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Dismissal of Involuntary Bankruptcy Petition Against Taberna CDO is Win for Securitization Industry

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On November 8, 2018, Judge Vyskocil of the U.S. Bankruptcy Court for the Southern District of New York issued a decision dismissing the involuntary petition that had been filed against Taberna Preferred Funding IV, Ltd. ("Taberna"), a non-recourse CDO, thus ending a nearly seventeen-month-long saga that was followed closely by bankruptcy practitioners and securitization professionals alike. *See Taberna Preferred Funding IV, Ltd. v. Opportunities II Ltd., et. al.*, *(In re Taberna Preferred Funding IV, Ltd.)*, No. 17-11628 (MKV), 2018 WL 5880918, at *24 (Bankr. S.D.N.Y. 2018). Judge Vyskocil's decision to dismiss the involuntary petition came in response to a motion filed by certain of Taberna's junior noteholders that were fighting against senior noteholders' attempt to use the chapter 11 process to liquidate the Taberna CDO's collateral in an accelerated fashion in a manner inconsistent with the terms of the underlying indenture.

Cadwalader advised the Structured Finance Industry Group ("SFIG") in connection with the case, arguing, via *amicus* brief, that involuntary chapter 11 petitions against securitization vehicles like Taberna serve no valid reorganizational purpose, violate public policy, and threaten industry expectations that such vehicles are bankruptcy-remote. Further, SFIG argued that investors in non-recourse and bankruptcy-remote securitizations should not be eligible to commence involuntary cases.

This decision is significant in that it sends a clear message to the capital markets that noteholders of non-recourse securitizations will face obstacles if they attempt to invoke the involuntary bankruptcy process as a strategic tool to try to override bargained-for liquidation provisions in underlying transaction documents. Here, Judge Vyskocil rejected the petitioning noteholders' attempt to manufacture eligibility credentials to qualify for commencing an involuntary bankruptcy case under the Bankruptcy Code, in turn creating a formidable barrier that should make investors pause before attempting strategic maneuvers against other nonrecourse, bankruptcy-remote vehicles similar to those that were attempted here.

I. Background

On the heels of other unsuccessful attempts to initiate a fast liquidation via a failed tender offer and a failed consent solicitation, on June 12, 2017, three funds managed by HH Holdco (the "Petitioning Creditors") filed an involuntary chapter 11 petition against Taberna. The Petitioning Creditors were holders of all of the senior priority Class A-1 notes, and a large percentage of the second priority Class A-2 notes. Since the filing of the involuntary petition, several junior noteholders (the "Junior Noteholders") had been opposing and contesting the Petitioning Creditors' filing of the involuntary petition and generally arguing that the Petitioning Creditors wrongly filed the involuntary petition in order to accelerate payments by liquidating the collateral that secures both the Petitioning Creditors and junior creditors' notes, in contravention of the terms of the applicable indenture.

On August 14, 2017, following weeks of discovery amongst the parties, the Petitioning Creditors moved for summary judgment on the threshold Bankruptcy Code requirement for commencing an involuntary case under section 303(b)(1) of the Bankruptcy Code, which requires that a petitioning creditor hold, in the aggregate, claims that exceed the value of any lien(s) securing those claims by a certain dollar threshold ($15,775). Taberna's collateral manager and the Junior Noteholders, supported by SFIG's *amicus* brief, opposed the Petitioning Creditors' summary judgment motion and argued that, among other things, because the notes were nonrecourse, even if the Petitioning Creditors' could show that their claims were not fully secured, they still would have no unsecured claims against Taberna itself (as opposed to Taberna's property) as required to qualify under Bankruptcy Code section 303(b)(1). Ultimately, Judge Vyskocil denied the Petitioning Creditors' motion for summary judgment, and a trial commenced on the eligibility of the Petitioning Creditors to maintain the case. After five days of trial, on February 1, 2018, the Junior Noteholders filed a motion seeking entry of a judgment on partial findings on the specific issue of whether the Petitioning Creditors were not eligible petitioners, and the matter has been under advisement since February 28, 2018.

On September 27, 2018, Judge Vyskocil subsequently entered an order to show cause "why, in light of the decision in *In re Murray*, 900 F.3d 53 (2d Cir. 2018), the Court should or should not dismiss the involuntary petition in this case pursuant to Sections 305(a), 1112(b), and 105(a) of the Bankruptcy Code." In *Murray*, the Second Circuit affirmed the lower courts' dismissal of an involuntary petition, including for the reason that that New York law offered adequate remedies for the petitioning creditors such that bankruptcy was not necessary. *Murray*, 900 F.3d. at 61-62.

Against this backdrop, on November 8, 2018, Judge Vyskocil issued the much-anticipated decision dismissing the involuntary petition.

