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Chapman Client Alert

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Opportunistic Investors' Drive to Accelerate Termination of a CDO Hits a Dead End

Having failed in attempts to accelerate the termination of a CDO, an investor group holding senior notes (the *"Petitioning Creditors"*) filed an involuntary petition against an issuer to liquidate the CDO before its stated maturity under the United States Bankruptcy Code (the "*Bankruptcy Code*").[1] In *In re Taberna Preferred Funding IV, Ltd.*, 2018 WL 5880918, Case No. 17-11628 (MKV) (Bankr. S.D.N.Y. Nov. 8, 2018), the United States Bankruptcy Court for the Southern District of New York (the *"Bankruptcy Court"*) put the brakes on these holders' actions by dismissing the petition on the grounds that the Petitioning Creditors did not meet the eligibility requirements for initiating an involuntary proceeding under the Bankruptcy Code because of the non-recourse nature of the obligations held thereby, and because the filing of the involuntary petition failed to serve any legitimate bankruptcy purpose. The Bankruptcy Court found that the Petitioning Creditors agreed to the terms of the Indenture that already contained provisions for the liquidation of the transaction. The Bankruptcy Court's decision may affect investment strategies designed to purchase debt issued by a CDO with a view towards terminating the CDO and liquidating the underlying collateral in advance of the maturity of the notes or certificates issued thereby.

In the instant case, Taberna Preferred Funding IV, Ltd. (*"Taberna"* or *"Issuer"*) issued notes in various tranches (the *"Notes"*) to the public under a collateralized debt obligation (a *"CDO"*) pursuant to the terms of an indenture (the "*Indenture*"), and used the proceeds to purchase various financial instruments, which mostly included long-term securities issued by real estate investment trusts and other real estate entities. Taberna was a vehicle of limited duration, the sole purpose of which was to collect proceeds generated from the financial instruments or to sell such assets in the manner prescribed in the Indenture. The Noteholders, through the Indenture trustee, were secured by a security interest in the financial instruments. Proceeds were to be distributed in accordance with a waterfall set forth in the Indenture. Senior tranches were entitled to payment priority over junior tranches. Noteholders bore the risk that the proceeds received from the financial instruments would generate insufficient proceeds to pay-off the Notes. In the event of a shortfall, the Indenture allocated, through the waterfall, how losses would be distributed. At the stated maturity of all of the Notes, Taberna's existence would terminate in accordance with the Indenture. The value of the financial instruments was depressed, leaving junior Noteholders out of the money in any liquidation scenario.[2] Prior to the CDO's stated maturity, however, the cash flow from the financial instruments securing the Notes could improve, and/or the market value of the financial instruments could increase, which could enable Taberna to pay junior holders some amount of their claims. Taberna has no economic interest in any of the assets, and has no creditors (and was designed not to have any other creditors) besides the holders of the various tranches of Notes.

The Petitioning Creditors, described by some of the parties as "opportunistic", sought in a number of ways, to sell the investments early and terminate Taberna. Some of these methods included seeking a consent solicitation through the Indenture trustee and initiating tender offers for the remaining outstanding Notes. However, unable to generate sufficient interest from other investors to terminate the vehicle outside of a judicial proceeding, the Petitioning Creditors sought to terminate and "unlock" the value of Taberna through an involuntary bankruptcy proceeding, which was an action (i) not contemplated by the Indenture and (b) that might be prejudicial to holders of other notes that were subordinated to the notes held by the Petitioning Creditors. Certain holders of subordinated notes (the *"Objecting Creditors"*) objected to the petition, and the Structured Finance Industry Group submitted an amicus curiae brief in support of the positions of the Objecting Creditors. While the Objecting Creditors objected on a variety of grounds, the Bankruptcy Court focused on two issues in its recent decision: whether the Petitioning Creditors met the criteria for filing an involuntary petition under Section 303 of the Bankruptcy Code and whether the involuntary petition should be dismissed on equitable grounds.[3]

The Bankruptcy Court first analyzed the types of creditors that are eligible to file a involuntary petition for bankruptcy against a debtor, noting that Section 303(b)(1) provides that an involuntary proceeding may be commenced by three "entities", each of which holds "a claim against such person" that is not contingent as to liability or the subject of a *bona fide* dispute. Petitioning creditors bear the initial burden of proving a *prima facie* case with regards to their eligibility. The Bankruptcy Court found that the Petitioning Creditors did not have "a claim against such person" as their claims were non-recourse, and therefore deemed them ineligible to file the involuntary petition.

Looking to the terms of the Indenture, as is required under New York law, the Bankruptcy Court found that the Indenture was unambiguous with respect to the non-recourse nature of the Notes, and as a result the Petitioning Creditors had only the right to payment from the collateral held by Taberna with no right to look to Taberna for any deficiency.[4] Section 2.6(h) of the Indenture provided that the Notes "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 Noteholders shall be extinguished and shall not thereafter revive." The Bankruptcy Court considered arguments made by the Petitioning Creditors based on other provisions of the Indenture, but found all of them unpersuasive.

