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CDO Holders at Risk: New Jersey Bankruptcy Court Declines to Dismiss CDO Issuer's Involuntary Chapter 11 Case

The United States Bankruptcy Court for the District of New Jersey, in *In re Zais Investment Grade Ltd. VII*,[1] recently jolted the structured finance community by declining to dismiss an involuntary chapter 11 case commenced against a Cayman-based collateralized debt obligation ("CDO") issuer. The ruling, which is currently on appeal,[2] broke new ground by permitting the debtor's senior noteholders to use chapter 11 as a means of avoiding express provisions in the indenture that otherwise required each tranche of senior noteholder debt to approve any liquidation of the issuer's assets by a supermajority vote. It is important that participants in the structured finance markets take account of the possible ramifications of the decision in evaluating their current CDO exposure and in structuring finance vehicles in the future.

Background

In 2005, Zais Investment Grade Limited VII (the "Debtor" or "ZING VII"), a special purpose entity formed under the law of the Cayman Islands, issued various tranches of senior notes aggregating $365.5 million. The Debtor used the proceeds to acquire securities consisting of a portfolio of CDOs, including residential and commercial mortgage-backed securities and asset-backed securities. It then pledged those CDO securities as collateral for its obligations to the senior noteholders, thereby creating a structure commonly known as a "CDO Squared." A trustee and a collateral manager were appointed under the indenture. The trustee was a US bank that held the assets in trust in the United States. The collateral manager was based in New Jersey. The Debtor also issued $40 million of unsecured "income notes" that were treated as equity under the terms of the indenture.

[1] *In re Zais Inv. Grade Ltd. VII*, No. 11-20243 (RTL), 2011 WL 3795169 (Bankr. D. N.J. Aug. 26, 2011).

[2] *Babson Capital Mgm't. v. Zais Inv. Grade Ltd. VII*, case no. 11-05516 (D.N.J. 2011). On October 4, 2011, the district court denied appellants' motion for expedited treatment of the appeal.

In March 2009, a covenant default occurred under the indenture. The indenture trustee became obligated under the terms of the indenture to hold the collateral securities intact and was prohibited from disposing of the collateral unless (a) directed to do so by the holders of 66.66% of the outstanding amount of each tranche of notes (excluding the income notes), or (b) the indenture trustee determined, with the consent of certain noteholders, that the value of the collateral was sufficient to pay all tranches of notes in full.[3]

Certain holders of the most senior notes (*i.e.*, Class A-1 notes) who had acquired their notes post-default (the "Petitioning Noteholders") believed that the portfolio needed to be actively managed in order to maximize its value, but they were unable to satisfy either of the foregoing two conditions for disposition of the collateral. As a result, to effectuate this strategy, the Petitioning Noteholders filed an involuntary chapter 11 petition against the Debtor on April 1, 2011. The Debtor did not oppose the petition, and an order for relief was entered by the bankruptcy court on April 26, 2011. The Debtor's schedules listed as assets only a Cayman Islands bank account containing $500 and debt obligations held by the indenture trustee. The indenture trustee submitted a declaration attesting that certificated securities were held in a vault in New York City and uncertificated securities were registered with Depository Trust Company in New York City and Euroclear in Brussels. The indenture trustee also held millions of dollars in cash in a US bank account.

Following the Debtor's agreement to terminate its exclusive periods under section 1121 of the Bankruptcy Code for filing a plan of reorganization and soliciting votes on the plan, the Petitioning Noteholders filed a plan of reorganization and a disclosure statement. The plan was supported by 95% of the noteholders in Class A-1, as determined by votes cast prior to the filing of the involuntary petition.[4] The plan provided that the collateral securities would be transferred to one of the Petitioning Noteholders for management and liquidation, with the proceeds to be distributed to the holders of Class A-1 notes and certain other priority creditors.

Hildene Capital Management and Hildene Opportunities Master Fund, Ltd. (collectively, "Hildene"), holders of junior notes that were purchased on the eve of the entry of the order for relief, moved for dismissal of the chapter 11 case or alternatively for abstention. Hildene made two principal arguments with regard to dismissal. First, it argued that the Debtor was not eligible to be a debtor under the Bankruptcy Code because it had no place of business or property in the United States. Second, it argued that the Petitioning Noteholders were not qualified petitioning creditors because their debt was nonrecourse and therefore they were secured creditors. With regard to abstention, it argued that the interests of creditors would be better served if the bankruptcy court would abstain from exercising jurisdiction and dismiss the case.

[3] Motion of Hildene Capital Management and Hildene Opportunities Master Fund Ltd. to Dismiss Chapter 11 Case Pursuant to 11 U.S.C.§§ 305 and 1112, or, in the Alternative, Abstain Pursuant to 11 U.S.C. § 305 [Docket No. 46] ("Motion") at 8.

