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Taberna Bankruptcy Ruling Brings Relief For CDO Investors

By **James T. Bentley** (November 30, 2018, 11:43 AM EST)

On Nov. 8, 2018, in a decision of significant importance to the securitization market, a bankruptcy court dismissed an involuntary Chapter 11 bankruptcy case commenced by three noteholders, or petitioning creditors, against Taberna Preferred Funding IV Ltd., an issuer of collateralized debt obligations.[1][2] In a well-reasoned and thoughtful opinion, the U.S. Bankruptcy Court for the Southern District of New York held in Taberna Preferred Funding IV Ltd. v. Opportunities II Ltd. that the petitioning creditors failed to satisfy one of the key requirements to commence an involuntary bankruptcy case because they were not creditors of Taberna itself. Rather, the petitioning creditors' claims arose under nonrecourse notes Taberna issued and thus, their claims were limited to the collateral securing their notes. Therefore, the petitioning creditors did not hold claims against Taberna.

Moreover, even had the petitioning creditors been qualified to commence an involuntary case, the court held that several compelling reasons existed to dismiss the involuntary case for "cause." First, the petitioning creditors had taken "intricate — choreographed — steps to manufacture eligibility to file an involuntary case," and no bankruptcy purpose would be served by the filing because Taberna was winding down and would never reorganize under Chapter 11 of the Bankruptcy Code.[3] Second, the contractually negotiated wind-down process contemplated under Taberna's indenture would provide a better recovery for all noteholders, rather than an involuntary bankruptcy case that would primarily benefit only the petitioning creditors. Third, the bankruptcy court acknowledged that CDOs are "designed to avoid bankruptcy," and permitting the involuntary case to proceed would likely create significant uncertainty across capital markets.[4] This decision ought to provide comfort to CDO investors, collateral managers, trustees and other interested parties, while serving as a cautionary tale for activist investors.

Background

In 2005, Taberna, an offshore Cayman company, issued more than $630 million of secured notes in 11 descending tranches under an indenture, maturing in 2036. The notes were all secured by subordinated debt securities issued by entities in the real estate and home building industries, with the payments on the collateral used to repay principal and interest on the notes.

In August 2009, Taberna defaulted under the indenture by failing to make payments to junior noteholders due in large part to the significant downturn in real estate markets following the 2008 recession. In September 2009, the notes were accelerated and all principal and interest under the indenture became immediately due and payable. The indenture set forth the timing and manner of the

liquidation of the collateral after an event of default and Taberna began to wind down.

Six years later, in 2015, the petitioning creditors began purchasing the most senior tranches of notes. At the time of the involuntary bankruptcy filing, the petitioning creditors owned 100 percent of the Class A-1 notes and approximately 34 percent of the Class A-2 notes.

The Indenture

The Indenture contained characteristic noteholder protections, such as a no-action clause that prohibited the petitioning creditors from unilaterally liquidating the collateral without the consent of other parties. Thus, the petitioning creditors instructed the indenture trustee to solicit consents (for no consideration) from other noteholder classes to permit the underlying collateral to be immediately liquidated. This effort failed to garner support, so the petitioning creditors launched a tender offer; however, they ultimately did not purchase any notes. Two months after their unsuccessful tender offer, the petitioning creditors filed an involuntary bankruptcy petition against Taberna.

The Involuntary Bankruptcy

An involuntary bankruptcy petition ordinarily requires at least three unsecured creditors with aggregate claims exceeding $15,775,[5] holding noncontingent and undisputed claims against the target of the involuntary petition. The petitioning creditors, which held notes secured by the collateral, attempted to manufacture an unsecured claim to satisfy the Bankruptcy Code's requirement by filing a "partial waiver" of their secured claim. Under this "partial waiver," the petitioning creditors waived their secured status in $15,775 of the collateral. The day after filing the involuntary petition, the petitioning creditors sought to terminate Taberna's exclusivity period to file a Chapter 11 plan to permit the petitioning creditors to file their own proposed plan that contemplated the immediate liquidation of the securities in the CDO.

The Adversary Proceeding

After the involuntary bankruptcy case was filed, Taberna was instructed by several junior noteholders (objecting parties) to move to dismiss the case. Taberna's collateral manager projected that the collateral would generate in runoff sufficient proceeds to pay the Class A-1 through Class A-3 notes in full, while also providing a substantial recovery to the junior Class B notes; however, the runoff could take years. The objecting parties asserted that the petitioning creditors were attempting to use the involuntary bankruptcy to accelerate the liquidation of Taberna's collateral to their benefit, which would adversely affect distributions to junior noteholder classes. The petitioning creditors, on the other hand, argued that the indenture did not prohibit their claims against Taberna. As a result of this dispute, Taberna filed an interpleader complaint to allow the parties to present their competing positions to the bankruptcy court and requested that the court determine whether to dismiss the involuntary case or permit the bankruptcy case to proceed.[6]

