint because (1) the transfer by SunEdison Holdings of the securities to Wilmington Trust (in the form of a collateral pledge of those securities) was a transfer of securities made "in connection with a securities contract" (in the form of the PSA providing for the sale by the seller defendants of the First Wind equity interests); and (2) Wilmington Trust was clearly a financial institution.

The Litigation Trust recognized its exposure to this safe harbor defense under existing case law precedent in the Second Circuit and in the Southern District of New York, but in an attempt to avoid dismissal, argued that (1) the step one transfer and the step two transfer were separate and distinct transfers; (2) it was only seeking to avoid the step one

transfer of the securities from SunEdison Holdings to Seller Note; and (3) the value of the securities could nevertheless be recovered from the seller defendants (pursuant to Section 550(a) of the Bankruptcy Code) because the step one transfer of the securities was ultimately made for the benefit of the seller defendants or because the seller defendants were subsequent transferees of Seller Note, the initial transferee. The lynchpin of the Litigation Trust's argument was that the step one transfer was and should be treated as a separate transfer from the step two transfer for fraudulent conveyance purposes. Conversely, the seller defendants argued that the step one transfer and step two transfer should be treated as a single integrated transaction for fraudulent conveyance analysis purposes because the step one transfer would not have occurred without the step two transfer. The seller defendants' arguments prevailed.

In rejecting the Litigation Trust's lynchpin argument, Judge Bernstein first cited to the 2018 Supreme Court decision in *Merit Management Group LP v. FTI Consulting Inc.* for the proposition that "the relevant transfer for purposes of the section 546(e) safe-harbor inquiry is the overarching transfer that the trustee seeks to avoid under one of the substantive avoidance provisions" and "not any component part of that transfer." In further support of this proposition, Judge Bernstein also cited *In re Tribune Co. Fraudulent Conveyance Litigation*, the 2019 Second Circuit precedent interpreting *Merit*, and *In re Nine West LBO Securities Litigation*, another recent decision in this line of cases, by the Southern District of New York.

Judge Bernstein also cited with approval and significantly relied on the reasoning in another recent decision by the Bankruptcy Court for the Southern District of New York, *Holliday v. K Road Power Management LLC (In re Boston Generating LLC)*. *Boston Generating* also involved the 546(e) safe harbor and a two-step transaction. Boston Generating LLC (BosGen) and its parent, EBG Holding LLC, borrowed $2.1 billion to fund a tender offer for the equity interests held by EBG's members. In step one of this transaction, $708 million of the borrowed funds were transferred upstream from BosGen's account with US Bank into EBG's account with Bank of America. In step two, the $708 million was transferred from EBG's account with Bank of America into EBG's account with Bank of New York to fund the payments to the redeeming equity holders pursuant to the tender offer. Following BosGen's bankruptcy, the liquidating trustee brought a constructive fraudulent conveyance action seeking to (1) avoid the step one transfer as a constructive fraudulent conveyance; and (2) recover the value of the step one transfer from the subsequent transferees. The liquidating trustee argued that because neither BosGen nor EBG was a financial institution, the 546(e) safe harbor did not apply. Here too, the court ruled that the two steps in the transaction were part of the same overarching transfer and importantly held that (1) BosGen itself qualified as a financial institution either because it was a customer of US Bank, which acted as its agent in connection with the tender offer, or that both BosGen and EBG qualified as financial institutions because they were customers of Bank of New York, which acted as their agent in connection with the tender offers; and (2) the transfer was made "by" a financial institution (i.e., BosGen and/or EBG) to consummate a securities contract for the redemption of the tendered securities.

After rejecting the Litigation Trust's lynchpin argument, the bankruptcy court concluded that: (1) the PSA was a "securities contract" within the meaning of the Bankruptcy Code; (2) the two-step integrated transfer of the securities was made "in connection with a securities contract"; and (3) Wilmington Trust was a financial institution. Accordingly, in granting the seller defendants' motion to discuss the Litigation Trustee's complaint, Judge Bernstein held that because the transfer of the securities (in the form of a collateral pledge to Wilmington Trust as collateral for payment of the exchanged note) was a transfer made "to" a financial institution, the transfer was insulated from avoidance as a constructive fraudulent conveyance under the safe harbor of Section 546(e).

Section 546(e) protects payments made "by," "to," or "for the benefit of" a financial institution. *Merit*, *Tribune*, *Nine West*, and *Boston Generating* all focused on the question of whether a transfer could be protected from avoidance under the 546(e) safe harbor because it was made "by" a financial institution acting other than as a mere conduit or intermediary. *SunEdison* instead dealt with the question of whether the challenged transaction was made "to" a financial institution and concluded that it was. As the courts work their way through and around all facets of the 546(e) safe harbor, it seems clear that the recent trend is toward broad interpretation of the safe harbor in favor of creditors. ■

Forecasting 2021 State Licensing Trends for Passive Investors in Non-mortgage Consumer Assets

A passive secondary market investor has an endless number of potential concerns before entering into any business, not the least of which is ensuring that it holds all state licenses that are required based on its business activities and the particular asset class.

The industry has been mindful of the trend toward requiring passive investors in residential mortgage loans and the related servicing rights (MSRs) to be licensed as mortgage servicers. Approximately 30 states require passive investors to be licensed merely to hold MSRs, but this has not always been the case. In the years following the 2008 housing crisis, passive investors trudged through a quagmire of new and unclear state licensing requirements, enforced in the spirit of consumer protection. The battle cry of "Never again!" could almost be heard from state regulators as a wave of enforcement actions swept through the industry after years of passive investors being largely unregulated on the state level.

Passive investors may now be staring down the barrel of a similar state licensing trend for non-mortgage consumer assets. Considering recent developments in student loan servicer licensing laws, a 2020 no action letter from the Connecticut Department of Banking regarding consumer collection agency licensing requirements, new California debt collection legislation, and an incoming Administration expected to be laser focused on strengthening consumer protections, more rigorous licensing requirements in this sector seem an inevitability.