II. The Decision

Judge Vyskocil dismissed the involuntary petition on the grounds that: (1) as holders of nonrecourse claims, the Petitioning Creditors did not hold claims against the person (Taberna) as required by section 303(b) of the Bankruptcy Code and, therefore, were not eligible to file the involuntary petition; and (2) cause existed for dismissal pursuant to section 1112(b) of the Bankruptcy Code, including because the case served no legitimate bankruptcy purpose and dismissal was in the best interest of the creditors and the estate.[1] *Taberna Preferred Funding IV, Ltd. v. Opportunities II Ltd., et. al.*, *(In re Taberna Preferred Funding IV, Ltd.)*, No. 17-11628 (MKV), 2018 WL 5880918, at *24 (Bankr. S.D.N.Y. 2018).[2]

A. Petitioning Creditors Did Not Qualify As Eligible Petitioners under Bankruptcy Code 303(b)

Section 303(b) of the Bankruptcy Code "requires that an involuntary petition be brought by at least three qualifying creditors and that each such creditor holds a claim *against the target of the involuntary petition*." *Id.* at *6. The Petitioning Creditors argued that they held claims against Taberna as required by section 303(b), both because the terms of the indenture stated that they held recourse claims, and because the Bankruptcy Code should be read to say that even holders of nonrecourse claims are eligible to file involuntary petitions. In response to these arguments, Judge Vyskocil held that: (1) the terms of the indenture explicitly stated that the Petitioning Creditors' notes were nonrecourse; and (2) the Bankruptcy Code does indeed distinguish between recourse and nonrecourse debt for purposes of determining eligibility to file an involuntary petition. *Id.* at *6-*16. Accordingly, Judge Vyskocil held that the Petitioning Creditors were ineligible to have filed the involuntary petition against Taberna. *Id.* at *6.

Judge Vyskocil found that based on the plain meaning of the language in the indenture, it was clear that the notes at issue were nonrecourse and that Taberna was not personally liable to the noteholders in connection therewith. *Id.* at *7-*8. In other words, the noteholders could only look to the collateral for recourse – but not to Taberna itself – leaving the noteholders with no unsecured claims against the purported debtor. In the absence of holding unsecured claims, the procedural threshold to commence an involuntary case under section 303(b) was not satisfied. In reaching that conclusion, Judge Vyskocil expressly rejected the Petitioning Creditors' argument that the language in the indenture provided that the underlying notes did not become nonrecourse until the collateral was liquidated. *Id.* Rather, Judge Vyskocil found that the language in the indenture unambiguously provided that a noteholders' claim was to be extinguished "following realization of the collateral and its reduction to zero." *Id.*

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[1] Note that either of these two grounds alone would have been sufficient for Judge Vyskocil to dismiss the petition.

[2] Judge Vyskocil directed the parties to settle a judgment. *Id.* Upon Judge Vyskocil entering the judgement, the dismissal may be subject to a potential appeal.

Further, the Petitioning Creditors argued that sections 1111(b) and 102(2) of the Bankruptcy Code eliminate the distinction between recourse and nonrecourse debt, including for purposes of evaluating whether a creditor is eligible to commence an involuntary case under section 303(b) of the Bankruptcy Code. Specifically, the Petitioning Creditors argued that section 1111(b) of the Bankruptcy Code "eliminates any distinction in chapter 11 between recourse and nonrecourse debt," and therefore, when determining whether a petitioning creditor holds a claim against the entity that is the subject of an involuntary petition as required under section 303(b), nonrecourse creditors must be treated as holding recourse claims.[3] This argument failed, however, as Judge Vyskocil held that section 1111(b) is not applicable for the purposes of determining a party's eligibility to initiate an involuntary bankruptcy under section 303. *Id.* at *9-*12. Judge Vyskocil explained that the plain language of section 1111(b) makes clear that the recourse transformation is for plan distribution purposes and does not change the nature or terms of a creditor's security interest. *Id.* at *10. As a result, section 1111(b) does not treat all nonrecourse claims as recourse under all circumstances, including at the commencement of every chapter 11 case. *Id.* And thus, because an order for relief had not been entered given the dispute, there was no chapter 11 case such that section 1111(b) could be considered triggered for purposes of determining a party's eligibility to initiate an involuntary bankruptcy under section 303(b) in the first instance. *Id.*

Moreover, the Petitioning Creditors argued that, based on the text of section 102(2), which provides that a "claim against the debtor includes [a] claim against property of the debtor", they met the requirement under section 303(b) that they hold a "claim against such person" (*i.e.* against Taberna) since under section 102(2), a claim against Taberna necessarily includes a claim against property of Taberna (*i.e.* the collateral). After distinguishing cases cited by the Petitioning Creditors, Judge Vyskocil noted that section 303(b) does not employ the phrase "claim against the debtor" (i.e., -- the language used in section 102(2)), and instead refers to an unsecured claim "against such person." Judge Vyskocil held that the plain language of section 303(b), in conjunction with additional context provided in other definitions in the Bankruptcy Code, make clear that a "claim against such person" does not include a "claim against such person's property." *Id.* at *13-*15. Accordingly, Judge Vyskocil concluded that because the Petitioning Creditors hold claims against *only the collateral*, and do not hold claims against Taberna, they fail to meet the eligibility requirements under section 303(b) of the Bankruptcy Code of holding unsecured claims. *Id.* at *15.