[4] Although the voting results were disputed, that issue was not before the court.

The Bankruptcy Court's Decision

As discussed below, the bankruptcy court denied the motion to dismiss or abstain in its entirety.

A. ZING VII'S Eligibility to Be a Debtor in the United States

The court began its analysis by reviewing section 109(a) of the Bankruptcy Code, which provides that a debtor under chapter 11 must be "a person that resides or has a domicile, a place of business, or property in the United States."[5] Since the Debtor was a Cayman Islands company, it did not reside in or have a domicile in the United States. Thus, the focus of the court's decision with respect to the eligibility requirement was whether the Debtor had a place of business or property in the United States.

(1) Place of Business

The court relied in part on *In re Paper I Partners, L.P.*, a decision from the United States Bankruptcy Court for the Southern District of New York, which made clear that "'[a] person has a place of business in the United States if such person conducts business in the United States or business is conducted in the United States on the person's behalf.'"[6] Thus, passive business operations may suffice. The court in *Zais* found that section 109(a) of the Bankruptcy Code only requires that the debtor have "a" place of business in the US, so it does not have to be a "principal" place of business.[7]

The bankruptcy court concluded that although the Debtor maintained a registered office in the Cayman Islands, it conducted most of its business in the US because its primary operations consisted of the services provided by the collateral manager, collateral administrator and indenture trustee in the US. The court noted that without those services, "the Debtor would not be able to operate."[8]

(2) Property

The court also found that the Debtor also satisfied the bankruptcy eligibility requirements under section 109(a) because virtually all of its property was located in the US, *i.e.*, collateral securities either physically located or registered in New York and cash collateral accounts maintained in a US bank.

B. Qualification of the Petitioning Noteholders

Section 303(b) of the Bankruptcy Code only permits unsecured or undersecured creditors to be petitioners in an involuntary bankruptcy case.[9] Since the notes held by the Petitioning Noteholders were non-recourse, Hildene argued that the Petitioning Noteholders could not qualify as petitioners in an involuntary bankruptcy case because they were secured

[5] 11 U.S.C. § 109(a).

[6] *Zais*, 2011 WL 3795169, at *3 (quoting *In re Paper I Partners*, 283 B.R. 661, 672 (Bankr. S.D.N.Y. 2002)).

[7] *Id.*

[8] *Id.*

[9] 11 U.S.C. § 303(b).

creditors. The court declined to determine whether the Petitioning Noteholders were qualified to file an involuntary petition. Rather, it held that Hildene was precluded from challenging the petitioner's qualifications because only an alleged debtor is authorized to do so, and here the Debtor did not oppose the involuntary petition.[10]

C. Avoidance of Indenture Restrictions Is Not Bad Faith

The court declined to abstain from exercising jurisdiction over the Debtor's bankruptcy case, finding it was "not realistic" to suggest another forum might be available to grant relief.[11] For purposes of the dismissal motion, the court rejected Hildene's contention that the Petitioning Noteholders were acting in bad faith because (a) it was improper to use bankruptcy to avoid the restrictions on collateral disposition contained in the indenture and (b) the proposed plan would not reorganize the Debtor. The court saw no reason why it should dismiss the case prior to the plan confirmation hearing, at which time Hildene could assert its objections. The court noted that "[l]iquidation is an appropriate purpose of a chapter 11 case."[12] Moreover, it observed that "classes of unsecured creditors and equity interests may be wiped out in a confirmed plan so long as it is fair and equitable; *i.e.*, no junior claim or interest receives anything."[13]

The court found that in order to abstain or dismiss under section 305 of the Bankruptcy Code, it was required to find that it is in the best interest of creditors and the debtor.[14] Since the Debtor took no position and had no economic stake, the matter boiled down to an inter-creditor dispute. The court ruled that Hildene failed to prove that it was in the best interest of creditors to abstain because the assets of the estate were not being managed outside of bankruptcy.

The court rejected Hildene's argument that bankruptcy should not be used to circumvent the express terms of an indenture that limit management of collateral securities. It observed that sections 365(a) and 1123(b)(2) of the Bankruptcy Code permit the rejection of an executory contract, and thus provide an indication "that there are circumstances justifying overriding a burdensome contract."[15] Additionally, section 1123(b)(1) of the Bankruptcy Code expressly provides that a plan may impair claims or interests, as was being proposed in the plan filed by the Petitioning Noteholders.

