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CMBS Certificateholders Shut Out

'Innkeepers' precludes participation in borrower restructuring for lack of standing.

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THE ABILITY OF INVESTORS in commercial mortgage backed securities (CMBS) to participate directly in a borrower's restructuring was recently curtailed by a New York bankruptcy court, raising a number of practical restructuring considerations for distressed borrowers, special servicers and CMBS investors.

While it is clear that a CMBS trust itself has standing as a "party in interest" under §1109(b) of Title 11 of the United States Code (Bankruptcy Code) to participate in a borrower's bankruptcy proceeding, prior to the decision of the court in *In re Innkeepers USA Trust*,[1] the question of whether a certificateholder in a CMBS pool was a "party in interest" had not been specifically decided.

In *Innkeepers*, the court ruled that certain certificateholders in two CMBS pools holding the debtors' loans were not parties in interest pursuant to §1109(b) of the Bankruptcy Code, and thus did not have standing before the court to object to the debtors' motion for an order approving proposed bidding procedures. While no court previously had determined this precise issue, the *Innkeepers* court found persuasive and closely analogous decisions by other courts holding that parties with only an indirect (or derivative) connection to a debtor (such as a creditor of a creditor) were not parties in interest for purposes of participating in bankruptcy proceedings.

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These courts, like the *Innkeepers* court, noted that bankruptcy courts were established to provide a forum for debtors and their creditors to settle disputes and that an overly lenient party-in-interest standard potentially could overburden the reorganization process by allowing numerous parties to interject themselves throughout the proceeding. The *Innkeepers* decision is consistent with this principle and likely will limit the ability of CMBS investors to meaningfully participate in a bankruptcy proceeding.

CMBS Structure and Standing

While the CMBS structure and process of creation may be familiar to many, a review will be helpful to set the stage.

In a typical CMBS, commercial mortgage loans of different size, location and property type are pooled together by a sponsor and sold to a trust (the trust usually elects to be treated as a "real estate mortgage investment vehicle" (a "REMIC") for U.S. tax purposes). The trust then becomes the lender by assignment under each of the commercial mortgage loans and issues pass-through certificates entitling investors to certain collections on the pool of commercial mortgage loans.

These certificates may vary in terms of yield, duration and payment priority. The conduct of the trust, and distributions therefrom, are governed by a pooling and servicing agreement (servicing agreement).

Nationally recognized ratings agencies, such as Standard & Poor's Rating Services, assign credit ratings to the certificates, often ranging from AAA to below investment grade. Investors choose which certificates to purchase based on their desired level of risk, duration and/or yield.

The trust, through its agents such as the master servicer and the special servicer, serves as the intermediary between an individual certificateholder and a borrower. Thus, there is no direct relationship between a borrower and a certificateholder.

As discussed herein, because standing in bankruptcy proceedings generally is limited to parties with direct relationships to the debtor, the indirect relationship created by the CMBS structure complicates a certificateholder's argument that it is a "party in interest," i.e., that the certificateholder is a creditor of the debtor. Moreover, once the loans have been securitized, the certificateholders' and borrowers' relationships are managed by parties appointed pursuant to the servicing agreement, further removing the certificateholder from any direct relationship with the debtor-borrower.

A. The Master Servicer. In the case of a loan in a CMBS where the borrower is adequately servicing its debt obligations, the servicing agreement places the master servicer in control. The master servicer's primary responsibility is to oversee each loan in the CMBS pool through maturity, unless the borrower defaults or will foreseeably

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default (known in CMBS transactions as a "servicing transfer event").[2]

The master servicer generally manages the flow of payments and information between the borrower and the certificateholders and also performs routine loan administration functions. Unless otherwise provided in the servicing agreement, the master servicer's authority typically is limited to granting routine waivers and consents and does not include the ability to agree to an alteration of material terms of a loan or mortgage.

B. The Special Servicer. Upon the occurrence of a servicing transfer event, the administration of the distressed loan will be transferred to a special servicer, usually a professional with experience in managing distressed mortgage loans. In fulfilling its duties under the servicing agreement, and conventionally with the consent of 25 percent of the certificateholders, the special servicer may agree to any modification of the loan that affects the amount or timing of any related payment of principal, interest or other amount, or otherwise materially alters the terms of the mortgage.

In certain CMBS transactions, like the CMBS pools at issue in *Innkeepers*, the certificateholders agree to allow the special servicer to administer and service the loans in the certificateholders' collective best interests, including through the exercise of remedies.

Servicing agreements also commonly contain "no action" clauses, which prohibit certificateholders from instituting any action without (i) providing the trustee under the servicing agreement with written notice of default under the agreement and (ii) certificateholders entitled to at least 25 percent of the voting rights directing the trustee to institute an action and the trustee neglecting to take such action for at least 60 days.

C. Roadblocks to Refinancing: a Catch-22 Situation. Outside of a CMBS transaction, a borrower negotiates amendments to its mortgages directly with its lenders. However, the CMBS structure imposes significant limitations on a borrower effectuating an out-of-court restructuring or entering into Chapter 11 protection with the support of the certificateholders if the loan has not yet been transferred to a special servicer.

