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Case Study: ZING VII

Law360, New York (January 26, 2012, 12:20 PM ET) -- On Dec. 21, 2011, the U.S. Bankruptcy Court for the District of New Jersey approved a liquidation plan for collateralized debt obligation issuer ("CDO") Zais Investment Grade Limited VII ("ZING VII"). The plan incorporates a settlement between senior noteholders who had initiated the bankruptcy case by filing an involuntary petition against the CDO, and junior noteholders who were appealing the Bankruptcy Court's April 26, 2011, order granting the involuntary petition. In a previous article, we reviewed the bankruptcy court opinion denying the junior noteholders' motion to dismiss the filing.[1]

While the senior noteholders' ability to achieve a successful confirmation demonstrates that, under certain circumstances, bankruptcy may be a viable option for investors seeking to maximize returns on troubled CDO investments by actively managing the CDO's collateral, a number of issues raised by the junior noteholders that were expected to be resolved on appeal will remain open. Additionally, this case presents another clear example that "bankruptcy remote" does not necessarily mean "bankruptcy proof."

Settlement Resolves Competing Plans

ZING VII was a CDO that owned a broad array of structured products, including residential and commercial mortgage-backed securities, asset-backed securities and tranches of other CDOs (a so-called "CDO squared"). ZING VII issued several tranches of notes, secured by its assets, in the aggregate amount of approximately $365 million. As a result of deteriorating market conditions, ZING VII's notes became undercapitalized, triggering a covenant default under the indenture.

Notwithstanding the default, ZING VII's indenture did not permit a liquidation of its assets absent consent of ZING's junior noteholders. Accordingly, senior noteholders filed an involuntary petition in bankruptcy court to effectuate a liquidation of ZING VII's assets that would have left junior noteholders out of the money.

After the senior noteholders commenced the involuntary case, junior noteholders[2] challenged the petition and filed a motion to dismiss the bankruptcy case. As discussed in greater detail below, the bankruptcy court denied the motion to dismiss.[3] Thereafter, the junior noteholders objected to the senior noteholders' liquidation plan and filed their own disclosure statement and liquidation plan. Unlike the plan set forth by the senior noteholders, which called for an accelerated liquidation of ZING VII's assets, the junior noteholders' plan called for a liquidation over time. Such a liquidation, it argued, would allow value to reach the junior noteholders.

On Oct. 5 and 6, 2011, the bankruptcy court conducted a hearing to consider confirmation of the senior noteholders' plan. The hearing was adjourned to permit settlement discussions to occur between the senior and junior noteholders. As a result of a court-supervised mediation, the senior and junior noteholders reached a settlement, which ultimately was embodied in a jointly filed plan, providing for a cash payment of $4.375 million to junior noteholders.[4] The plan projects that senior noteholders will receive approximately $152.5 million, representing a recovery of over 80 percent of outstanding principal.

Previously Raised Questions Remain Unresolved

An Aug. 26, 2011, decision of the Bankruptcy Court had denied on several grounds the junior noteholders' motion to dismiss the involuntary bankruptcy petition filed by the senior noteholders. The court, citing a procedural technicality, did not allow the junior noteholders to question the petitioning creditors' qualifications and found that ZING VII was eligible to be a debtor under Section 109(a) of the Bankruptcy Code and that the senior noteholders did not file the petition in bad faith.

The decision left unresolved the question of whether the petitioning creditors were qualified to file the involuntary petition. In its motion to dismiss, the junior noteholders argued that the senior noteholders were not qualified to be petitioning creditors because they did not hold claims that exceeded the value of collateral securing such claims by the amount prescribed in the Bankruptcy Code Section 303(b).

Rather, they held nonrecourse notes whose value could never exceed the value of the collateral. The court did not address the merits of this argument. Instead, it held that the junior noteholders could "not question the petitioning creditors' qualifications," because the debtor failed to contest the petition in the time prescribed by the Bankruptcy Code and the court already entered an order for relief by default.[5]

The junior noteholders also urged the bankruptcy court to dismiss the petition on the ground that it was filed in bad faith. The junior noteholders argued that the petitioning creditors' status as secured — rather than unsecured — creditors was indicia of bad faith. Noting its finding that the junior noteholders could not challenge the petitioning creditors' qualifications, the bankruptcy court found no reason to consider that factor as a basis for dismissal. The junior noteholders originally appealed this portion of the bankruptcy court's ruling,[6] but agreed to withdraw their appeal as part of the settlement.[7]

The court had also reserved for the confirmation hearing the question of whether the plan put forth by the senior noteholders treated creditors fairly and equitably. The junior noteholders argued in the motion to dismiss that the plan would not reorganize ZING VII, "but merely transfer the [underlying mortgage-backed securities and other assets] to [the senior noteholders] without benefiting other creditors."[8]

The court noted that liquidation is an appropriate Chapter 11 purpose and that "classes of unsecured creditors and equity interests may be wiped out" so long as the plan satisfies the "fair and equitable" standard under Section 1129(b) of the Bankruptcy Code. The court expressed that it would reserve judgment until confirmation, however, on whether the plan satisfied this standard.[9] As a result of the settlement these questions remain unanswered.

Potential Implications

Although several questions impacting distressed CDOs were left unanswered, the ZING VII case demonstrates that, under certain circumstances, CDO noteholders may be able to use the bankruptcy process to accelerate the liquidation of underperforming CDOs.

Further, the case reinforces a critical point previously raised by the bankruptcy court in the General Growth Properties bankruptcy case — that "bankruptcy remote" does not mean "bankruptcy proof."[10] Here, the bankruptcy court analyzed the provisions in ZING VII's indentures that limited noteholders' ability to commence an insolvency proceeding (so called "nonpetition clauses") and found that, while these clauses prevented junior noteholders from filing an involuntary petition against ZING VII, they did not mention the senior noteholders.

Thus, the court concluded that the nonpetition clauses were intended to serve as, and for the "benefit of senior noteholders, not a limitation on their rights to file a petition." As such, investors are advised to carefully review an entity's organizational and transactional documents to determine the scope of "bankruptcy remote" limitations on commencing an insolvency proceeding.

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[1] See Zais Investment Grade Limited VII — CDO Noteholders Take Advantage of Chapter 11, Schulte Roth & Zabel Client Alert, Oct. 3, 2011, available at http://www.srz.com/zais-investment-grade-limited-vii--cdo-noteholders-take-advantage-of-chapter-11-10-03-2011/.

[2] ZING VII's collateral manager, Zais Group LLC, and a senior noteholder joined the motion to dismiss.

[3] See In re Zais Investment Grade Ltd. VII, 455 B.R. 839 (Bankr. D.N.J. 2011).

[4] The original senior noteholders' plan had provided for the junior noteholders to receive no distribution.

[5] 455 B.R. at 846.

[6] See Designation of Record and Statement of Issues to be Presented On Appeal, Case No. 11-20243 (RTL) [D.I. 152].

[7] A separate senior noteholder also appealed the bankruptcy court's decision but it too agreed to withdraw its appeal as part of the settlement.

[8] Id. at 847.

[9] Id.

[10] See In re Gen. Growth Props., Inc., 409 B.R. 43 (Bankr. S.D.N.Y. 2009).