Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Recent Trends In Structuring Risk Retention Vehicles

By **Jason Schwartz, Gregg Jubin and Adam Risell** (February 14, 2018, 1:40 PM EST)

Jason Schwartz

Gregg Jubin

Adam Risell

In the wake of the 2007-2008 global financial crisis, the United States and Europe enacted "risk retention" rules that require sponsors of securitization vehicles to maintain a financial interest in those vehicles (i.e., "skin in the game").[1] Historically, collateral managers of collateralized loan obligation issuers (CLOs) have not had sufficient capital on hand to acquire significant interests in the CLOs they have managed.[2] Accordingly, to comply with the risk retention rules as CLO "sponsors," collateral managers often have relied on significant funding from third-party investors by organizing a capitalized manager vehicle (CMV).[3] The CMV, in turn, acts as the collateral manager of the applicable CLOs and acquires a financial interest in those CLOs. By September 2017, collateral managers of CLOs are estimated to have raised at least $10 billion from third-party investors to comply with these rules.[4]

On Feb. 9, 2018, the U.S. Court of Appeals for the D.C. Circuit held that CLO managers are not "securitizers," and therefore are not required to retain a financial interest in the CLOs under the U.S. risk retention rules.[5] Time will tell whether or not the government chooses to appeal or take other actions with respect to this decision. What is clear is that collateral managers that have already set up CMVs to raise capital from third-party investors may, as a practical matter, be required to invest that capital in CLO notes. In addition, if the notes of a CLO are sold to certain European investors, the collateral manager will have to comply with the European risk retention rules (which, as discussed below, are similar to the U.S. rules).

The risk retention rules are intended to align the interests of securitization "sponsors" and securitization investors by requiring the sponsors to retain at least 5 percent of the credit risk relating to the underlying securitized assets. As applied to CLOs, the U.S. rules — before the U.S. court of appeals decision — generally required the collateral manager or a "majority-owned affiliate" of the collateral manager (MOA) to acquire and retain (x) 5 percent of the face amount of each class of notes issued by the CLO (an "eligible vertical slice"), (y) notes of the most subordinated class issued by the CLO representing, in the aggregate, 5 percent of the fair value of all notes issued by the CLO (an "eligible horizontal slice"), or (z) a combination of an eligible vertical slice and an eligible horizontal slice representing, in the aggregate, 5 percent of the fair value of all notes issued by the CLO (an "L-shaped slice"). For convenience, we refer

to an eligible vertical slice, an eligible horizontal slice or an L-shaped slice as the "risk retention notes."

The European rules are similar to the U.S. rules with respect to U.S.-based collateral managers, except that (1) subject to certain exceptions, the CMV (as the named collateral manager) must be the retaining entity, and (2) in addition to holding the risk retention notes, the CMV has to qualify as an "originator" by acquiring 5-10 percent of each CLO's target fully ramped portfolio (by face amount) on the secondary market at least 15 business days before the CLO's closing date and selling the loans to the CLO on the closing date.[6] These sales are effected pursuant to a forward sale agreement that passes along all economics to the CLO, so that the CMV retains no profits with respect to the "originated" portfolio.[7]

The CMV Structure

A CMV is a new collateral manager. The CMV typically is structured as a newly formed Delaware series limited liability company or series limited partnership that, in either case, is treated as a partnership for U.S. tax purposes. The CMV typically designates one series ("Series A") to receive all management fees, and another series ("Series B") to receive all proceeds on the risk retention notes.

The legacy collateral manager (often through a wholly owned affiliate) holds all of the Series A interests, and thus is allocated all of the management fees that the CMV receives, net of any expenses related to the CMV's management activities. If the legacy collateral manager (or its affiliate) contributes cash to the CMV, then it also holds a pro rata share of the Series B interests, and thus is allocated a pro rata share of any payments that the CMV receives on the risk retention notes.

Third-party investors typically invest in the CMV through one or more foreign (typically Cayman Islands or Jersey) "blocker" entities that are treated as corporations for U.S. tax purposes (collectively, the "foreign blocker"). The foreign blocker invests substantially all of its cash directly into the CMV in exchange for Series B interests, and is allocated a pro rata portion of any payments that the CMV receives on the risk retention notes.

Return to Third-Party Investors

The risk retention notes provide for two types of return, both of which are allocated to the foreign blocker: (1) the "regular return," which consists of payments made in respect of the risk retention notes pursuant to the priority of payments contained in the CLO's indenture, and (2) an "increased return" on the most subordinated class of risk retention notes (which are commonly referred to as "subordinated notes"). The increased return effectively compensates investors in the CMV for serving as indirect "anchor investors" in the CLOs, and is payable as a result of a corresponding reduction in the fees that the CMV charges the CLOs.

A CLO typically pays the increased return to the CMV under a side letter pursuant to which (1) the CLO contractually agrees to distribute on the subordinated notes that are risk retention notes (in addition to the regular return) an additional amount, based on a specified formula, (2) the management fees are contractually reduced by the same amount,[8] and (3) the parties agree to treat the additional amount as part of the investment return on the risk retention notes (and not as a share of the management fees). The additional amount is payable on the risk retention notes regardless of whether the management agreement is terminated, and regardless of whether the risk retention notes are held by the CMV or transferred to another person.