Historical Trends in Mortgage Servicer Licensing

Beginning in 2014, state regulators began to enforce broadly worded mortgage servicer licensing laws against passive investors in MSRs and whole residential mortgage loans on a servicing-released basis to protect the industry from experiencing another housing crisis. The Connecticut Department of Banking was a trailblazer in the industry, clarifying in a 2014 no action letter that a passive investor in

Connecticut MSRs or whole residential mortgage loans on a servicing-released basis must be licensed as a mortgage servicer because it "indirectly" acts as a mortgage servicer by holding the MSRs. The word "indirectly" was not—and is not—defined in applicable Connecticut laws, and the department exercised its authority to interpret the word to apply its mortgage servicer licensing requirements to a passive investor. Other state regulators, like Hawaii, Louisiana, and Michigan, followed suit around 2015 without issuing a similar advisory opinion.

This left passive investors in residential mortgage loans and the related MSRs unsure of whether they appropriately mitigated their state mortgage licensing and regulatory risks and whether they would be subjected to "regulation by enforcement" from a growing and uncertain number of state mortgage regulators.

A Potential New State Licensing Trend for Non-mortgage Consumer Assets

The industry has been aware for some time that a passive investor in non-mortgage consumer assets, such as unsecured consumer loans, non-real-estate-secured consumer loans, and student loans, must hold state licenses to engage in business; however, the applicable state licensing requirements have been more clear-cut. States like New Hampshire and South Dakota, for example, enacted specific consumer lender licensing laws that expressly state that an entity that "acquires" or "holds the servicing rights" in certain consumer assets must be licensed. Other states, such as North Carolina and Washington, choose to regulate passive investors in certain consumer loans through their collection agency laws, defining the term "debt buyer" in a way that makes clear that the licensing requirement applies to a passive investor.

This may not continue to be the case, especially on the verge of a Biden Administration.

Student Loan Servicer Licensing

Several jurisdictions, including California, Colorado, Connecticut, D.C., Illinois, Maine, New Jersey, New York, Rhode Island, and Washington, enacted legislation regulating student loan servicers, many of which carry with them a licensing component that applies to those that "indirectly" act as student loan servicers. Connecticut is one such state that enacted a licensing requirement for those "indirectly" servicing Connecticut student loans. Given Connecticut's express position on the use of the word "indirectly" in its 2014 no action letter for mortgage servicers and more recently in a 2020 no action letter for consumer collection agencies, passive investors should be prepared for the state to issue another no action letter and take a similar position for student loan servicers. This could result in the same domino effect experienced after the housing crisis when other states with similar statutory language begin to enforce their licensing requirements against passive investors in student loans, with or without issuing a formal advisory opinion.

Passive investors should stay abreast of any statutory changes, regulatory changes, and formal or informal regulator guidance issued on this point. With history as our guide, this appears to be a case of determining when, and not if, these licenses will be required for a passive investor in student loans.

Debt Collector and Collection Agency Licensing

On August 26, 2020, the Connecticut Department of Banking issued a 2020 no action letter that clarified the state's position on the use of the word "indirectly" in its consumer collection agency laws. The 2020 no action letter expressly states that "persons are acting *indirectly* as consumer collection agencies when they contract out consumer collection activities to licensed consumer collection agencies." Though representatives within the department have confirmed for Alston & Bird that this licensing requirement will not be enforced against passive investors, passive investors should be mindful of this licensing requirement because the state appears to provide itself with enough leeway to pivot from this position without issuing another no action letter. Specifically, page 2 of the 2020 no action letter provides: "While this memorandum *sets forth examples* of indirect collection activity, *each circumstance must be reviewed on a case-by-case basis* to determine the nature of the activity being performed and ensure adequate protection of both creditors and consumer debtors in Connecticut." The letter goes on to state that the department does not intend to capture as indirect consumer collection activity "typical forwarding arrangements whereby the only activity performed is the forwarding of Connecticut consumer debtor accounts to a licensed or exempt consumer collection agency,

and there is no further involvement by the forwarding entity nor the receipt of monies or fees by the forwarding entity in connection with the forwarding of Connecticut consumer debtor accounts." At the very least, a passive investor should be mindful to make sure that its activities within the state allow it to be characterized as a "forwarding entity" to ensure that it falls outside the scope of this licensing requirement.

Shortly thereafter, on September 25, 2020, California Governor Gavin Newsom signed Senate Bill 908, which enacts the California Debt Collection Licensing Act. Effective January 1, 2022, the Act requires persons that "engage in the business of debt collection," a term that is broadly defined under the Act as "*any act or practice in connection with* the collection of consumer debt," to be licensed as a debt collector. Though the newly enacted law will not include an express requirement for a "debt buyer" to be licensed, the broad definition of the term "debt collection" to include any act or practice tied to the collection of a consumer debt may prove to function similarly to the word "indirectly" in other state licensing laws. At the moment, it appears that only first- and third-party servicers of consumer debts must be licensed; however, this license will be administered by a newly reorganized California Department of Financial Protection and Innovation (DFPI), empowered by California's mini-CFPB legislation. The DFPI will begin preparing to administer the statute and adopt regulations beginning January 1, 2021, and passive investors should keep their eyes open to ensure that the DFPI does not use its broad authority to administer the license to include passive investors within its scope.

A New Administration

President-elect Biden has been forthcoming in his criticism of the Trump Administration's policies toward deregulation of the industry. He has made clear, on numerous occasions, that robust consumer financial protection will be an immediate focus for his Administration, and we expect that same focus to be felt on the state level. Passive investors may not prove to be the pariahs they were once categorized to be in the wake of the housing crisis; however, it should be expected that state regulators, empowered and supported by the federal government by a Biden Administration, will look to more highly regulate the industry in an attempt to preserve consumer financial protections on all levels.