A five-day bench trial commenced regarding whether the petitioning creditors were eligible to commence the involuntary bankruptcy case. At the close of the petitioning creditors' case in chief, the objecting parties moved for "judgment on partial findings," seeking a determination whether the (i) petitioning creditors' notes were nonrecourse, and (ii) if so, did they nonetheless meet the eligibility criteria to commence an involuntary bankruptcy.[7]

The objecting parties asserted the petitioning creditors were not entitled to file the involuntary case

because their claims under the notes were nonrecourse[8] and could only be satisfied from the proceeds of the collateral securing the notes.[9] The Objecting Parties argued that because the Notes provided the Petitioning Creditors with no recourse beyond the Collateral, they did not hold claims against Taberna itself.[10]

The bankruptcy court began its analysis with the indenture, which plainly provided, among other things, that the

The obligations of the Co-Issuers under the Notes and this Indenture are non-recourse obligations of the Co-Issuers payable solely from the Collateral and in accordance with the Priority of Payments, and following realization of the Collateral and its reduction to zero any claims of the Noteholders shall be extinguished and shall not thereafter revive.[11]

Thus, the bankruptcy court held that the notes were nonrecourse and the petitioning creditors were ineligible to file an involuntary bankruptcy case.

The petitioning creditors also asserted two technical arguments that, even if their notes were nonrecourse, they could still hold claims against Taberna (and not only the collateral) because Sections 102(2)[12] and 1111(b)(1)[13] of the Bankruptcy Code eliminate any distinction between recourse and nonrecourse debt for purposes of determining eligibility to commence an involuntary bankruptcy case. The bankruptcy court spent considerable time evaluating the petitioning creditors' arguments and ultimately overruled them.

Dismissal for Cause

The bankruptcy court further concluded, in the exercise of its discretion, that even were the petitioning creditors eligible to file an involuntary petition (which they were not), the involuntary case should nonetheless be dismissed. The court noted that, even when an involuntary petition meets the Bankruptcy Code's statutory requirements, a court may dismiss a case for "cause."[14] A court has discretion to determine what constitutes "cause" to dismiss a case.[15] While the court stopped short of finding that the petitioning creditors had filed the case in bad faith (which would have exposed the petitioning creditors to a claim for damages by Taberna), the court held that there were many reasons to dismiss this case.

As an initial matter, the involuntary case served no "bankruptcy purpose."[16] The court held that the petitioning creditors' notes were fully secured, and their "partial waiver" of a portion of their security interest was plainly a scheme to satisfy the statutory requirements to file an involuntary petition and cause the early liquidation of the collateral solely for their benefit and at the expense of the other noteholders. In fact, a principal of the petitioning creditors "conceded that junior creditors are not necessarily out of the money outside of bankruptcy."[17]

Moreover, the petitioning creditors had purchased the defaulted notes in order to commence the involuntary bankruptcy case, in violation of Federal Rules of Bankruptcy Procedure 1003(a).[18] If the petitioning creditors' tactics were countenanced and rewarded with the entry of an order for relief, then, the court found, it likely would create significant uncertainty across capital markets.[19] In fact, the involuntary petition was fundamentally at odds with the purpose of securitization vehicles, in addition to violating the spirit and purpose of the Bankruptcy Code.[20]

Takeaways

This case is important for the securitization industry and capital markets generally. The dismissal of Taberna's involuntary bankruptcy case reinforces the accepted principle that the contractual terms set forth in an indenture are the best means for liquidating a nonrecourse securitization vehicle. That the court cited the purpose of securitization vehicles and concern for the capital markets generally in using its broad discretionary powers to dismiss this involuntary petition should provide comfort to CDO investors, collateral managers, trustees and other parties interested in the stability of the CDO model. Effectively, by dismissing the involuntary case, the bankruptcy court affirmed that involuntary bankruptcy petitions should not be used by secured noteholders as a means to toggle between the contractually agreed-upon liquidation plan set forth in an indenture and the Bankruptcy Code's priority scheme in order to more quickly realize on their notes. This case should discourage secured noteholders from attempting similar tactics against CDOs in the future.

On the other hand, this case is a reminder to creditors seeking to exercise remedies upon a debtor's default that they must first understand the nature of their debt instrument. When a creditor has a nonrecourse debt instrument, it can only look to the collateral securing that instrument. As holders of nonrecourse claims, the court held that the petitioning creditors did not have claims against Taberna itself — only the collateral securing the notes. The petitioning creditors' attempt to waive a portion of their secured claim in order to engineer an unsecured deficiency claim was clever; however, it did not work. Instead, the waiver only reduced the petitioning creditors' claims to the collateral proceeds. The notes held by the petitioning creditors were completely secured by the collateral, and thus, the petitioning creditors did not meet the procedural threshold to commence an involuntary case.[21] In any event, even if the petitioning creditors' scheme had resulted in an "unsecured" claim, the debtor likely would have disputed that claim, making it ineligible to serve as a basis to file an involuntary bankruptcy petition.