In further support of their argument for eligibility under Section 303, the Petitioning Creditors made other arguments based on certain provisions of the Bankruptcy Code that the Bankruptcy Court dismissed. They argued that Section 102(2) and Section 1111(b) do not distinguish between recourse and non-recourse debt. Turning to Section 1111(b) first, the Bankruptcy Court analyzed the language of Section 1111(b) and found that the purpose of the provision was to enable an undersecured creditor to split its allowed secured claim into a secured claim equal to the value of the collateral and an unsecured claim for the deficiency, even if the secured claim was non-recourse. The Bankruptcy Court noted, however, that the provision applies for allowance and distribution purposes only, and not to establish eligibility for purposes of filing an involuntary petition. The Court discussed that even if the collateral were sold under Section 363 or pursuant to a reorganization plan, the character of the debt would not change and, in any event, the creditors could protect themselves by bidding in at any auction of such collateral. Further, "Section 1111(b) was designed to protect the rights of nonrecourse lienholders in chapter 11 reorganizations 'where the debtor elected to retain the collateral property[,]'" the Bankruptcy Court explained.

The Petitioning Creditors' second argument was based on Section 102 of the Bankruptcy Code, which provides that "a claim against the debtor includes [a] claim against property of the debtor." Relying on the differences in the language between Section 102 and Section 303, the Bankruptcy Court again determined that the Petitioning Creditors failed to meet eligibility requirements for filing an involuntary petition against the Issuer. The Bankruptcy Court reasoned that Section 303 may be more limited than Section 102 in that Section 303 requires a petitioning creditor to hold claims against a "person", as defined in Section 101(14). Under the Bankruptcy Code, the term "person" is defined to include an individual, partnership, corporation, or under certain circumstances, a government. Therefore, claims against the property of a debtor are not claims against a "person". The Bankruptcy Court also noted that an involuntary petition is a "powerful weapon" and by narrowly limiting Section 303, Congress intended to restrict persons that are able to wield that power.

Finally, on grounds not argued by either party, the Bankruptcy Court exercised discretion and dismissed the involuntary petition sua sponte under Section 1112, in light of *In re Wilk Auslander LLP v. Murray*, 900 F.3d 54, (2d Cir. 2018) ("*Wilk*"). In *Wilk*, the Second Circuit affirmed the dismissal of an involuntary petition for cause under chapter 7[5] where the bankruptcy court found that the petition was merely a judgment enforcement tactic for a two-party dispute for which an adequate remedy existed under state law, and where no bankruptcy purpose would be served by continuing the case. The Second Circuit in *Wilk* determined that "cause" is a fact specific inquiry and a variety of factors may be relevant to whether "cause" exists. An "inappropriate use of the Bankruptcy Code may constitute cause to dismiss".[6]

On the other hand, the Bankruptcy Court noted that an involuntary petition that seeks to achieve objectives that benefit all creditors is consistent with the Bankruptcy Code.[7] "Specifically, under chapter 11, the Code's objective is to 'preserv[e] going concerns and maximiz[e] property available to satisfy Creditors . . . and [to] achieve fundamental fairness and justice'".[8] The Bankruptcy Court found that the instant use by the Petitioning Creditors was not consistent with bankruptcy policies and exercised its discretion to dismiss the petition for cause. The Bankruptcy Court's reasoning included that (a) Taberna is not an operating business so no rehabilitative purpose was served by the chapter 11 filing, (b) the Petitioning Creditors were not prejudiced by following the liquidation scheme contained in the Indenture—provisions to which they had agreed, (c) the accelerated liquidation desired by the Petitioning Creditors might have a deleterious effect on the recoveries of junior creditors (therefore the petition would only benefit the Petitioning Creditors at the potential expense of the junior creditors) and (d) allowing the case to proceed would lead to uncertainties in the capital markets—it would make it more difficult for investors to evaluate future cash flows and asset values from similar types of vehicles and investments.[9] The involuntary petition was therefore dismissed.

In dismissing the petition, the Bankruptcy Court protected structured finance transactions by restricting senior holders from using the Bankruptcy Code to obtain extra-contractual liquidation rights. This case likely will limit the use by investors of the bankruptcy process to liquidate collateral and terminate a CDO or other structured finance transaction on an accelerated basis.

For More Information

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1 11 U.S.C. § 101 *et seq*.

2 A payment default occurred under the Indenture in 2009.

3 Hereafter, all references to "Section", unless otherwise specified, are to sections of the Bankruptcy Code.

4 Through their purchase of Notes, the Bankruptcy Court found that the Petitioning Creditors agreed to the terms of the Indenture.

5 The Second Circuit noted that the same considerations would be applicable under chapter 11.

6 Wilk at 60.

7 *Taberna*, 2018 WL 5880918, at *17 (citing *Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co*., 547 U.S. 651, 655 (2006)).

8 *Id*. (citing *In re Am. Capital Equip., LLC*, 668 F.3d 145,157 (3d Cir. 2012)).

9 The Bankruptcy Court distinguished the case of *In re Zais Inv. Grade Ltd. VII*, 455 B.R. 839 (Bankr. D. N. J. 2011), a case on which the Petitioning Creditors had heavily relied, on grounds that the request for dismissal of the proceeding therein occurred after the case had proceeded for some period.

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