As they say, nothing is new under the sun. Passive investors must continue to actively and closely monitor their ongoing regulatory compliance, including their state licensing obligations. But as we enter into a new Administration highly focused on preserving consumer financial protection and an age when state regulators have the latitude and authority to enforce state licensing requirements against passive investors outside the formal legislative process, passive investors must remember the lessons learned in the wake of the housing crisis. Remain active, remain diligent, and remain well-informed about regulatory and state licensing trends. ■

The Impact of 2020 on Mezzanine Lenders' Ability to Enforce Remedies

Like nearly everything else, the commercial real estate (CRE) lending market has been disrupted by the COVID-19 global pandemic. Certain CRE asset classes have experienced decreased cash flows, missed monthly payments, and decreased debt service coverage ratios. State and judicial authorities have limited the availability of foreclosure and other bargained-for remedies in connection with CRE loans. At the outset of the pandemic, many lenders offered borrowers short-term forbearances with an expectation that the borrower would shortly be able to repay unpaid amounts in 2020. As we close out 2020, the CRE market has slowly started to come back to life, and lenders are looking toward the future. While some assets may rebound quickly and repay previously unpaid debt service, many others, particularly those affected most by the pandemic (nonessential retail, hospitality, and office), may remain delinquent and require lenders to exercise enforcement remedies.

Mezzanine lenders are always in a precarious position, even more as a result of COVID-19, given that they are subordinate to mortgage lenders. Pre-pandemic, completing a UCC equity foreclosure could be accomplished in a matter of weeks rather than the months-to-years-long process sometimes required for a mortgage loan foreclosure. Now, there are additional hurdles a mezzanine lender may need to clear in order to foreclose.

In New York, which is the governing law of many mezzanine loan agreements, executive orders from Governor Cuomo and administrative orders from the courts have halted foreclosure proceedings during the pandemic. For instance, New York's Administrative Order 157/20 had prohibited mortgage foreclosure real property auctions through October 15, 2020. Administrative Order 157/20 lapsed without extension, and now courts can resume pending mortgage foreclosure actions and foreclosure auctions of real property. However,

per Governor Cuomo's Executive Order 202.70, dated October 20, 2020, there is a prohibition on filing new real property foreclosure actions in New York through January 1, 2021.

Since mezzanine lenders are generally in the first loss position, these lenders have been compelled to exercise remedies this year during the pandemic. This has given rise to critical questions. Is it possible to conduct a commercially reasonable auction of mezzanine collateral, as required by the UCC, during the pandemic? In light of New York's mortgage foreclosure prohibitions, can mezzanine sales nonetheless move forward?

These questions have been presented to New York courts multiple times during the pandemic. Before October 15, four cases were filed in New York by mezzanine borrowers against mezzanine lenders to enjoin scheduled UCC sales. Two cases resulted in the outright denial of the mezzanine borrowers' applications for a preliminary injunction. Specifically, in *1248 Associates Mezz II v. 12E48 Mezz II LLC*, the court refused to enjoin the UCC sale of mezzanine loan collateral because "harm to a plaintiff's commercial property interest is the loss of an investment," is not irreparable, and "may be properly remedied subsequent to the sale." Similarly, in *893 4th Avenue Lofts v. 5AIF Nutmeg LLC*, the court refused to stay a UCC sale by a mezzanine lender. A third court decision enjoined the UCC sale relating to the Mark Hotel in New York that had been scheduled to occur during the height of the COVID-19 pandemic (while New York State was still in Phase 1 and prospective buyers could not tour the property), but for only 30 days. In a fourth such case, *Shelbourne BRF LLC v. SR 677 BWAY LLC*, the New York court granted an injunction to block the UCC sale from late July to October 15, 2020 for a total of 120 days, relying principally on Administrative Order 157/20, which prohibited foreclosure auctions of real property until October 15, 2020. In each of these cases, the court awarded a temporary restraining order to enjoin the sale, but only one court issued a meaningful preliminary injunction.

In the *677 BWAY* case, after the expiration of the injunction, the mezzanine lender, then represented by replacement counsel Alston & Bird, commenced the UCC auction process and noticed a public sale scheduled for October 30, 2020. On October 27, 2020, the mezzanine borrower filed another application for a temporary restraining order to again enjoin the sale, alleging the sale was commercially unreasonable due to COVID-19. This time, however, with Administrative Order 157/20 expired, the court denied the plaintiffs' application for a temporary restraining order and allowed the sale to proceed, noting that current conditions permit mezzanine foreclosures to proceed because prior prohibitive administrative orders were no longer in effect, and further noting "given the circumstances of the case and the current state of the pandemic, further enjoining this sale would be highly inequitable." The sale proceeded as scheduled, virtually, on October 30, 2020.

A fifth court decision, *301 West 53rd Street Junior Mezzanine LLC v. CCO Condo Portfolio (AZ) Junior Mezzanine LLC*, has some unusual facts and offers a warning to overly aggressive mezzanine lenders. The borrower filed for a temporary restraining order in New York state court on November 10, 2020 to enjoin a November 12 sale. The lender removed the case to federal court, and the federal court remanded the case to state court on Veterans Day, November 11, when courts are closed. In response, a state court judge, pressed for time to stop the now-imminent sale, granted a preliminary injunction and set a hearing for November 16. On November 15, the mezzanine lender notified the borrower it had scheduled the UCC auction for November 17—apparently in violation of the temporary restraining order. At the outset of the hearing, the borrower informed the court of the sale scheduled on one day's notice and the court immediately extended the temporary restraining order, without hearing from the lender. The court set an evidentiary hearing for November 30, hearing from both fact and expert witnesses, but did not rule until December 9. In its ruling, the court found that the proposed sale was commercially unreasonable, but nevertheless could proceed within 15 days with modifications. Specifically, the court held it was commercially unreasonable for the lender to (1) create confusion in the marketplace by marketing the sale of mezzanine loans rather than equity collateral; (2) requiring bids for the entire package, rather than the option to bid piecemeal or all together; (3) requiring bidders to post an "unreasonably high" deposit; and (4) prohibiting the mezzanine borrowers and guarantors from bidding if they satisfy a reasonable deposit requirement. The court rejected the borrowers' request for another 60-60-90-day marketing

period. The sale had been delayed enough already, the court held (86 days by the time of the ruling), and the parties' contract provided for 15-day minimum, which the court held was controlling. The court found the sale could proceed within 15 days as modified.

