INVOLUNTARY CHAPTER 11 CASE FILED AGAINST CAYMAN "CDO SQUARED" ISSUER SURVIVES MOTION TO DISMISS

In a recent opinion with potentially far-reaching implications for holders of collateralized debt obligations ("CDOs"), the United States Bankruptcy Court for the District of New Jersey denied a junior noteholder's motion to dismiss an involuntary chapter 11 case commenced against a Cayman CDO issuer. The decision, *In re Zais Investment Grade Ltd. VII*,[1] sets new precedent for an offshore CDO issuer's senior noteholders to use a chapter 11 proceeding to seek liquidation of the issuer's assets, despite specific provisions in the indenture that otherwise require supermajority consent of every tranche prior to any such liquidation. Investors in CDOs, collateral managers and other market participants should consider the potential significance of *Zais* for their existing and future interests in CDOs and other similar structured product investments.

The Facts

The debtor, Zais Investment Grade Limited VII ("ZING VII"), a special-purpose entity formed under Cayman Islands law, issued eight tranches of senior notes ("Notes") pursuant to a 2005 indenture.[2] As collateral for the Notes, ZING VII pledged a portfolio of residential and commercial mortgage-backed securities, asset-backed securities, and other CDOs.[3] A collateral manager located in New Jersey was appointed to manage the collateral portfolio subject to the terms of the indenture.[4]

A covenant default (but not a payment default) under the indenture occurred in March 2009.[5] The indenture provided that after an event of default, the trustee was required to hold the collateral securities intact and could only dispose of collateral under either of two conditions: (i) upon a determination by the trustee, with the consent of the controlling class of Notes, that the collateral had sufficient value to pay all tranches of Notes in full or (ii) upon a direction by the holders of 66.66% of the outstanding amount of each tranche of Notes.[6]

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

2 Id. at *1; see also 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 5.

3 Id.

4 Id. at * 3.

5 Id. at *2.

6 Motion at 8.

On April 1, 2011, a group of funds holding super-senior (Class A-1) Notes (the "Petitioning Noteholders") filed an involuntary chapter 11 petition against ZING VII.[7] ZING VII did not contest the petition, and it consented to the termination of its exclusive periods under the Bankruptcy Code for filing and soliciting a plan of reorganization. The Petitioning Noteholders filed a plan supported by 95% of the A-1 Noteholders.[8] The proposed plan provided for the orderly liquidation of the collateral and distribution of proceeds to the holders of A-1 Notes and certain other priority creditors (including hedge counterparties).[9]

Hildene Capital Management and Hildene Opportunities Master Fund, Ltd. (collectively, the "Movant"), which purchased junior notes shortly after the bankruptcy filing, moved for dismissal of the chapter 11 case, arguing that: (i) ZING VII was not eligible to be a debtor under the Bankruptcy Code because it had no place of business or property in the United States, (ii) the Petitioning Noteholders were not qualified petitioning creditors because their debt was non-recourse and (iii) the interests of creditors would be better served if the bankruptcy court would abstain from exercising jurisdiction and dismiss the case.[10]

The Decision

The bankruptcy court denied the motion to dismiss, rejecting all of the Movant's arguments.

Eligibility of Cayman CDO Issuer as U.S. Debtor

In finding that ZING VII met the requirements for eligibility under section 109 of the Bankruptcy Code, the court found that ZING VII had both a place of business and property in the U.S.[11] The court found instructive the "center of main interest" ("COMI") analysis applied in *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122 (Bankr. S.D.N.Y. 2007), *aff'd* 389 B.R. 325 (S.D.N.Y. 2008). In *Bear Stearns*, the court found that a Cayman Islands insolvency proceeding involving a group of Cayman investment funds was not a "foreign proceeding" for purposes of invoking chapter 15 of the Bankruptcy Code. There, the court found that since the Cayman investment funds at issue had no business operations in the Cayman Islands and their U.S.-based administrator and investment manager provided services in the U.S., the funds' COMI was not the Cayman Islands. Similarly, ZING VII maintained a registered office in Cayman but conducted most of its business in the U.S. through the New Jersey-based collateral manager and New York-based indenture trustee.[12] The court found that the business conducted through these parties established a place of business in the U.S. for purposes of ZING VII's eligibility to be a debtor under the Bankruptcy Code.

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7 Zais at *2.

8 Id. The Petitioning Noteholders solicited support for the Plan prior to the bankruptcy. Although Movant challenged the voting tabulation, that issue was not before the court for purposes of the motion to dismiss.

