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ZING VII—Implications for the Bankruptcy Remoteness of Special Purpose Entities

In re Zais Investment Grade Ltd. VII[1] is the latest in a recent line of bankruptcy cases challenging bedrock assumptions regarding securitization special purpose entities (SPEs) and bankruptcy considerations in securitization transactions.[2] *Zais* establishes precedent allowing a senior noteholder of a collateralized debt obligation (CDO) to place the CDO issuer in an involuntary chapter 11 bankruptcy in order to advance an asset management plan that would otherwise require supermajority approval of all noteholders (including all junior classes) under the related indenture. Investors should be aware of the implications of this decision for existing and future investments in CDOs and other asset-backed debt issued by SPE issuers. Particular attention must be paid to the non-petition provisions in operative deal documents.

Background

Zais Investment Grade Limited VII (ZING VII) is a cash flow CDO issuer formed in the Cayman Islands in 2005. In March 2009, a covenant default (for failure to maintain a certain debt coverage ratio) occurred under the related indenture, which in turn triggered an event of default and resulted in the declaration of the notes to be due and payable. Following such an event of default and acceleration of the notes, the indenture requires that the indenture trustee hold the CDO's assets passively to maturity. Any deviation from this, including disposition of any of the CDO's assets, is not permitted under the indenture except upon the direction of at least 66 2/3% of all noteholders.

According to publicly available investor communications regarding *Zais*, various subsidiaries of Anchorage Capital Group, LLC (Anchorage) purchased a majority of the class A-1 notes in October 2009 (i.e., after the covenant default). Anchorage has since advocated a plan of active management or orderly liquidation of the assets designed to accelerate payment of the class A-1 notes. It submitted its plan to a vote of the class A-1 noteholders and received two-thirds approval. However, as noted above, such a plan would require two-thirds approval of all noteholders. Deeming such approval unlikely, Anchorage asked ZING VII's directors to submit its plan via a voluntary chapter 11 petition. The directors declined to do so, and Anchorage filed an involuntary petition in April 2011.

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[1] No. 11-20243, 2011 WL 3795169 (Bankr. D. N.J. Aug. 26, 2011).

[2] In 2009, the *In re General Growth Properties Inc.* case established precedent for an insolvent debtor placing its solvent SPE subsidiaries into bankruptcy, and also found that an SPE's fiduciary duties run to its shareholders rather than its creditors. In the 2010 case *Paloian v. LaSalle Bank*, the Seventh Circuit Court of Appeals overturned the district court's finding of a true sale from a bankruptcy debtor to its subsidiary SPE. The appeals court declined to apply the long-standing parties' intent analysis in favor of a conduct-based analysis.

Arguments and Opinion

Junior noteholder Hildene Capital Management, LLC (Hildene) moved for dismissal of the involuntary petition. Hildene's primary arguments were that (i) ZING VII is not an eligible debtor in the United States; (ii) Anchorage is not an eligible petitioning creditor; (iii) Anchorage is using the bankruptcy courts in bad faith; and (iv) the indenture is a subordination agreement or intercreditor agreement to be recognized under bankruptcy law. The *Zais* court denied Hildene's motion to dismiss, rejecting each of Hildene's arguments.

Eligibility of ZING VII as a Debtor. The court stated that ZING VII, although formed and maintained in the Cayman Islands, is an eligible debtor in the United States because (i) ZING VII has a New York-based trustee and a New Jersey-based collateral manager who together perform the major portion of ZING VII's operations on its behalf in the United States; therefore, ZING VII has a place of business in the United States and (ii) the CDO collateral, which, even though pledged to and held by the trustee, is nominally ZING VII's property and is held in the United States; therefore, ZING VII has property interests in the United States.

Eligibility of Anchorage as a Petitioning Creditor. Hildene argued that, under section 303(b)(1) of the Bankruptcy Code, Anchorage was not eligible to file an involuntary chapter 11 petition against ZING VII because only creditors holding unsecured or undersecured claims can file an involuntary chapter 11 petition. According to Hildene, because the notes issued by ZING VII are non-recourse, a noteholder's claim can never exceed the value of the collateral and, therefore, no noteholder could ever be an unsecured or undersecured creditor of ZING VII. While not passing on the merits of this argument, the court found it moot because only the debtor may challenge an involuntary petition, and ZING VII had declined to do so.

Bad Faith. Hildene claimed Anchorage was attempting to use bankruptcy proceedings to the disadvantage of other noteholders. The *Zais* court did not find sufficient evidence of bad faith warranting a dismissal. In its opinion, the court stated "[l]iquidation is an appropriate purpose of a chapter 11 case." Furthermore, in its petition, Anchorage asserted that even if managed well, the collateral would never generate enough cash to pay off the class A-1 noteholders in full, so no junior noteholder could expect to recover anything further. The court found that, assuming Anchorage is correct, the junior noteholders cannot be disadvantaged by the bankruptcy proceedings. If Anchorage's assertion proved incorrect at the plan confirmation stage, the court would reject its plan at such point in time.