There are some key takeaways from these decisions. A mezzanine lender seeking to enforce remedies during the pandemic must be prepared to defend the terms of its UCC sale process in court. A commercially reasonable sale will often include having a virtual attendance option, hiring a reputable auctioneer, and hiring a well-known real estate broker to advertise the sale or, in the alternative, making significant strides to self-advertise the sale and reach out to potential bidders. Though the UCC requires a minimum of 10 days' notice to be commercially reasonable, during the pandemic it may be wise to give additional notice if the mezzanine lender does not believe there is serious risk in doing so. In addition, the mezzanine lender will need to explain to the court: (1) the significant economic impact that a delayed sale will have, namely that the lender will be required to pay accrued sums on the mortgage loan upon completion of foreclosure; and (2) the risk the mortgage borrower offers the mortgage lender a deed in lieu of foreclosure. A deed-in-lieu for the mortgage property would wipe out the mezzanine lender's position and leave the mezzanine lender with its sole remaining remedy to purchase the entire mortgage loan debt (typically a very big pill to swallow for a much smaller, subordinate lender).

Although there have been some bumps along the road, the majority of judges presented with these questions this year have held that a mezzanine lender can exercise remedies against mezzanine collateral in the face of a default. Mezzanine lenders should feel confident that they can fashion a commercially reasonable sale, even during a pandemic and thus eventually accomplish the steps needed to protect their investment. ■

Nightmare on Loan Street: The Citi–Revlon Case

In the over $1 trillion corporate, syndicated leveraged loan market, there are countless payments made between financial institutions every day, some of which include administrative agents making principal and interest payments to the lender syndicate, funding of primary new loans by lenders to administrative agents, and buyers paying purchase prices to sellers in exchange for loans purchased in the secondary market. As if we didn't have enough to worry about, this year graced us with a case that could have huge implications for the syndicated credit markets and potentially other loan markets as well.

On August 11, 2020, Citigroup, acting as administrative agent for a 2016 syndicated term loan facility extended to Revlon maturing in 2023, accidentally made a $900 million principal payment to its lenders instead of a $7.8 million payment it intended to remit solely as an interim interest payment. The following day, Citi initiated efforts to recover the payments from the lenders, stating that the remittance was a mistaken processing error. Since that time, Citi has recovered $400 million of the payments from 200 lenders; however, lenders for 10 financial institutions have refused to return their portion of the payments made. Consequently, Citi brought a lawsuit in the Southern District of New York seeking to claw back the balance of the funds (approximately $500 million) from the 10 investment managers for the lenders that have not returned the funds.

At the heart of the matter is the defendants' "discharge-for-value" defense, which stems from a ruling in the 1991 New York case *Banque Worms v. BankAmerica International*, that allows, under certain circumstances, a creditor that received money transferred in error to retain the money. The defendants argue that a lender that receives funds it is entitled to, having no knowledge that the money was mistakenly wired, can treat the funds as a final and complete transaction. Although Citi does not dispute the theory of the defense, it contends that certain requirements for the discharge-for-value rule to apply were not met because (1) the loans were outstanding but not currently due for another three years; (2) the debt was not discharged by the defendants since the defendants never applied the funds to credit Revlon's account; and (3) the defendants had notice of Citi's mistake, pointing to correspondence of certain defendants stating that Citi explicitly acknowledges that the

payments were made in error. According to the defendants, internally crediting funds is merely a bookkeeping matter, Citi credited the transfer as a full paydown in the official register, and the defendants did not have notice of Citi's payment mistake at the time it occurred because actual notice is required and not, as Citi claims, constructive notice.

Additionally, Citi contends that on August 12, certain defendants sent Revlon a notice aiming to accelerate a loan under a separate Revlon credit facility and filed a lawsuit through UMB Bank as agent under that credit facility alleging Revlon's insolvency, that the funds were Citi's own and not Revlon's, and that the credit agreement does not allow for an optional prepayment of principal without prior notice by Revlon, which was never provided. The defendants maintain that Citi, as one of the largest and most sophisticated financial institutions in the world, would not accidentally transfer hundreds of millions of dollars in the exact outstanding amounts on the lender's loans.

The Loan Syndications and Trade Association (LSTA), a trade association that represents a broad and diverse membership of financial institutions promoting fairness and efficiency in the syndicated loan market, filed an amicus brief supporting Citi. While the LSTA acknowledged that filing the brief was unusual with its participating members on both sides of the case, it noted that the importance of industry stability compelled it to file the brief because allowing the defendant lenders to keep the payments "would undermine the smooth functioning of syndicated lending and the ability to transfer and assume loans under credit agreements by encouraging the kind of non-cooperative opportunistic behavior that destabilizes any market dependent on trust and transparency." The LSTA argued that due to the high volume of transactions in the secondary loan market, even extraordinary care may allow mistakes to occur from time to time.

The outcome of this case could significantly impact the secondary syndicated leveraged loan market and the way administrative agents in all manner of credit facilities operate. If the defendants prevail in this case, query whether any large, sophisticated financial institution would be willing to take the risk of remitting a mistaken payment that could exceed millions of times the fees such entity receives for acting in the capacity of an administrative agent. We are keeping an eye on this case (as we suspect you are as well) and will keep you posted. ■

The Welcome Rise of ESG Considerations in the Global CLO Markets

Seventy percent of respondents to the end-of-year 2020 European Loan Market Association (LMA) members' survey, "Outlook for the Syndicated Loan Market in 2021," anticipated total new collateralized loan obligation (CLO) issue volume in Europe below €20 billion in 2021 (new issuance was €30.1 billion in 2019), even as a rollercoaster 2020 looks set to surpass that figure and demand for AAA paper builds afresh into year-end. Resilience, particularly in view of ratings actions and rising defaults in legacy 1.0 and some 2.0 CLOs, has certainly been tested through 2020. That headwinds remain is an obvious understatement, no doubt borne out in the survey's sentiment.