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[1] A CDO is an investment-grade security backed by a pool of various other securities. CDOs can be made up of any type of debt. These obligations are then divided into tranches that contain debts with various levels of risk with each tranche having its own credit rating. CDOs are constructed as a way of selling cash flows to investors.

[2] Taberna Preferred Funding IV Ltd. v. Opportunities II Ltd. (In re Taberna Preferred Funding IV, Ltd.), 2018 Bankr. LEXIS 3557.

[3] Id. at *62.

[4] Id. at *54 (citing In re Zais Investment Grade Limitd VII, 455 B.R. 839, 849 (Bankr. D.N.J. 2011).

[5] 11 U.S.C. § 303(b)(1). There are separate rules if the company has fewer than 12 creditors. Here, all three petitioning creditors were controlled by a single secured investor, Holdco Asset Management LP Affiliated entities (i.e., domestic and offshore funds acting as lenders under a single loan agreement)

should constitute separate creditors if their separate existence is recognized under applicable nonbankruptcy law. E.g., In re Gibraltor Amusements, Ltd., 291 F.2d 22 (2d Cir.) cert. denied 368 U.S. 925 (1961).

[6] Ordinarily, Section 303(d) of the Bankruptcy Code only permits a debtor or the general partner of a debtor that did not join in the petition to file an answer to the involuntary petition. 11 U.S.C. §303(d). CDOs are investment vehicles whose sole purpose is to hold securities and their proceeds as collateral for the various note classes. Thus, Taberna had no employees or operations of its own. As a result, its directors authorized the filing of an interpleader complaint. TP Management LP, Taberna's collateral manager, filed the answer to the complaint on behalf of Taberna, asserting authority under a power of attorney granted under the collateral management agreement.

[7] Id. at *12. Under Federal Rule of Civil Procedure 52(c) (incorporated by Federal Rule of Bankruptcy Procedure 7052), if a party has been fully heard on an issue during a nonjury trial and the court finds against the party on that issue, then the court may enter a judgment against that party. Unlike a motion to dismiss, in which the court must consider the evidence in the light most favorable to the non-moving party, when considering a motion under Federal Rule 52(c), "a court does not consider the evidence in the light most favorable to the non-moving party or draw any special inferences in the non-movant's favor." Id. at *14.

[8] As the bankruptcy court explained, the term "nonrecourse" describes a type of debt that is "of, relating to, or involving an obligation that can be satisfied only out of the collateral securing the obligation and not out of the debtor's other assets." Black's Law Dictionary (10th ed. 2014). Id. at *17-18. A nonrecourse note is "[a] note that may be satisfied upon default only by means of the collateral securing the note, not by the debtor's other assets." Id. Similarly, a "nonrecourse creditor is a creditor who has agreed to look only to its collateral for satisfaction of its debt and does not have any right to seek payment of any deficiency from a debtor's other assets." Id.

[9] Id. at *17.

[10] Id.

[11] Id. at *19.

[12] Section 102(2) of the Bankruptcy Code defines a "claim against the debtor" to include "a claim against the property of the debtor." Therefore, the petitioning creditors argued, they met the requirement to commence an involuntary petition because they held a claim against Taberna's property (the collateral) and thus, a claim against Taberna itself. The bankruptcy court dispensed with this argument by pointing out that section 303 of the Bankruptcy Code, which is the provision regarding the filing of involuntary petitions, does not use the defined term "claim against the debtor," and instead uses the phrase, "claim against such person." Id. at *36.

[13] Section 1111(b) of the Bankruptcy Code provides that an undersecured, nonrecourse creditor in a Chapter 11 case may for allowance and distribution purposes, have its claim split into (i) an allowed secured claim equal to the value of its collateral and (ii) an allowed unsecured claim for the deficiency (notwithstanding that the claim is nonrecourse) unless either (a) the class of which the creditor's claim is a part elects to have the claim treated as fully secured, or (b) the collateral is sold under Section 363 of the Bankruptcy Code or pursuant to a plan of reorganization. Id. at *29-30. The bankruptcy court held that Section 1111(b) is not applicable for purposes of determining a party's eligibility to initiate an

involuntary bankruptcy. Moreover, the court noted that it had not yet entered an order for relief and therefore there is no Chapter 11 case such that Section 1111(b) could be triggered. Id. at *34.

[14] Id. at *50 (citing Wilk Auslander LLP v. Murray (In re Murray), 900 F.3d 53 (2d Cir. 2018).

[15] Id. Section 1112 of the Bankruptcy Code sets forth a non-exclusive list of factors of what constitutes "cause" to dismiss a bankruptcy case.

[16] Id. at *54.

[17] Id. at *68.

[18] Id. at *59.

[19] Id. at *66-67.

[20] Id. at *70.

[21] The result, however, may have been different had the senior-most notes held by the petitioning creditors been undersecured.