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[3] Section 1111(b) provides a basis for a secured claim holder, whether its contractual claim provides for recourse against the debtor (a "full recourse" claim) or only against the collateral (a "nonrecourse" claim) to decide whether, in the context of confirmation of a plan, its claim should be treated as a full recourse claim, so that it would hold an allowed secured claim to the extent of the value of the security and an allowed unsecured claim for the deficiency; or to elect to have its entire claim deemed secured by the collateral and thereby waive any deficiency claim. 6 Collier Bankruptcy Practice Guide ¶ 91.06 (2018).

B. Dismissal "For Cause" Under Section 1112(b) Was Appropriate

Relying on the recent Second Circuit decision *In re Murray*, the court held that even if the Petitioning Creditors were eligible under section 303(b), dismissal was still appropriate in this case pursuant to section 1112 of the Bankruptcy Code "for cause." *See Wilk Auslander LLP v. Murray (In re Murray)*, 900 F. 3d 53 (2d Cir. 2018). Specifically, Judge Vyskocil noted that Taberna is not an operating business, and there was therefore no rehabilitative objective that can be served by allowing the case to proceed, particularly since the indenture independently established the parties' agreements as to liquidation. *Taberna Preferred Funding IV, Ltd.*, 2018 WL at *21. In fact, Judge Vyskocil stated that "it would be an injustice for the Court to find that the Petitioning Creditors, sophisticated business entities who analyzed and bargained for Taberna's current liquidation scheme, are prejudiced by the contractual terms and conditions they freely sought out and entered." *Id.* Further, citing SFIG's *amicus* brief, Judge Vyskocil noted that the she was "convinced that if the Petitioning Creditor's tactics were permitted and rewarded with an entry of an order for relief, this would create significant uncertainty across the capital markets." *Id.* at *23.

In support of her decision that dismissal was appropriate under Section 1112(b), Judge Vyskocil noted the following factors:

- the debtor was not an operating business and does nothing other than hold securities that generate cash flow to pay noteholders pursuant to the terms of the indenture;
- by the terms of the indenture, Taberna was intended to exist only for a finite period of time;
- the debtor does not need or want a bankruptcy discharge;
- no assets would be lost or dissipated if the bankruptcy case were dismissed;
- the Petitioning Creditors are being paid pursuant to the indenture;
- the Petitioning Creditors have adequate remedies for any grievances under nonbankruptcy law;
- the Petitioning Creditors previously engaged in unsuccessful serial efforts to liquidate the collateral;
- the Petitioning Creditors were seeking to liquidate the collateral solely for their benefit, at the expense of other noteholders;
- the Petitioning Creditors paid 91.1875 percent on the outstanding principal amount to purchase the remaining Class A notes, thereby giving Petitioning Creditors a controlling share of Class A notes, yet three weeks earlier offered to buy the same Class A notes at only 76 percent of the outstanding principal;
- the Petitioning Creditors' principal sought to follow and pattern his initiatives in this case after those in *In re Zais Investment Grade Limited VII*, 455 B.R. 839, 849 (Bankr. D.N.J. 2011), another involuntary bankruptcy filing against a CDO, which Judge Vyskocil found to be

distinguishable from this case in part because the facts here established that the Petitioning Creditors have, in a methodical and deliberate process, set out to force an accelerated liquidation; and

- the Petitioning Creditors purchased the defaulted notes with an eye towards commencing this involuntary petition.

Id. at *19-*20.

When weighing the foregoing factors together with the goals of the Bankruptcy Code and the reasoning of *Murray,* Judge Vyskocil held that cause existed for the involuntary petition to be dismissed. *Id.* at *20.

III. Conclusion

As argued by SFIG in its *amicus* brief, the actions taken by the Petitioning Creditors in filing the involuntary chapter 11 petition against Taberna threatened to undermine a core underpinning of the securitization industry—that securitizations are generally nonrecourse vehicles that should be liquidated in accordance with the pre-agreed terms in their respective transaction documents. Indeed, "to jettison the already agreed upon procedures under an indenture in favor of a different scheme advanced by a disruptive party upsets market expectations and prejudices other creditors." *Amicus Curiae* Brief of Structured Finance Industry Group, Inc., at 2, No. 17-11628 (MKV) (Bankr. S.D.N.Y. Oct. 12, 2017), ECF No. 97.

The involuntary filing against Taberna had market participants anxiously awaiting to see whether the Petitioning Creditors' course of action would get any traction, and thereby risk potentially encouraging similar creditor tactics across the securitization industry. Indeed, as SFIG further argued, the Petitioning Creditors' "tactic [was] in stark contrast to the spirit of the Bankruptcy Code: to afford a debtor an opportunity to continue business and a more promising future, preserve equity, and increase overall creditor recoveries. It is also fundamentally at odds with how such securitizations operate. As such, if a tactic like this were now to be permitted to proceed it would create significant uncertainty across the capital markets, which place great weight on the bankruptcy remote and nonrecourse nature of securitizations and the pre-agreed and certain disposition of assets thereunder." *Id.* at 4.

But with the Taberna case dismissed for now, the capital markets can continue business as usual.

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