U.S. Tax Considerations

In General

As mentioned above, a CMV typically is treated as a partnership for U.S. tax purposes. The CMV is treated as "engaged in a U.S. trade or business" for U.S. tax purposes as a result of its U.S. management activities. As a partner in the CMV, the foreign blocker would be subject to U.S. tax liability if any part of its allocable share of income from the CMV were characterized as fee income from the CMV's management activities, or were otherwise treated for U.S. tax purposes as "effectively connected" with a "U.S. trade or business."

The CMV allocates two types of profits to the foreign blocker: (1) the regular return on the risk retention notes, and (2) the increased return on the risk retention notes. We discuss each of these profit types in turn.

Regular Return

CLOs typically are treated as foreign corporations for U.S. tax purposes. Very generally, payments by a foreign corporate CLO to the CMV should not be treated as effectively connected with the CMV's U.S. trade or business unless either (1) the payments are derived in the active conduct of a banking, financing or similar business within the United States or (2) the principal business of the CMV is trading in stocks or securities for its own account.

The CMV's principal activities are providing investment management services to CLOs and purchasing notes issued by the CLOs with the intention of holding those notes to maturity. Accordingly, neither of the tests described above should be satisfied, and payments by a foreign corporate CLO to the CMV should not cause the foreign blocker to have income that is effectively connected with a U.S. trade or business.

Increased Return

Because the CMV is economically entitled to an amount equal to the increased return regardless of whether it enters into the side letter, some tax advisers are concerned that the increased return may be characterized as a portion of U.S.-source management fees. In this event, the foreign blocker would have income that is effectively connected with a U.S. trade or business.

However, the better view is that the increased return should be treated as an investment return on the subordinated notes.

First, the increased return is payable even if the CMV's management agreement is terminated, and thus is not contingent upon the CMV's (or any other person's) performance of services. By contrast, the CMV's right to receive management fees is contingent upon the CMV's continued performance of services.

Second, the increased return is payable to the CMV only as long as the CMV holds the risk retention notes. By contrast, the CMV is entitled to receive management fees regardless of whether the CMV holds the risk retention notes.

Third, the increased return may be transferred only with the risk retention notes. By contrast, the CMV's right to receive management fees is fixed under the investment management agreement, and thus is

not transferrable with the risk retention notes.

Closing Observations

The risk retention rules add some complexity for third-party anchor investors. However, with appropriate planning, the after-tax return to these investors with respect to the risk retention notes held by a CMV should be the same as the return that they would have received with respect to the notes had they invested in the notes directly.

Jason Schwartz is a partner in the tax group of Cadwalader Wickersham & Taft LLP. Gregg Jubin is a partner and Adam Risell is an associate in the firm's capital markets group.

The authors would like to thank Cadwalader special counsel Jean Bertrand and associate Sejin Park for their contributions to this article.

[1] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); Capital Requirements Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013.

[2] For a detailed discussion of the taxation of CLOs, see Jason Schwartz and David S. Miller, Collateralized Loan Obligations, 6585-1st Tax Mgmt. Port. (BNA) (2018)

[3] For a more detailed discussion of the tax considerations applicable to a risk retention structures, see Jason Schwartz et al., The Taxation of Risk Retention Structures, 15 J. Tax'n Fin. Products (2018), forthcoming.

[4] See Structured Credit Investor, "Risk Retention Capital Largely Deployed?" (Oct. 3, 2017) (responses to a JPMorgan survey of market participants regarding how much risk retention capital financing had been raised in the U.S. CLO market ranged from $1 billion to $500 billion, with a mean response of $13.5 billion and a median response of $10 billion), available at http://www.structuredcreditinvestor.com (login required).

[5] The Loan Syndications & Trading Ass'n v. SEC, No. 17-5004, 2018 WL 798290 (D.C. Cir. Feb. 9, 2018).

[6] As an alternative to the CMV structure, some collateral managers have set up an MOA that, itself, is the named collateral manager. (Practitioners sometimes refer to such collateral-manager MOAs as "C-MOAs.") The C-MOA can satisfy the European risk retention rules because it is the named collateral manager, is the retaining entity, and qualifies as an originator. For simplicity, the remainder of this article discusses CMVs. However, much of this discussion applies equally to C-MOAs.

We note that the European risk retention rules have changed with effect from Jan. 1, 2019. The changes will impose additional diligence and disclosure requirements on collateral managers, and may permit certain U.S. collateral managers to be eligible to act as sponsors without acting as originators.

[7] U.S. tax advisers are concerned that any profits in respect of the "origination" activities could be treated as U.S.-source "services" income, which attracts U.S. tax. Accordingly, if there is any possibility that the CMV will earn profits with respect to its origination activities, then these profits are allocated (both economically and for U.S. tax purposes) entirely to a Delaware "blocker" entity that is treated as a corporation for U.S. tax purposes and pays U.S. corporate-level tax on the profits. Because the CMV usually earns no material amount of profits with respect to origination activities, the remainder of this article does not discuss origination activities.

[8] Typically, this reduction comes from the subordinated management fees.