But a very large tailwind has appeared in our global loan markets in the form of environmental, social, and governance (ESG) considerations, an area that is gaining prominence throughout the globe, particularly in the U.S. credit markets. The U.S.'s Loan Syndications and Trade Association has launched an ESG Working Group focused on ESG developments in the U.S. loan markets, which includes ESG integration as well as the development and evolution of ESG loan products. The Working Group has introduced an ESG Diligence Questionnaire that offers a streamlined method for underlying loan borrowers to communicate their ESG story to investors as well as working with global loan trade associations, such as the LMA, to develop frameworks and guidance documents, such as the Sustainability Linked Loan Principles (SLLP).

CLO managers are increasingly looking to issue funds with socially responsible principles that reflect their firm's and investors' values, while still offering competitive returns. CLO issuers, managers, investors, and sponsors are all now getting on board and evaluating ESG risk in an increasing business imperative to both meet diverse stakeholder needs and mitigate potential legal, operational, or reputational risks. The shift from shareholder to stakeholder can no longer be ignored, and investors are already working with CLO managers to find ways to incorporate ESG elements into their decision-making when creating leveraged loan portfolios. Further, our bond markets—and our CLO markets in particular—have the reach and access to liquidity to raise the funds the UN believes will be required to deliver its Sustainable Development Goals (SDGs) by 2030.

So, with ESG gaining traction—which we believe will continue into 2021—it is clear that investors are realizing that social and environmental intersections with business matter: they bring value and risk and are crucial to sustainability. This realization is making *impact* a third norm for investors to think about, right along with risk and return. Using terms like *impact* or *ESG* may seem like an easy way of scoring publicity points, but the reality is that those who truly incorporate impact on social and environmental considerations into their analytics will have a distinct advantage over time. We are seeing this now in the market with the emergence of specific sustainable-focused CLOs. A prime example is the $409.5 million CLO with Morgan Stanley raised by Partners Group this past November, which included several ESG considerations.

This Christmas we asked Saint Nick to bring us the present of improved reporting and data that surrounds ESG compliance and our loan markets. A recent client of ours was lamenting the fact that they were being asked to complete 2000 data points! Although much improved over the last 5–10 years, these types of pain points call for standardization in the market and the development of a mature reporting environment where there is comfort and understanding of who has genuine SDG credentials to remove any "greenwashing" perceptions. Enhanced transparency in sustainability reporting will also facilitate accountability in terms of walking the walk on sustainability. It will take time, but impact, risk, and return can become the way investors think about analytics over time.

The investment landscape is changing. Whether this is a result of or has been accelerated by the COVID-19 pandemic or not is up for debate. Nonetheless, we believe ESG is becoming an increasingly important investment decision for companies to consider. At some point, all businesses and investments will have an ESG component, and those with strong ESG metrics will prosper over those without. As more and more examples of good and bad social or governance strategies emerge from the COVID-19 pandemic, investors may increasingly demand, and managers may increasingly become mandated to invest in, ESG products such as green bonds and sustainability-linked bonds (SLBs). Investor demand for ESG-related investments such as these will increase as demographics, public opinion on social and justice issues, the aftermath of the COVID-19 pandemic, and climate change continue to evolve, especially as we enter into a Biden presidency. The CLO markets are perfectly placed to embrace this, and we should expect more SDG CLOs focusing on sectors such as infrastructure, renewables, and clean energy—solar, wind, and electric. A further game changer will come in 2021 from the announcement of the European Central Bank (ECB) that it will be able to accept SLBs as collateral, and we expect SDG CLOs will qualify as ECB repo collateral in due course.

Finally, we think a theme of 2021 will be transition. We know what's green, we know what's brown—the biggest question will be how we move from brown to green. SLLPs could be a very good way to provide such transition, and we expect to see more sustainable CLOs as one of the best ways to fund environmental and other SDG projects at the pace required to confront climate change and to deliver the SDGs by 2030. The ESG future is bright! ■

COLLATERALIZED LOAN OBLIGATION

Blowing Up the LIBOR Phase-Out

The London Inter-bank Offered Rate (LIBOR) is the benchmark interest rate that underscores approximately $300 trillion worth of global financial contracts. In 2017, the UK's Financial Conduct Authority (FCA) announced the cessation of LIBOR. Complete cessation was expected to occur at the end of 2021, but announcements last week from the ICE Benchmark Administration (IBA), FCA, and Federal Reserve indicate that USD LIBOR for certain tenors may still be published until mid-2023 to permit a large volume of legacy contracts to mature before the complete cessation.

As usual, lawyers ruin everything. Amid the global financial community's preparation for the end of LIBOR, numerous consumer-borrowers filed a lawsuit in August 2020 in the Northern District of California against LIBOR panel banks and the Intercontinental Exchange (which administers LIBOR), *McCarthy, et al. v. Intercontinental Exchange Inc., et al*., No. 3:20-cv-05832 (N.D. Cal. Aug. 18, 2020). The plaintiffs allege that the defendants were "members of a price-fixing cartel" that engaged in an antitrust conspiracy to fix an intrabank interest rate used for consumer loans.

Notably, the plaintiffs did not allege that the defendants engaged in actions to circumvent the rules setting LIBOR. Instead, they alleged that the rules in and of themselves are illegal and the result led to consumers paying higher rates of interest on consumer-based loans. The relief sought under the complaint included the voiding of every financial instrument for variable interest rate consumer loans that uses USD LIBOR and prohibiting the defendants from enforcing any USD LIBOR-based agreement. Moreover, the complaint seeks to prohibit the defendants from "conspiring to agree upon another so-called benchmark rate to replace LIBOR."

