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Case Study: In Re Zais Investment Grade

Law360, New York (October 17, 2011, 1:04 PM ET) -- The U.S. Bankruptcy Court for the District of New Jersey recently held that a Cayman Islands collateralized-debt obligation issuer ("CDO") could be a debtor under Chapter 11 of the U.S. Bankruptcy Code and declined to dismiss an involuntary case commenced against the CDO by certain noteholders on the grounds that the notes held by such noteholders were "nonrecourse" notes. Below is a discussion of the court's decision and its potential implications. The decision is currently being appealed.

Senior noteholders of Zais Investment Grade Limited VII ("ZING VII"), a Cayman Islands CDO, commenced an involuntary case under Chapter 11 of the Bankruptcy Code against ZING VII in the U.S. Bankruptcy Court for the District of New Jersey on April 1, 2011.[1] ZING VII failed to contest the involuntary petition, and the Bankruptcy Court entered an order for relief on April 26, 2011.

The petitioning creditors had acquired senior Class A-1 notes issued by ZING VII after the notes were already in default. Following the petitioning creditors' commencement of the involuntary case, other investors acquired junior Class A-2 notes. The petitioning creditors' Class A-1 notes are nonrecourse notes (i.e., recourse under the notes is expressly limited to the assets of the CDO) and senior to the junior noteholders' notes.

The junior noteholders contested the filing of ZING VII's bankruptcy case and are opposing the Chapter 11 plan proposed by the petitioning creditors. Under the plan, ZING VII's assets would be transferred to a newly formed entity controlled by the petitioning creditors for liquidation and distribution. The Class A-1 noteholders would receive a pro rata recovery from ZING VII's available cash, and the other classes of noteholders would recover nothing.

If the petitioning creditors are successful in obtaining confirmation of ZING VII's Chapter 11 plan, holders of senior notes issued by CDOs may have an additional strategy for maximizing returns from troubled CDOs. As discussed below, however, it is not clear that senior noteholders holding nonrecourse notes in all cases will be able to establish their eligibility to commence an involuntary case against the CDO issuer.

Events Leading to Bankruptcy

ZING VII is a CDO incorporated under the laws of the Cayman Islands. ZING VII's assets span a broad array of structured products, including residential and commercial mortgage-backed securities, asset-backed securities (including consumer loans and nonconsumer loans), and tranches of other collateralized debt obligations (a so-called "CDO squared"). As a result of deteriorating market conditions, ZING VII's notes became undercapitalized, and ZING VII defaulted under its indenture.

The petitioning creditors allege that the Class A-1 noteholders would receive a greater and more certain recovery (in present value terms) through an opportunistic liquidation of ZING VII's assets than they would through passive management of the assets and distributions under the indenture. The indenture, however, requires the consent of two-thirds of all noteholders to liquidate ZING VII's assets to satisfy its obligations under the notes.

According to the disclosure statement filed with the Bankruptcy Court, only the holders of the Class A-1 notes (acquired by the petitioning creditors) are likely to receive distributions through a liquidation of ZING VII's assets, and junior noteholders likely will find themselves out of the money. The petitioning creditors were unable to muster the required two-thirds consent from all noteholders and thus commenced an involuntary bankruptcy case against ZING VII on April 1, 2011.

Junior Noteholders Challenge Bankruptcy

The junior noteholders purchased their notes a few weeks after the petitioning creditors commenced ZING VII's involuntary case. After the bankruptcy court entered the order for relief, the junior noteholders moved to dismiss the case.

They argued that the case should be dismissed because (1) ZING VII, as a Cayman Islands company, is not eligible to be a debtor under the Bankruptcy Code, (2) the petitioning creditors were ineligible to commence the involuntary case because they hold nonrecourse notes and only unsecured creditors may commence involuntary cases, (3) the petitioning creditors are the only parties that stand to benefit from the bankruptcy and the interests of ZING VII and its creditors would be better served without circumventing the indenture, and (4) the petitioning creditors commenced the case in bad faith to avoid the indenture's restrictions on commencing a liquidation of ZING VII's assets.