Because the master servicer lacks authority to negotiate material amendments to a mortgage agreement, a distressed borrower may not be able to avoid, through consensual, out-of-court refinancing negotiations, the occurrence of an event of default (or, in extreme cases, a bankruptcy filing) that otherwise might have been avoided had loan administration been transferred to a special servicer.[3]

Inside the 'Innkeepers' Case

Prior to their bankruptcy, Innkeepers USA Trust and its affiliated debtors (Innkeepers) had outstanding debt of approximately $1.5 billion, including $825 million in mortgage debt that was transferred to two CMBS trusts, which in turn issued certificates of different priorities to various investors. Included in the governing servicing agreement was a standard "no action" clause similar to the one described above.

After filing for Chapter 11 protection and concluding that it would be unable to develop a confirmable standalone plan, Innkeepers determined to sell their assets pursuant to Bankruptcy Code §363, identified potential purchasers and selected a "stalking horse" bid that they believed would maximize value and provide an opportunity to bring consensus to their stakeholders.

Because standing in bankruptcy proceedings generally is limited to parties with **direct relationships** to the **debtor**, the indirect relationship created by the **CMBS structure complicates** a certificateholder's argument that it is a '**party in interest**,' i.e., that the certificateholder is a creditor of the debtor.

After many rounds of amendments to the stalking horse bid, Innkeepers, with the support of the special servicer for the fixed-rate loan, filed a motion to approve proposed bidding procedures. By this time, only certain certificateholders, holding less than 25 percent of the face value of the certificates, continued to object to the motion.

In their objection, the certificateholders asserted that the proposed bidding procedures unduly inhibited competitive bidding and that, because the special servicer was providing "stapled financing" for the proposed bid (or any competing, qualified bid), it impermissibly placed its own financial interests over those of the certificateholders.

Innkeepers and the special servicer responded that the certificateholders lacked standing to bring such objections before the court and, alternatively, that the "no action" clause contained within the specific CMBS servicing agreement prohibited individual certificateholders from instituting any action, suit or proceeding under the servicing agreement unless certain conditions were met.

Given the certificateholders' determination to press their objections, the *Innkeepers* court was compelled to address the issue of whether a certificateholder in a CMBS facility was a "party in interest" under the Bankruptcy Code.

Bankruptcy Code §1109(b) provides that "[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or an indenture trustee, may raise and may appear and be heard on any issue in a case under [Chapter 11 of the Bankruptcy Code]."[4]

Whether an entity is a party in interest therefore is dispositive of whether such entity has standing to be heard before a bankruptcy court.

As noted by the *Innkeepers* court, while courts in the Second Circuit broadly interpret "party in interest," they nevertheless grant standing only to those parties with a direct interest in the outcome of the proceeding.[5] As a result, standing under §1109(b) does not exist if the party seeks to assert some right that is purely derivative of another party's rights in the bankruptcy proceeding.[6]

No Direct Interest, No Standing

In *Innkeepers*, the certificateholders asserted that they were parties in interest in the debtors' Chapter 11 cases by virtue of their status as substantial certificateholders in both REMICs.

The court disagreed, holding that while these particular certificateholders had standing in their capacities as preferred shareholders and as participants in Innkeepers' debtor in possession financing facility, they did not have standing in their capacity as certificateholders because they were creditors of a creditor (the CMBS trust) without a direct interest in the adjudication of the bidding procedures motion.[7]

The court reasoned that in a CMBS transaction, a certificateholder's relationship is with the trust, and the right to payment comes from the trust's assets, not from the debtor as the originator of the assets in the trust. While the certificateholders in *Innkeepers* may have had an indirect interest in the outcome of the bidding procedures motion and in any sale arising thereafter, the certificateholders, in their capacity as such, did not have standing before the court because they were not direct creditors of Innkeepers. Instead they were creditors of a creditor of Innkeepers, a relationship that the court determined was too tenuous to provide a basis for standing.[8]

As noted above, the *Innkeepers* court, although the first to address specifically the issue of a CMBS

certificateholder's standing rights, was guided by related and persuasive precedent of several courts in analogous circumstances.

In *In re Shilo Inn*,[9] the bankruptcy court held that certificateholders in an asset securitization could not vote on the debtor's proposed plan as the claims sought to be voted belonged to the investment trusts, not to individual certificateholders that held only beneficial interests in the trusts and did not have a direct creditor relationship to the debtor. Further, the servicing agreement gave the right to vote to the special servicer.

Additionally, in *In re Refco Inc.*, the U.S. Court of Appeals for the Second Circuit affirmed the bankruptcy and district court decisions holding that a segregated non-debtor portfolio company, not the individual investors therein, was the "party in interest" under Bankruptcy Code §1109(b) with standing to be heard in the bankruptcy case.[10]

In rendering its decision, the *Innkeepers* court was informed by the fact that the servicing agreement governing the trust contained a standard no action clause. In the court's view, granting standing would override this provision and alter the terms and risks investors undertook and bargained for when they bought the certificated interests.