Hildene argued that, because the indenture sufficiently addresses all post-default considerations and all necessary parties to the bankruptcy proceedings are bound by the indenture, Anchorage's use of bankruptcy to circumvent limitations under the indenture also indicated bad faith. The court found that the indenture may be rejected as an executory contract under the Bankruptcy Code and mentioned in dicta that "any knowledgeable attorney opining on the enforceability of a contract will disclaim the effects of bankruptcy law." The *Zais* court essentially rejected the proposition that the use of bankruptcy proceedings to avoid certain contract limitations or restrictions is on its face an indication of bad faith.

The Indenture. Hildene asserted that the indenture is a subordination agreement that must be respected under the Bankruptcy Code[3] and that the indenture's non-petition provision is an intercreditor agreement to be enforced under *In re Ion Media Networks, Inc.*[4] The court allowed that section 501(a) of the Bankruptcy Code may protect the integrity of a subordination agreement in bankruptcy, but pointed to section 1129(b)(1) of the Bankruptcy Code, which permits confirmation of a plan "notwithstanding section 510(a)." In addressing the indenture's non-petition provision, the court found that because the language did not specifically bar petitions by senior noteholders, such provision was intended to benefit senior noteholders rather than limit their ability to institute bankruptcy proceedings against ZING VII.[5]

3 Citing 11 U.S.C. 510(a).

4 419 B.R. 585 (Bankr. S.D.N.Y. 2009).

5 Anchorage's answer quotes the provision "in relevant part": "The Holders of each Junior Class agree, for the benefit of the Holders of the Notes of each Priority Class in respect of such Junior Class, not to cause the filing of a petition in bankruptcy against the Issuer for failure to pay to them amounts due to such Junior Class or hereunder until the payment in full of such Priority Class and not before one year and one day, or if longer, the applicable preference period then in effect, has elapsed since such payment." *Objection and memorandum of GRF Master Fund, L.P. Anchorage Illiquid Opportunities master Offshore, L.P. and Anchorage Capital Master Offshore, Ltd. in Response to 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, to Abstain Pursuant to 11 U.S.C. § 305* [Docket No. 105] at 2, no. 1.

Implications for Structured Entities and Their Investors

Structured finance market participants will need to review current and future deal documents and consider the risk that an involuntary bankruptcy petition may be filed by certain classes of noteholders against SPE issuers. Where non-petition language similar to that in *Zais* leaves open the possibility of such a bankruptcy filing, participants will need to evaluate risks and take steps to mitigate them.

In future transactions, operative deal documents will need to more clearly set out limitations on bankruptcy petitions by noteholders. The ZING VII indenture non-petition provision establishes a period (from the closing date to the date that is one year and one day after the senior noteholders have been paid in full) during which *junior* noteholders may not place the issuer into bankruptcy for failure to make required payments. Because the *Zais* court found this provision allowed Anchorage, as a senior noteholder, to file the involuntary petition, operative deal documents will need to better reflect the intent, if it exists, to bar involuntary petitions by all noteholders, and to clarify the circumstances in which noteholders may file. Highlighting the need for such attention to non-petition language, a recent Royal Bank of Scotland study of a small sampling of securitization transaction documents found pervasive use of non-petition clauses substantially similar to that in the ZING VII indenture.

Anchorage's petition is the latest challenge to the structured finance status quo and may trouble industry participants. The *Zais* filings and communications surrounding the case do not paint a clear picture of Anchorage's motives, but understanding those motives is not important. The petitioning creditor's motives, if not evidencing bad faith per se, are not part of the dismissal analysis under *Zais*. The *Zais* court's concern is whether the proposed plan maximizes estate value, and this is a question for the plan confirmation process. The ability of one noteholder to choose bankruptcy court as the forum for deciding this question may have real dollar implications for other noteholders. If *Zais* is followed, contracted-for post-default payment priorities and voting requirements may be regarded by bankruptcy courts as burdensome, making deal documents susceptible to rejection in bankruptcy. Noteholders would need to spend time and money in bankruptcy litigation to support or oppose any proposed alternative scheme, rather than supporting or opposing such an alternative through the voting mechanism already agreed to in the operative deal documents. For some holders of SPE debt, this may be a positive development, paving the way for value-maximizing alternatives that could not likely otherwise be approved under indenture voting requirements. For other investors, this may be an undisclosed risk of existing investments, and one to be aware of when considering investments in the future.