To accelerate the relief sought under the complaint, the plaintiffs filed an injunction on November 10, 2020 that sought to prohibit the defendants from enforcing any financial instrument that relies on USD LIBOR, to void any such agreement or contract, and to suspend the publication of LIBOR. The plaintiffs argue that this relief is warranted because LIBOR is based on an alleged anticompetitive agreement between defendant LIBOR panel banks.

Such an injunction would have disastrous results and, as the defendants argue in their opposition, "would wreak havoc on global financial markets and undermine years of work on LIBOR reform," especially in light of the ongoing efforts across the industry to transition away from LIBOR.

The Structured Finance Association, International Swaps and Derivatives Association, Securities Industry and Financial Markets Association, U.S. Chamber of Commerce, Bank Policy Institute, and Loan Syndications and Trading Association filed an amicus brief on December 10, 2020, aligning with majority market participant support for a smooth transition away from LIBOR. Specifically, the amici argue that the plaintiffs' proposed injunction would undermine years of planning and billions of dollars spent to ensure a smooth transition from LIBOR—the very type of risk that the plaintiffs' proposed injunction would cause. Such planning has included, among other things, the identification and development of successor indexes, development of fallback contractual language, and the review of hundreds of thousands of agreements to identify LIBOR-related risks.

The court will hear the motion for injunction on January 14, 2021. ■

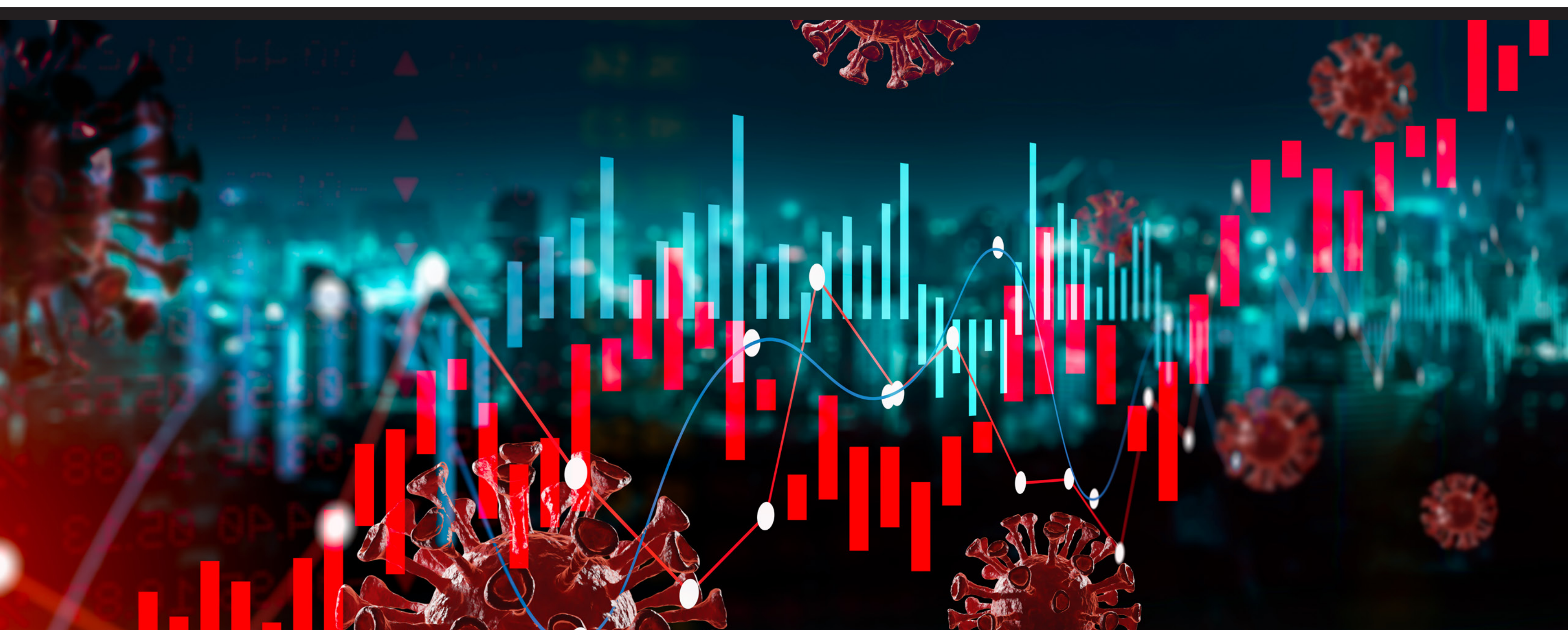
CLO Q&A

In November, we welcomed a trio of collateralized loan obligation (CLO) experts to our Structured Finance & Warehouse Team in New York, partners Joe Gambino and Pete Williams along with associate Liz Walker. They have broad experience structuring and executing complex structured finance and securitization transactions involving all major commercial and consumer asset classes. Below is a Q&A with Joe and Pete talking about CLOs and the current financial market.

With market sentiment fluctuating as COVID-19 effects evolve, what has been the impact on new and legacy CLO transactions?

A: COVID-19 has represented the biggest test of CLO structure since the 2008–09 financial crisis. CLOs performed relatively well during the financial crisis, and post-crisis deals have generally incorporated additional structural features intended to protect investors from losses resulting from deteriorating portfolios. This spring, the rating agencies started to place large numbers of CLO issuers on review for downgrades. But actual downgrades have not been as severe as the market initially feared, and at any rate, downgrades are not the equivalent of defaults. CLO structures appear to be operating as intended. CLOs are still cash-flowing and managers are still actively managing portfolios, although the collateral coverage tests and collateral quality tests incorporated into CLOs have forced the deleveraging of certain deals and the derisking of certain portfolios.