The *Innkeepers* court also was concerned that granting a certificateholder standing under such circumstances would "inevitably serve to delay and complicate bankruptcy cases as debtors [would be] forced to litigate issues with additional parties who previously were contractually obligated to speak with one voice, that of the special servicer."[11]

Because the conditions precedent to the no action clause were not satisfied and because of overriding bankruptcy policy considerations, the *Innkeepers* court ruled that the certificateholders could not circumvent the special servicer and be afforded standing to be heard in connection with the bidding procedures motion.

Practical Considerations

In light of the increase in bankruptcy filings involving complex CMBS structures, the *Innkeepers* decision adds needed (although unsurprising) guidance.

As a result of the decision, a certificateholder owning insufficient voting percentages to direct the special servicer likely will face significant, if not insurmountable, roadblocks to participating and exerting leverage in a bankruptcy of the originator of the loans in a CMBS pool. The decision therefore should prove beneficial to debtor-borrowers by providing them with comfort that, with the support of the special servicer, their proposed restructuring will be insulated from attacks by disgruntled certificateholders. This risk should be carefully considered by an entity deciding to invest in CMBS transactions.

A certificateholder, however, is not left without redress. As with intercreditor disputes between first and second lien creditors that have no bearing on a debtor's bankruptcy estate, a dispute between a certificateholder and a special servicer can be brought in the appropriate non-bankruptcy court. Thus, to the extent a certificateholder believes the special servicer has breached a servicing agreement or violated the servicing standards contained therein (as was asserted in *Innkeepers*), a lawsuit against the special servicer filed in an appropriate non-bankruptcy court may be the best course of action for the disenfranchised certificateholder.

Additionally, if an individual certificateholder is sufficiently economically motivated, it may attempt to avoid the result of the *Innkeepers* ruling by purchasing a meaningful amount of claims against the debtor, the legal entitlements of which are economically aligned with its interests as a certificateholder.

Finally, to the extent they are permitted to do so by the relevant servicing agreement, individual certificateholders may desire to identify and band together with other certificateholders so that they are in a position to direct the actions of the special servicer.

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1. *In re Innkeepers USA Trust*, Case No. 10-13800, 2011 WL 1206173 (Bankr. S.D.N.Y. April 1, 2011).

2. Servicing Transfer Events include (i) a borrower's failure to make scheduled principal and interest payments (unless cured within the stated period), (ii) a borrower's bankruptcy or insolvency, (iii) a borrower's failure to make a balloon payment upon maturity, and (iv) a determination by the master servicer that a material and adverse default under the loan is imminent and unlikely to be cured.

3. This was one of the dilemmas faced by General Growth Properties Inc. and its affiliates (GGP) prior to its bankruptcy filing in April 2009. At its filing, GGP had approximately $15 billion of project level mortgage debt held in CMBS pools. *In re General Growth Properties Inc.*, No. 09-11977 (Bankr. S.D.N.Y. 2009).

4. 11 U.S.C. §1109(b).

5. *Innkeepers*, 2011 WL 1206173, at 14 (citing *In re St. Vincent's Catholic Med. Ctrs. of N.Y.*, 429 B.R. 139, 149 (Bankr. S.D.N.Y. 2010)).

6. See, e.g., *In re Refco Inc.*, 505 F.3d 109, 117 (2d Cir. 2007).

7. The *Innkeepers* court also determined that: (i) the certificateholders' ownership of preferred shares was de minimis and that such shares admittedly were purchased to bolster their standing arguments; and (ii) the DIP repayment was never at risk. Thus, the certificateholders' only real interest in objecting to the bidding procedures was in their capacity as certificateholders, not as shareholders or DIP lenders. *Innkeepers*, 2011 WL 1206173, at 4 n.14-15.

8. The *Innkeepers* court was careful to distinguish the case before it from *In re Extended Stay Inc.*, Case No. 09-13764 (JMP) (Bankr. S.D.N.Y. 2009), wherein individual certificateholders in a CMBS transaction appeared before and were heard by the bankruptcy court in the initial stages of the bankruptcy cases. The *Innkeepers* court noted that *Extended Stay* was readily distinguishable because, in *Extended Stay*, the debtor-borrowers had engaged in meaningful prepetition restructuring negotiations with several large holders of CMBS certificates, parties did not object to their being heard and the special servicer had not been appointed prior to the commencement of the bankruptcy cases.

9. 285 B.R. 726 (Bankr. D. Or. 2002).

10. *Refco*, 505 F.3d at 117 ("Only Sphinx, not individual investors, or even investors as a group, could assert a claim against the Refco estate, and only Sphinx was permitted to negotiate a settlement with the Committee. Investors maintain a financial 'interest' in Sphinx, but they are not a 'party in interest' within the meaning of the Bankruptcy Code").

11. *Innkeepers*, 2011 WL 1206173, at 9.