JONES DAY

APRIL 2014

COMMENTARY

High Yield Debt: Credit Bubble and Litigation Risks

The past few years have seen a surge of high yield debt ("HYD") issuances. By some accounts, issuers sold more than $400 billion in HYD in 2012 and more than $500 billion in 2013, and the HYD markets are off to a healthy start in 2014.[1] With yields on U.S. Treasuries, money market funds, and other investments depressed as a result of unprecedented monetary policy in the U.S. and EU, demand for HYD products continues to rise, fueled by yield-seeking investors.[2] This increased demand has caused HYD bond prices to rise and yields to fall.[3]

As investment in HYD booms and the yield spreads over Treasuries shrink, some believe that the next credit bubble is growing and about to pop.[4] If the bubble bursts, investor losses, governmental investigations, and litigation are sure to follow. This *Commentary* identifies potential litigation risks for those institutions engaged in the issuance and placement of HYD products and discusses several measures institutions can implement now to address exposure to those potential litigation risks.

High Yield Debt: The Basics

High yield bonds—sometimes referred to as "junk bonds"—are characterized by below-investment-grade credit ratings and therefore a greater risk of default than higher rated issuances.[5] To compensate investors for this increased risk, issuers of HYD typically pay interest rates higher than those of more stable and higher rated investments such as money market funds or U.S. Treasuries. HYD was used widely in the 1980s by issuers seeking to fund hostile takeovers, enable large acquisitions, or invest in new businesses. Today, HYD issuers are often corporations attempting to improve their balance sheets by replacing expensive existing debt with new high yield bonds issued on more favorable terms. Despite the risk associated with high yield bonds, investors have increasingly turned to high yield debt offerings in an attempt to secure meaningful return in a slow-growth, low-interest-rate economy still recovering from the financial crisis of 2008.[6]

High Yield Debt and the Asian Markets

In addition to U.S. high yield issuances, the Asian markets, including emerging markets in Southeast Asia, have seen a surge in HYD offerings. In 2013, 60 percent of Asian debt market growth originated from the high yield sector, including a considerable rise in offerings in China (fueled by, among others, Chinese real estate developers), India, and Southeast Asia. Issuers in Indonesia and the Philippines also tapped the market

© 2014 Jones Day. All rights reserved. Printed in the U.S.A.

beginning in the middle of last year.[7] Indian HYD issuers made record offerings in 2013, including, for example, a $1.2 billion offering by an Indian natural resources and mining company, for which U.S. investors purchased more than 50 percent of bonds.[8] Major U.S. investors reported seeing value in Asian HYD offerings in 2013 despite record high bond prices.[9]

Investor appetite for Asian HYD did not taper off in 2013, despite increased offerings from the more challenging emerging markets such as Indonesia and the Philippines, and despite offerings with complex structures that could contain higher risks.[10] Analysts have been warning for months that the growing high yield bubble could extend to the Asian market, citing increasingly lower-rated issuances and growing capital inflows, but such fears have not yet materialized.[11]

High Yield Debt and the Return of Structured Products

The reemergence of complex structured products designed to leverage exposure to high yield debt, such as collateralized debt obligations ("CDOs") and collateralized loan obligations ("CLOs"), suggests that investors have exhausted the favorable returns traditionally available through so-called "plain vanilla" high yield debt instruments and are now turning to more highly leveraged complex products to search for yield.[12] In 2012, global CDO sales surged fourfold to approximately $55 billion, and jumped up again to $87 billion in 2013, with 26 percent of those global sales occurring in the fourth quarter.[13] Approximately $23 billion of the $87 billion in CDO issuances in 2013 were backed by high yield loans.[14]

The Possibility of a High Yield Debt Bubble?