9 Id.

10 Id. at *3-*4.

11 Section 109(a) of the Bankruptcy Code 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."

12 Id. at *3.

The court also found that ZING VII's property located in the U.S., which included certificated collateral securities physically located in New York and cash collateral accounts with the New York indenture trustee, separately satisfied the eligibility requirement under section 109.[13]

The bankruptcy court declined to consider whether the Petitioning Noteholders were qualified to file an involuntary petition under the Bankruptcy Code.[14] Since only an alleged debtor can contest an involuntary petition (which ZING VII did not do), the bankruptcy court found that the Movant had no right to challenge the petitioners' qualifications.[15]

Use of Chapter 11 to Overturn Limitations of Indenture Does Not Constitute Bad Faith

The bankruptcy court refused to abstain from exercising jurisdiction over the bankruptcy case, finding it was "not realistic" to suggest another forum might be available to grant relief.[16] The Movant contended that the Petitioning Noteholders were using bankruptcy for an improper purpose (*i.e.*, to avoid express limitations on collateral liquidation contained in the indenture) and that the proposed plan would not "reorganize" ZING VII. The court found that these concerns, even if true, were not grounds for dismissal before a confirmation hearing.[17] The court noted that "liquidation is an appropriate purpose of a chapter 11 case" and that "classes of unsecured creditors and equity interests may be wiped out in a confirmed plan provided the plan is fair and equitable; *i.e.*, no junior claim or interest receives anything."[18]

The bankruptcy court also found that the Movant had failed to make a *prima facie* case of bad faith, specifically rejecting the Movant's contention that the Petitioning Noteholders were trying to gain an unfair advantage over other noteholders. The bankruptcy court observed that "[r]eceiving zero under the plan is no worse than getting nothing from a runoff collection of the Collateral Securities. If the court were to find [the Petitioning Noteholders'] valuations incorrect, and that some other tranches are in the money, then [the] plan cannot be confirmed."[19]

The court was unpersuaded by the Movant's argument that bankruptcy should not be used to circumvent the terms of an indenture. In that regard, the court pointed out that sections 365(a) and 1123(b)(2) of the Bankruptcy Code permit the rejection of an executory contract, "indicating that there are circumstances justifying overriding a burdensome contract."[20]

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13 Id. at *5.

14 An involuntary chapter 11 petition may be commenced by three (3) creditors holding claims that are not contingent and not subject to a bona fide dispute, so long as those claims aggregate at least $14,425 more than the value of the petitioning creditors' liens on the debtor's property. 11 U.S.C. § 303(b).

15 Id.

16 Id. at *6.

17 Id.

18 Id. (citing 11 U.S.C. 1129(b)(2)(B) and (C)).

19 Id. at *7.

20 Id.

The bankruptcy court rejected the Movant's assertion that the indenture was a subordination agreement that must be enforced pursuant to section 510(a) of the Bankruptcy Code, which gives effect to contractual subordination agreements. In doing so, the court noted that "one need only note that section 1129(b)(1) permits confirmation of a plan 'notwithstanding section 510(a)'" and that the non-petition clause in the indenture was for the benefit of the senior noteholders, not a limit on their right to file a petition.[21]

Based on all of these findings, the court held 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."[22]

The Movant has filed a notice of appeal.

Implications for Other CDOs and Similar Investments

Zais has significant implications for other CDOs and similar investment vehicles designed to limit their exposure to U.S. bankruptcy proceedings.

Perhaps most significantly, in ruling that ZING VII was eligible to be a debtor in an involuntary chapter 11 proceeding, the court in *Zais* relied on certain facts and circumstances that are common among many offshore CDOs and similar vehicles managed by U.S.-based managers.

First, even though ZING VII indisputably did not have a domicile or residence in the United States, the court emphasized that because "[t]he important functions of investing, collecting, disbursing, recordkeeping and communicating with noteholders [are] primarily done in the U.S.," ZING VII had a place of business in the United States for purposes of eligibility through the New York-based indenture trustee and the New Jersey-based collateral manager. The court's reasoning suggests that any offshore CDO issuer or similar vehicle that has a collateral manager, administrator or indenture trustee performing customary services in the United States could be eligible for chapter 11. The court's close comparison of ZING VII to the investment funds in *Bear Stearns* also raises questions concerning the extent to which ZING VII could be used to support involuntary chapter 11 proceedings against other offshore investment funds.

Furthermore, the court's finding that the CDO issuer's property interests in the United States were an independent basis for ZING VII's eligibility makes it clear that pledged collateral held in the United States (whether in a bank account, in a vault or registered through the DTC) could render an offshore CDO or similar entity susceptible to a voluntary or involuntary chapter 11 proceeding.

Zais is also noteworthy in its finding that a senior CDO noteholder's efforts to avoid limitations in an indenture designed to protect junior tranches from being wiped out in a liquidation is not *per se* improper. The court equated such restrictions to burdensome executory contracts that can

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21 Id. at *8.

22 Id.

be rejected in bankruptcy, noting that "[a]ny knowledgeable attorney opining on the enforceability of a contract will disclaim the effects of bankruptcy law."[23] It remains to be seen whether other courts will apply the court's reasoning in the context of other indentures, which often include similar restrictions.

The court's observations with respect to the indenture's non-petition clause are also significant. Although the junior noteholders under the *Zais* indenture were explicitly prohibited from instituting an insolvency proceeding against ZING VII before senior noteholders were paid in full, there was no analogous restriction on the most senior noteholders. The court construed that as an indication that the non-petition clause existed for the senior noteholders' benefit and was not a limitation on their right to file an involuntary petition.

In sum, the *Zais* decision stands as support for the filing of involuntary chapter 11 proceedings against offshore CDO issuers under some circumstances. Senior noteholders of defaulted or otherwise insolvent issuers may look to *Zais* as a roadmap for an alternative strategy to realize accelerated returns through liquidation of CDO collateral. Holders of junior notes or interests should consider how an involuntary bankruptcy could impact their positions and whether measures can be taken to avoid or reduce those risks.

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[23] Id. at 7.