According to the junior noteholders, allowing ZING VII to be placed in involuntary bankruptcy sets a bad precedent for the CDO market. The bankruptcy court issued an opinion on Aug. 26, 2011 denying the junior noteholders' motion.[2]

Cayman Islands CDO Was an Eligible Debtor

The court rejected the junior noteholders' argument that ZING VII is ineligible to be a debtor under the Bankruptcy Code. Section 109(a) of the Bankruptcy Code provides that "only a person that resides or has a domicile, a place of business, or property in the United States ... may be a debtor under [the Bankruptcy Code]." 11 U.S.C. § 109(a). No one contested whether ZING VII resided or had a domicile in the United States. Zais, 2001, at *3.

The junior noteholders argued, however, that as a CDO, ZING VII did not engage in business and thus had no "place of business" in the United States. Id. They asserted that the business activities of collecting money from the collateral securities and distributing it to noteholders were performed by the trustee and management of the collateral securities was done by the collateral manager. Id.

The court disagreed. Recognizing that a person has a place of business in the United States if business is conducted in the United States on its behalf, the court held that ZING VII had a place of business in the United States because the collateral manager, the collateral administrator, and the trustee all performed services on its behalf in the United States. Id.

The court analogized ZING VII to a "letterbox company": "All that happens in the Cayman Islands are the necessities for maintaining registration. The important functions of investing, collecting, disbursing, recordkeeping and communicating with noteholders is primarily done in the U.S." Id. at *5. The court also held that ZING VII had property in the United States because the cash and securities that ZING VII pledged as collateral was nominally ZING VII's property and was held by the trustee in the United States. Id.

Nonrecourse Noteholders Could Commence an Involuntary Case Because Debtor Failed to Contest

The court rejected the junior noteholders' argument that the petitioning creditors were unqualified to commence an involuntary bankruptcy case against ZING VII. Section 303(b)(1) of the Bankruptcy Code requires creditors commencing an involuntary case to hold claims aggregating at least $14,425 in excess of the value of any collateral securing their claims. 11 U.S.C. § 303(b)(1).

The junior noteholders argued that because the petitioning creditors' notes were nonrecourse, their claims could never exceed the value of the collateral securing them. Zais, 2001, at *5. The court did not address this argument on the merits. Instead, it held that because the debtor failed to contest the involuntary petition in the time prescribed by the Bankruptcy Code and the court had already entered an order for relief by default, the junior noteholders "may not question the petitioning creditors' qualifications." Id.

Bankruptcy Court Will Hear Other Issues at Confirmation

The court declined to abstain from hearing the case or to dismiss it for being filed in bad faith. It found that the petitioning creditors "have shown good faith in their desire to realize the greatest present value of the Collateral Securities for the benefit of the A-1 creditors without negatively impacting junior creditors who have no prospect of recovery under the status quo." Zais, 2001, at *8. The court held that it would determine whether the plan treats creditors fairly and equitably without discrimination at the confirmation hearing. Id. at *6.

Litigation Continues

The junior noteholders have appealed the bankruptcy court's order to the district court. Meanwhile, the junior noteholders have objected to the petitioning creditors' proposed Chapter 11 plan, and a confirmation hearing began on Oct. 5, 2011.

Potential Implications

Special purpose entity CDOs may be eligible to be debtors under the Bankruptcy Code, particularly when the trustee, collateral manager, collateral administrator, and other agents operate the CDO from the United States or when the CDO has assets in the United States. The bankruptcy court's decision shows that while a special purpose entity CDO may be bankruptcy remote, it is not necessarily bankruptcy proof.

As a practical matter, however, the ability of a tranche of noteholders to commence an involuntary case against the CDO may be limited if the noteholders hold nonrecourse notes. Although the bankruptcy court declined to dismiss the case on that basis, if ZING VII had timely contested the involuntary petition, i.e., before the court entered the order for relief, the court may have considered the petitioning creditors' eligibility on the merits. This may be a critical issue on appeal.

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[1] According to papers filed in the bankruptcy court, the indenture governing the notes issued by ZING VII does not specifically prohibit the senior noteholders from commencing an involuntary case against the CDO.

[2] In re Zais Inv. Grade Ltd. VII, Case No. 11-20243 (RTL), 2001 (Bankr. D.N.J. Aug. 26, 2011).

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