Structural integrity aside, CLOs have not been immune from the larger forces at work in the credit markets. CLOs are securitized portfolios of leveraged loans, so as uncertainty grew this spring about the effects of COVID-19-related lockdowns on corporate borrowers' cashflows and the prospect of widespread rating downgrades of underlying assets, secondary market CLOs sold off. In the primary market, CLO new issuance essentially ground to a halt for approximately three months, and it is still down year over year. Prices of both leveraged loans and CLO debt have since recovered significantly, but this year's volatility has forced arrangers and managers to be more creative in structuring deals to attract investors. The market has seen deals issued with, among other things, shorter reinvestment periods, shorter non-call periods, more variated capital structures (such as the inclusion of fixed-rate and delayed draw tranches), and smaller overall size than pre-COVID-19.



How are higher credit enhancement levels and shorter reinvestment periods impacting the CLO landscape?

A: Shorter reinvestment periods, shorter non-call periods and, to a certain extent, higher credit enhancement levels have been key lubricants for CLO issuance this year. The CLO life cycle is generally divided into two phases: the reinvestment period and the amortization period. During the reinvestment period, the manager is generally permitted to reinvest principal payments and sales proceeds received from underlying loans in substitute assets. Pre-COVID-19, CLOs of broadly syndicated loans were typically structured with four- or five-year reinvestment periods; but this year, it is much more common to see one- or two-year reinvestment periods. Along with wider interest rate spreads and higher credit enhancement levels, shorter reinvestment periods help attract investors to the senior classes of rated CLO debt because the shortened timeframe means the amortization of those classes is expected to begin that much earlier in the CLO life cycle.

Investors in CLO equity (or the junior-most, unrated class in the capital structure) have different, and often competing, timing considerations from investors in rated CLO debt. A key focal point is the non-call period, or the period after closing during which the CLO equity is not permitted to cause an early redemption or refinancing of the rated CLO debt. Pre-COVID-19, the typical non-call period was two or three years; but this year, many non-call periods have been set well inside those timeframes. Doing so enhances the value of the CLO equity's call option, which is particularly salient given the wide spreads commanded by rated CLO debt this year.

Are lower-rated tranches less likely to be issued in this current market environment?

A: Yes. For much of this year, historically wide spreads across the CLO capital stack, with spreads widest at the bottom of the stack, have limited the economic case for issuing B-rated or even BB-rated tranches. Rating agencies and investors dictate the amount of subordination required for each CLO tranche, and all other things being equal, any reduction of the amount of below-investment-grade-rated debt being issued requires an increase in the amount of the CLO equity issued in order to account for the "lost" internal credit enhancement, ultimately resulting in an equity tranche that is less levered than normal market conditions would permit. The new-issue market has approached this in a number of ways, including by issuing delayed draw BB-rated tranches and issuing CLO equity with the ability to convert a portion into a BB-rated tranche. Those features notwithstanding, CLO spreads have narrowed significantly from their widest levels earlier this year, helping to facilitate further issuance of BB-rated tranches in recent months.

Are par value tests being set at higher levels? What impact does this have?

A: Par value tests exist for every class of rated CLO debt and are designed to protect those classes from losses on the collateral by maintaining a cushion of overcollateralization throughout the CLO life cycle. If overcollateralization falls below a predetermined level, waterfall payments are redirected from more junior classes to senior classes until test compliance is restored. Regardless of the market environment, the setting of par value test levels is a function of the subordination for the relevant class and collateral credit quality. In certain recent deals, rating agencies and investors have required that tests be set at slightly higher levels, the impact of which could be the earlier amortization of the senior-most classes of rated CLO debt during times of distress.

What's the downside of CLO liabilities being issued at discounted levels?

A: Issuing CLO liabilities—in particular, the AAA-rated and AA-rated classes, which typically account for upwards of 70% of a CLO issuer's capital structure—at a discount means less real leverage for the CLO equity. It also theoretically increases the risk that a new issue transaction will not successfully "ramp," or reach its target portfolio par. That said, CLOs typically include several structural features designed to mitigate the risks of not "going effective" at the end of the ramp-up period, and it is historically rare to see significantly discounted CLO liabilities other than the junior-most classes.

Are existing CLOs bracing for a period of continued credit distress? How is that impacting their portfolios?

A: CLO managers are not uniform. As a group, they have a variety of investment styles and trading strategies, and they differ in their ability to source loan assets in the market and to execute trades at advantageous prices. It stands to reason, then, that throughout the dislocation experienced by the market this year, certain managers have adopted a risk-on approach while others primarily have traded defensively. CLOs cannot carry excess CCC-rated loans at par for purposes of calculating par value tests, so the widespread downgrades of underlying loans in CLO portfolios, and the general increase in underlying default rates, have posed and will continue to pose challenges for CLO portfolio management. But, at the same time, the price volatility in the leveraged loan market this year has presented opportunities for CLO managers to build portfolio par and to monetize trading gains.

How are new-issue CLOs adapting to the economic downturn, and how are deal documents changing?

A: With very limited exceptions, CLOs are not distressed debt "plays," but with increased credit market volatility and more corporate borrowers experiencing distress, many CLO managers are trying to structure their new issue deals to better reflect current economic realities. For instance, managers have sought to increase the concentration limits for CCC-rated assets and for assets issued by single obligors. Increased loan default rates have also highlighted the ways certain features of traditional CLO documentation operate to limit the ability of CLO managers to participate effectively in workouts and restructurings. Managers have responded by proposing new mechanisms to enhance their ability to manage distressed assets, both in their new issue deals and (through platform-wide amendments) legacy deals.

In addition, recent amendments to the Volcker Rule permit the return of the 5% "bond bucket" that was common in pre-Volcker CLOs, subject to certain limitations prescribed by the amendments.

Are "print and sprint" CLOs here for the near future?