The increased flow of cash into the HYD market has begun to drive down the spread between interest rates and high yield issuances, causing some to speculate that a credit bubble may be forming in U.S., global, and emerging markets.[15] As early as February 2013, analysts and media commentators warned of investment red flags indicating a growing HYD bubble. These red flags include: (i) increasing bond prices paired with lowering yield; (ii) increased merger and acquisition activity; (iii) the high proportion (more than 15 percent) of distressed credits that comprised the U.S. high yield market; and (iv) the increasing use of structured products such as CLOs in the high yield debt market.[16] Other commentators have pointed to the rising price of high yield credit default swaps as foreshadowing looming losses for the holders of high yield debt.[17]

Following another year of strong HYD performance in 2013, analysts continue to warn that the HYD bubble is growing.[18] These analysts cite a deceptive influx of central bank money, a current average yield of 5.1 percent (down from 5.8 percent in 2013), a record high issuance of $15.3 billion in triple C rated bonds in 2013 (surpassing even the pre-crisis levels of 2007), and an increase in so-called "covenant lite" loans and payment-in-kind notes as signs that a global HYD credit bubble continues to swell and may yet burst, causing substantial losses to investors in the U.S. and abroad.[19]

Analysts have also recently warned of a so-called "mirage of liquidity" created by the massive influx of investment in emerging markets, warning that many investors mistakenly believe that selling high yield bonds issued by emerging market companies will be as easy as purchasing them.[20] In late 2013, the Treasury Department's Office of Financial Research released a report stating that asset managers, in attempts to "reach for yield," have begun to "herd" into popular asset classes, such as high yield bonds.[21] The report warns that this practice may increase prices, magnify market volatility, and cause financial distress should the market "face a sudden shock."[22] In the words of one analyst, "junk is getting junkier," and the current "dash for trash" may soon be followed by a corresponding dash to exit the asset class, causing major losses to investors stuck holding the depreciating bonds.[23] Indeed, in the first four months of 2014, the market has seen a $700 million uptick over the same period last year in the issuance of HYD bonds, providing issuers the ability to pay investors in additional debt rather than in cash.[24] Raising further concerns, Standard & Poor's recently estimated that corporate default rates, while still currently enjoying record lows, will rise from 1.7 percent in March 2014 to approximately 2.5 percent by year-end.[25] Meanwhile, hundreds of billions of dollars in debt is scheduled to start coming due in 2016, and if interest rates rise, corporate default rates spike, and/or investor demand for HYD declines in the interim, the ability of weaker issuers to refinance this maturing debt may be compromised, adding further complexity and uncertainty to the near future of the high yield market.[26]

The Fed and Quantitative Easing

The end of the Federal Reserve Bank's quantitative easing could also lead to significant losses for investors in the high yield debt market. The Fed has promised that it would keep interest rates near zero until the unemployment rate reached 6.5 percent.[27] However, in late March 2014, Federal Reserve Chairwoman Janet Yellen indicated that the Fed may raise interest rates as early as the second quarter of 2015, approximately six months after the end of the Fed's bond-buying program, which is expected to terminate in the fall of 2014.[28] In the immediate wake of this announcement, futures markets assigned a 52 percent likelihood that interest rate hikes will commence in April 2015, up nearly 20 percent from the probability assigned a month prior to Yellen's comments.[29] Similarly, in June 2013, following the Fed's first announcement regarding its decision to taper its bond-buying program, anxiety about a slowdown in the program and an increase in interest rates resulted in a record $4.63 billion one-week outflow from high yield debt funds and a steep decline in the amount of high yield debt offerings.[30] Although the Federal Reserve has attempted to assuage investors' fears, the Fed's quantitative easing taper is considered to be at least partly responsible for the 2013 decline in the Indian capital markets, as the Indian rupee depreciated by 17 percent during the months following the Fed's announcement.[31]

What Lies Ahead: Potential High Yield Debt Litigation Risks

In 2013, the Financial Industry Regulatory Authority ("FINRA") identified high yield debt instruments as one of the key investor-protection and market-integrity issues of the near future.[32] In its annual investor protection report, high yield bonds were identified by FINRA as one of a class of assets potentially unsuitable and otherwise problematic for retail investors.[33] The classification was due, in part, to FINRA's concern regarding the potential for abuse in the sale of high yield debt products, including failures by financial firms to adequately explain the risk-versus-return profile of such products to their customers.[34]

Such concerns ring the same note as the claims asserted against financial institutions by disgruntled subprime mortgage investors in courts across the country during the course of the past five years. Indeed, the market trend away from plain vanilla instruments toward complex structured products, including not just cash CLOs and CDOs, but so-called "hybrid" and "synthetic" CLOs and CDOs as well, which gain credit exposure through complex credit derivatives, recalls the financial environment in the days leading up to the financial crisis of 2008.[35]