Finally, the court rejected Hildene's assertion that the indenture was a subordination agreement that must be enforced under section 510(a) of the Bankruptcy Code, which provides that a subordination agreement is enforceable in bankruptcy to the same extent it is enforceable under applicable non-bankruptcy law.[16] In support of this determination, the court observed that "section 1129(b)(1) permits confirmation of a plan 'notwithstanding section 510(a).'"[17] The court further reasoned that the provision in the indenture that prohibits the indenture trustee and junior noteholders from filing an involuntary petition

[10] *Zais*, 2011 WL 3795169, at *5. The issue of who may contest an involuntary petition is not entirely clear. While it is true that, under section 303(d) of the Bankruptcy Code, only a debtor (or a general partner in a partnership debtor) may file an "answer" to an involuntary petition, section 303(h) provides that "[i]f the petition is not timely controverted, the court shall order relief against the debtor in an involuntary case . . . ." Since this section uses the word "controverted" rather than "answered" (to mirror section 303(b)), it is arguable whether parties other than the debtor may "controvert" or challenge an involuntary petition.

[11] *Id*. at *6.

[12] *Id*.

[13] *Id*.

[14] *Id*.

[15] *Id*. at *7

[16] 11 U.S.C. § 510(a).

[17] *Zais*, 2011 WL 3795169, at *8.

was for the benefit of the senior noteholders in Class A-1, not a limit on the senior noteholders' right to file a petition. The court concluded that the Petitioning Noteholders had "shown good faith in their desire to realize the greatest present value of the Collateral Securities for the benefit of the Class A-1 creditors without negatively impacting junior creditors who have no prospect of recovery under the status quo."[18]

Discussion

The facts of *Zais* are not dissimilar to those found with regard to many offshore CDO issuers and other special purpose entities that are specifically designed to minimize any risk of a bankruptcy filing. Indeed, the essential managerial and administrative functions for such entities are commonly performed by US-based institutions. According to *Zais*, this affords a basis for finding that such entities qualify as debtors under the US Bankruptcy Code because they can be deemed to have a place of business in the US. Similarly, it is common for such entities' pledged collateral to be held or registered in the US, which provides a further basis for finding that such entities qualify as debtors under the US Bankruptcy Code. Therefore, participants in the structured finance arena need to be aware of the potential implications of the *Zais* decision. To the extent that the decision is followed in other contexts, senior noteholders may be able to force special purpose entities into involuntary bankruptcy in the US notwithstanding express restrictions on collateral disposition contained in their indenture.

Among the more notable determinations in *Zais* was that it is not *per se* improper for a senior noteholder to use involuntary bankruptcy as a means of avoiding restrictions in an indenture with regard to collateral disposition. This is significant because such restrictions are specifically designed to protect the interests of junior noteholders. It seems, however, that structured finance vehicles that were intended to be bankruptcy-remote are increasingly turning out not to be bankruptcy proof.[19] Moreover, the impact of the court's ruling may also extend to debt issuances that do not involve special purpose entities. For example, holders of notes issued by a normal operating company may seek to file an involuntary petition against the debtor if they cannot garner the requisite supermajority support for modifying restrictions on collateral disposition imposed by the notes indenture.

The court's analogy to rejecting burdensome executory contracts seems highly questionable because there is nothing in the decision to suggest that the indenture was burdensome to the *Debtor's estate* (as opposed to being inconsistent with the best interests of the senior noteholders). It will be interesting to see whether, and to what extent, other courts will follow the rationale of *Zais* on this issue.

Zais likely will provide impetus for senior noteholders of other CDO issuers and similar special purpose entities to attempt to use involuntary bankruptcy as a means of liquidating their collateral. Junior noteholders will be required to assess the economic impact of such a tactic in any given case and whether they should take steps to reduce those risks.

It is possible that the risks faced by junior noteholders as a result of the *Zais* decision can be avoided by drafting the indenture more tightly. For example, the court in *Zais* noted that although the indenture prohibited junior noteholders from instituting an insolvency proceeding against the Debtor before senior noteholders were paid in full, there was no similar restriction on the senior noteholders. The court interpreted that to mean that the provision prohibiting a bankruptcy filing

[18] *Id.*

[19] For example, in connection with the chapter 11 cases of General Growth Properties, Inc. and its affiliates, a number of voluntary chapter 11 petitions were filed on behalf of special purpose entities. *In re General Growth Properties, Inc., et al.*, Case No. 09-11977 (Bankr. S.D.N.Y.).

was solely for the benefit of the senior noteholders and did not serve to restrict their ability to file an involuntary petition. If the provision had been drafted to indicate that senior noteholders were expressly precluded from filing an involuntary bankruptcy petition and that such provision was being included for the benefit of the junior noteholders, the court might have reached a different conclusion. It is also possible that drafting in this manner would cause other courts in future cases to enforce the restriction for the benefit of the junior noteholders.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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