A: The "print-and-sprint" approach, which basically involves pricing a deal and acquiring the underlying loan portfolio in a compressed timeframe, instead of warehousing the initial loan portfolio over a period of several months, has existed in the CLO market for many years. Volatility in the leveraged loan market impacts the market for CLO instruments, but

movements in the CLO market are never lockstep and different CLO tranches are impacted by varying degrees. The appeal of print and sprint largely depends on whether technical market conditions present an opportunity to take advantage of a particular dislocation between CLO tranche prices and underlying asset prices. What has become more common in the CLO market, and will likely persist in the near future, has been a slight variation of a traditional print and sprint, in which deals are launched with anchor investors already soft-circled at the AAA and equity level and then quickly priced after formal marketing commences. Several factors help make that approach possible, including shorter deal parameters (reinvestment period and non-call period) and replication of commercial terms from prior deals the anchor investors are familiar with.

Why is asset manager selection so important right now?

A: Asset manager selection is always important in CLOs because CLO managers have an outsized impact on portfolio performance. Investors rely on managers to avoid (or get the most out of) non- and underperforming credits and to obtain (at efficient prices) exposure to performing credits. That is the case during all market cycles, although volatile markets can present different tests of managers' asset selection and credit analysis capabilities.

Looking into 2021, what lies ahead for CLOs?

A: So long as spreads continue to tighten, we expect to see significant refinancing volumes of the widespread, one-year non-call deals that came to market in 2020. In addition, there was an extended stretch this spring and early summer when leveraged loan prices were significantly depressed, which likely presents an opportunity for the upsizing of existing deals, either through additional issuances or "call-and-rolls," which will present opportunities for equity investors to crystalize gains. ■

Rounding Out the Year with Good News on the QM Front

On June 22, 2020, the Consumer Financial Protection Bureau (CFPB) announced a proposed rule that would amend the qualified mortgage (QM) definition in Regulation Z to replace the requirement that a consumer's debt-to-income (DTI) not exceed 43% with a price-based approach. In order to smooth the transition to the new QM, this past October, the CFPB indefinitely extended the expiration of the QM Patch, the provision that accords QM status to loans meeting the standards of the Government Sponsored Enterprises (GSEs). The QM Patch was initially scheduled to expire on January 10, 2021. The CFPB estimates that allowing the QM Patch to expire in January would have affected 957,000 loans.

Christmas came early from the CFPB when, on December 10, it issued final rules related to QM loans, each with the objective of ensuring that consumers have access to responsible, affordable mortgage credit.

The general QM Final Rule replaces the 43% DTI requirement for QM loans with a limit based on the pricing of a loan. In adopting this approach, the CFPB determined that a loan's price, measured by comparing the annual percentage rate (APR) to the average prime offer rate (APOR) for a comparable transaction, better measures a consumer's ability to repay than DTI alone. Additionally, the Rule eliminated Appendix Q.

Under this rule, if the APR for a loan does not exceed the APOR for a comparable transaction by 1.5 percentage points or more as of the date the interest rate is set, the loan will receive a conclusive presumption that the consumer had the ability to repay. Retaining the distinction between safe harbor and rebuttable presumption QMs, a loan will receive a rebuttable presumption that the consumer had the ability to repay if the APR exceeds the APOR for a comparable transaction by 1.5 percentage points or more but by less than 2.25 percentage points. Among other things, the general QM Final Rule also:

- Provides higher pricing thresholds for loans with smaller loan amounts, for certain manufactured housing loans, and for subordinate-lien transactions.
- Requires lenders to consider the consumer's DTI ratio or residual income, income or assets (other than the value of the dwelling), and debts and verify the consumer's income or assets (other than the value of the dwelling) and the consumer's debts, but does not prescribe any particular underwriting standard.

A lender must maintain written policies and procedures for how it takes into account, pursuant to its underwriting standards, income or assets, debt obligations, alimony, child support, and monthly DTI or residual income in its ability-to-repay determination. The lender also must retain documentation showing how it considered the factors, including how it applied its policies and procedures.

Lenders can opt in to the new QM 60 days after the rule is published, but compliance becomes mandatory as of July 1, 2021.

In the second final rule, the CFPB created a new category for QMs, seasoned QMs. Regulation Z contains several categories of QMs, including the general QM category and a temporary category of loans that are eligible for purchase or guarantee by GSEs, and is now expanded to add a new category of QMs for first-lien, fixed-rate covered transactions that can season into a QM after meeting certain performance requirements.

To be eligible to become a seasoned QM, a loan must be a first-lien, fixed-rate loan with no balloon payments that meets certain performance and underwriting requirements and complies with general restrictions on product features and points and fees. The loan can have no more than two delinquencies of 30 or more days and no delinquencies of 60 or more days at the end of a 36-month seasoning period. The creditor generally must hold the loan on portfolio until the end of the seasoning period; however, a loan may still become a seasoned QM if it is sold, assigned, or otherwise transferred (but not more than once) before the end of the seasoning period, provided the transaction is not securitized before the end of that period. Higher-priced mortgage loans (but not a HOEPA loan) can season into a safe harbor QM if it otherwise meets all the requirements.

As under the general QM Final Rule, the creditor must also consider the consumer's DTI ratio or residual income, income or assets (other than the value of the dwelling), and debts and verify the consumer's income or assets (other than the value of the dwelling) and the consumer's debts.

The seasoned QM Final Rule will take effect 60 days after its publication and will apply to covered transactions for which creditors receive an application on or after the effective date.

Notwithstanding this CFPB rule bonanza, loans with points and fees that inadvertently exceed the allowable limits will be left out in the cold. The CFPB did not extend the provision that allows a creditor or assignee to cure a loan's QM status if the total points and fees exceed 3% by paying the consumer the excess plus interest within 210 days after consummation. This points-and-fees cure provision will expire for loans consummated on or after January 10, 2021. ■

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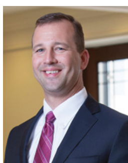

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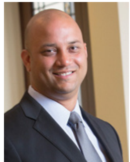

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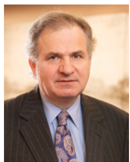

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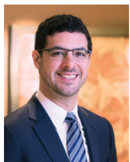

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