If corporate default rates rise and the high yield bubble identified by some commentators does indeed burst, investors likely will suffer losses. As a result, financial institutions and issuers active in the high yield market may face a new wave of claims similar to those brought by investors who lost money following the bursting of the subprime mortgage bubble six years ago. As illustrated by the litigation arising from losses sustained during the subprime crisis, even sophisticated investors claim after the fact to have misunderstood or misapprehended the risk–reward profile and financial mechanics of complex structured products. Whatever the particular nature of the structured product investment vehicle, it is all but certain that the next wave of claims could include allegations that the issuers and underwriters of high yield debt products had superior knowledge regarding the risks associated with the products and failed to share such knowledge with investors, or that these sell-side parties breached duties and obligations set forth in the transaction's governing documents. In any event, with interest rates destined to rise over the next few years, and with hundreds of billions of dollars of debt scheduled to come due starting in 2016, high yield debt is an area that should be closely monitored.

Protective Measures: Lessons Learned from the Subprime Crisis

One critical lesson that emerged from the subprime crisis is that the transactions that can be most problematic from a litigation perspective tend to occur in the late stages of bubble formation, when stellar performance of a particular asset class has raised demand for that asset while at the same time depleting supply. Under these market conditions, securities of deteriorating credit quality may be purchased by yield-hungry investors who fail to appreciate the long-term implications of changing risk profiles. At the same time, rating agencies may affix ratings that do not accurately reflect true credit quality in a maturing product and evolving market.

While there is nothing any one financial institution can do to correct large-scale market failures or redirect the trend of the HYD market, there are several measures institutions can implement now to minimize exposure to the litigation risks discussed above.

First, each institution—whether an issuer or an underwriter—should continue to invest resources in due diligence on issuers of all varieties, including both U.S. corporations and lesser known companies operating in more opaque emerging markets. This due diligence should aim to confirm that credit ratings accurately reflect an organization's own evaluation of risk while at the same time identifying any potential issues or problems with the issuer's business operations or balance sheet. Such measures will protect the integrity of the offering and ensure that there are no surprises revealed if a particular issuer defaults on its obligation or reports unexpected business developments or earning trends in the period shortly after issuance.

Second, placing/underwriting institutions should carefully review their sales practices, including the types and extent of disclosures made to customers. Judicial opinions from the subprime crisis instruct that such disclosures must be particularized and specific to the transaction at issue, rather than mere boilerplate generalizations or wholesale disclaimers of reliance. These specific disclosures should also be scrutinized in order to ensure that all material information has been shared with investors. Institutions should be particularly diligent in providing full disclosures where covenant packages are materially looser than current market practice. In light of the various bubble indicators and red flags discussed above, dealers, issuers, and investment banks distributing HYD and HYD-linked structured products should be especially diligent when navigating the landscape of today's market, where high demand has driven yield to historically low levels that may not fully and accurately reflect the associated risks.

Finally, institutions should ensure that their client-facing personnel take an informed and coordinated approach to handling customer accounts, orders, and inquiries, especially as the market turns and the bubble deflates or pops. In the early stages of the subprime crisis, institutions scrambled to manage failed transactions, identify contractual rights and obligations, and stem the flow of massive losses. More than six years later, these institutions continue to struggle with the fallout of the crisis, as litigation claims continue to pile up and government investigations lead to enforcement actions and costly settlements. Many of these lawsuits and investigations are buttressed by ill-advised statements unwittingly made by personnel of those institutions in the initial stages of the market downturn.

Simply put, after the market has moved is not the time to implement new practices or enhance current practices and procedures—issuers, underwriters, dealers, and others participating in the HYD market should learn from the past and ensure that adequate systems and processes are in place to respond appropriately and effectively to the anticipated developments in this market. All lines of communication between the front, middle, and back offices, and compliance/legal functions, should remain not only open, but in regular use. In addition, institutions should engage and involve counsel during the earliest stages of any downward turn in the market to analyze exposure on particular transactions and to evaluate potential claims on an aggregate basis. Counsel can also guide and advise businesses on internal communications as well as communication with customers and business affiliates. Institutions should consider current practices carefully, anticipating how events occurring in the ordinary course of business now may be viewed years later through the lens of potential future litigation.

While market participants can never completely insulate themselves from the effects of a market failure, those institutions that plan ahead and install the appropriate safeguards now may minimize exposure to litigation and clear the path toward recovery and renewed business growth.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Jayant W. Tambe
New York
+1.212.326.3604
jtambe@jonesday.com

Howard F. Sidman
New York
+1.212.326.3418
hfsidman@jonesday.com

J. Eric Maki
New York
+1.212.326.3780
emaki@jonesday.com

Scott J. Greenberg
New York
+1.212.326.3830
sgreenberg@jonesday.com

Michael Thayer, an associate in the New York Office, assisted in the preparation of this Commentary.

Endnotes

1 Chien Mi Wong, *Finance Asia*, "Bankers cash in on high yield bonds," Jan. 13, 2014; Tim Cross, *Forbes*, "High Yield Bond Issuance Starts Off 2014 with $6B Week," Jan. 10, 2014; Katy Burne, *The Wall Street Journal*, "Bond Investors Break Pattern, Dump Junk Bonds," May 31, 2013; Floyd Norris, *The New York Times*, "Junk Bonds Get Junkier, but Still Sell Briskly," Apr. 5, 2013.

2 Al Yoon and Katy Burne, *The Wall Street Journal*, "Investors Clamor for Risky Debt Offerings," Apr. 2, 2014; Tracy Alloway and Vivianne Rodrigues, *Financial Times*, "Strong demand for 'junk' bonds erodes investor protection," Mar. 12, 2014; Antonia Oprita, emergingmarkets.org, "US High yield bonds heading for bubble territory: indicator," Feb. 28, 2013.

3 Michael Aneiro, *Barron's*, "Indomitable Junk Bonds Already Up 0.8% In 2014," Jan. 15, 2014.

4 Al Yoon and Katy Burne, *The Wall Street Journal*, "Investors Clamor for Risky Debt Offerings," Apr. 2, 2014; Tracy Alloway and Michael Mackenzie, *Financial Times*, "2014 outlook: Sugar high," Jan. 1, 2014; Floyd Norris, *The New York Times*, "Junk Bonds Get Junkier, but Still Sell Briskly," Apr. 5, 2013.

5 High yield, high-risk bonds are rated below Baa3 by Moody's Investors Service and lower than BBB by Standard & Poor's.

6 FINRA Regulatory and Examination Priorities, Jan. 11, 2013, *available at* www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p197649.pdf.

7 Chien Mi Wong, *Finance Asia*, "Bankers cash in on high yield bonds," Jan. 13, 2014; Josh Noble, *Financial Times*, "Yield hunt boosts Asian junk debt," April 14, 2013; Chris Wright, emergingmarkets.org, "Asia debt issuance to hit record," Mar. 5, 2013; IDN Financials, "BHIT completes US$365 million senior notes offering," May 20, 2013.

8 Neha D'silva, *International Financing Review*, "Vedanta beats its own record," May 25, 2013.

9 Lisa Abramowicz, *Bloomberg News*, "BlackRock Seeing Value in Asian Junk-Bond Market, Rieder Says," May 28, 2013.

10 Josh Noble, *Financial Times*, "Yield hunt boosts Asian junk debt," Apr. 14, 2013.

11 Chien Mi Wong, *Finance Asia*, "Bankers cash in on high yield bonds," Jan. 13, 2014; Chris Wright, emergingmarkets.org, "Fear of bubble in EM market grows," Apr. 5, 2013.

12 Antonia Oprita, emergingmarkets.org, "US High yield bonds heading for bubble territory: indicator," Feb. 28, 2013; Christine Idzelis, *Bloomberg*, "Milken Protege Goodman Chases European Loans at Blackstone," Jan. 8, 2013; Mary Childs, *Bloomberg*, Synthetic CDOs Making Comeback as Yields Juiced, Mar. 20, 2013.

13 Global CDO Issuance and Outstanding (xls)—quarterly data from 2000 to Q3 2014 (issuance), 1990—Q4 2013 (outstanding), *available at* www.sifma.org/research/statistics.aspx.

14 *Id.*

15 Vivianne Rodrigues, Michael Mackenzie, *Financial Times*, "Junk Bond Rally Approaches End of Line," Mar. 4, 2014; Thomas Landon, Jr., *The New York Times*, "Global Bond Frenzy Raises Concerns," Feb. 19, 2014; Chien Mi Wong, *Finance Asia*, "Bankers cash in on high yield bonds," Jan. 13, 2014; Tracy Alloway and Michael Mackenzie, *Financial Times*, "2014 outlook: Sugar high," Jan. 1, 2014; Chris Wright, emergingmarkets.org, "Fear of bubble in EM market grows," Apr. 5, 2013; Larry Swedroe, CBS News, "Is a Bubble Growing in Junk Bonds?", Apr. 3, 2013.

16 Antonia Oprita, emergingmarkets.org, "US High yield bonds heading for bubble territory: indicator," Feb. 28, 2013; Michael Aneiro, *Barron's*, "RBS: Junk-Bond Bubble, Great Rotation Exist—But Only In U.S.," Mar. 1, 2013.

17 Vivianne Rodrigues, *Financial Times*, "Investors sell off high-risk Bonds," Feb. 26, 2013.

18 Al Yoon and Katy Burne, *The Wall Street Journal*, "Investors Clamor for Risky Debt Offerings," Apr. 2, 2014; Tracy Alloway and Michael Mackenzie, *Financial Times*, "2014 outlook: Sugar high," Jan. 1, 2014.

19 Vivianne Rodrigues, Michael Mackenzie, *Financial Times,* "Junk Bond Rally Approaches End of Line," Mar. 4, 2014; Tracy Alloway and Michael Mackenzie, *Financial Times*, "2014 outlook: Sugar high," Jan. 1, 2014.

20 Thomas Landon, Jr., *The New York Times*, "Global Bond Frenzy Raises Concerns," Feb. 19, 2014.

21 Office of Financial Research, Asset Management and Financial Stability, Sep. 2013, *available at* www.treasury.gov/initiatives/ofr/research/Documents/OFR__AMFS__FINAL.pdf.

22 *Id.*

23 Vivianne Rodrigues, Michael Mackenzie, *Financial Times*, "Junk Bond Rally Approaches End of Line," Mar. 4, 2014.

24 Al Yoon and Katy Burne, *The Wall Street Journal*, "Investors Clamor for Risky Debt Offerings," Apr. 2, 2014.

25 Vivianne Rodrigues, Michael Mackenzie, *Financial Times*, "Junk Bond Rally Approaches End of Line," Mar. 4, 2014.

26 Mike Cherney, *The Wall Street Journal,* "Mergers Could Clog Flow of Junk Bonds," Jan. 23, 2014.

27 John Hilsenrath, *The Wall Street Journal*, "Analysis: Fed Likely to Push Back on Market Expectations of Rate Increase," June 13, 2013.

28 Jon Hilsenrath and Victoria McGrane, *The Wall Street Journal*, "Yellen Debut Rattles Markets," Mar. 19, 2014.

29 Richard Leong, Reuters, "How to Play It—Yellen surprise suggests investors should go on defense," Mar. 23, 2014.

30 John Hilsenrath, *The Wall Street Journal*, "Analysis: Fed Likely to Push Back on Market Expectations of Rate Increase," June 13, 2013; Vivianne Rodrigues and Stephen Foley, *Financial Times*, "Bond sales dry up as interest rates rise," June 13, 2013; Michael Mackenzie and Stephen Foley, *Financial Times*, "Record outflows from US junk bond funds," June 6, 2013.

31 C.W., *The Economist*, "The taper disaster that wasn't," Jan. 15, 2014.

32 FINRA Regulatory and Examination Priorities, Jan. 11, 2013, *available at* www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p197649.pdf.

33 *Id.*

34 *Id.*

35 Approximately $23 billion of the $87 billion in CDO issuances in 2013 were backed by high yield loans, and the growing issuance of structured products that leverage high yield debt sets the stage for a new wave of investor, regulator, and bond insurer lawsuits should U.S. Treasuries and corporate default rates rise and investors suffer substantial losses. *See* Global CDO Issuance and Outstanding (xls)—quarterly data from 2000 to Q3 2014 (issuance), 1990—Q4 2013 (outstanding), *available at* www.sifma.org/research/statistics.aspx; *see also* Mary Childs, *Bloomberg*, "Synthetic CDOs Making Comeback as Yields Juiced, *Bloomberg*," Mar. 20, 2013; Larry Swedroe, CBS News, "Is a Bubble Growing in Junk Bonds?", Apr. 3, 2013.

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our website at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.