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Standing

Bankruptcy Court Rules CMBS Certificateholder Does Not Have Standing to Appear in Chapter 11 Case



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Until recently, no bankruptcy court has directly addressed whether certificateholders in commercial mortgage-backed security ("CMBS") REMICs (real estate mortgage investment conduits) have standing to be heard in chapter 11 cases under 11 U.S.C. § 1109(b) as "parties in interest."[2] This issue is particularly important given the potential upcoming wave of maturity defaults in the $3.5 trillion commercial real estate market.[3] By 2014, a total of $1.4 trillion in commercial real estate loans will reach the end of their terms.[4] Furthermore, CMBS loans represent approximately 20 percent of commercial property debt.[5] As a result, the issue of whether CMBS certificateholders have standing to appear and raise arguments on their own behalf in chapter 11 cases—an unprecedented bankruptcy law issue until now—will take on increased significance.

In *In re Innkeepers USA Trust*,[6] the United States Bankruptcy Court for the Southern District of New York (the "Court") squarely answered the question of a certificateholder's standing. In *Innkeepers*, a holder of certificated interests in the two REMICs that owned the largest of the debtors' prepetition loans urged the Court to adopt a broad interpretation of "party in interest" under § 1109(b) of the Bankruptcy Code to grant them standing to object to a motion to approve the debtors' entry into a plan sponsor stalking horse agreement. The Court denied the standing request, relying both on controlling law and the express terms of the applicable servicing agreement, which contractually binds the special servicer–the party responsible for representing the certificateholders upon an event of default under a mortgage loan held by the REMIC–to consider the collective interests of all certificateholders.

The Innkeepers Ruling

On July 19, 2010 (the "Petition Date"), Innkeepers USA Trust, owner and operator of 71 upscale hotels under premium, well-recognized brands, and its chapter 11 debtor affiliates (collectively, the "Debtors") each filed a voluntary petition commencing a chapter 11 bankruptcy case (collectively, the "Chapter 11 Cases").

Prior to the Petition Date, the Debtors' largest loan (the "Fixed Rate Loan"), collateralized by 45 of the Debtors' hotel properties, was transferred by certain of the Debtors' pre-petition lenders into two REMIC trusts known as the C-6 trust and the C-7 trust (together, the "C-6 and C-7 Trusts"). The pooling and servicing agreement that governed the Fixed Rate Loan (the "Servicing Agreement") contained a standard no-action clause (the "No-Action Clause") prohibiting a certificateholder from instituting an action under the Servicing Agreement or relating to the Fixed Rate Loan unless (a) written notice of a default under the Servicing Agreement is provided to the special servicer or (b)

a certificateholder entitled to at least twenty-five percent of the voting rights makes a written request to the trustee to institute such action, and the special servicer has neglected to take such action for at least sixty days.

On January 14, 2011, the Debtors filed a motion to authorize their entry into a commitment letter with a stalking horse plan sponsor for a restructuring transaction (the "Stalking Horse Motion"). The special servicer for the Fixed Rate Loan (the "Special Servicer") supported the Stalking Horse Motion. A holder of certificates in both the C-6 and C-7 Trusts (the "Certificateholder"), however, objected to the Stalking Horse Motion on various grounds, asserting standing as a certificateholder in the C-6 and C-7 Trusts, a debtor-in-possession financing lender, and a preferred shareholder. The Debtors did not dispute that the Certificateholder had standing in its capacity as a post-petition lender and preferred shareholder. The Debtors did, however, refute the Certificateholder's standing as a certificateholder and argued the Certificateholder should be limited to raising arguments related to the treatment of the claims arising out of the post-petition financing and the interests arising out of the preferred shares.

On January 25, 2011, the Certificateholder filed papers with the Court in support of its status as a party-in-interest entitled to standing in the Chapter 11 Cases.[7] In its memorandum of law, the Certificateholder asserted that its status as a holder of various interests in the Debtors' cases (including its certificated interest in the Fixed Rate Loan) confers rights on it as a party-in-interest sufficient to allow it to participate and be heard in the Debtors' cases on ***any*** issue, including with respect to a hearing on the Stalking Horse Motion.[8] The Certificateholder also claimed that, in supporting the stalking horse bid, the Special Servicer was making commitments that placed its own financial interest above those of the certificateholders, thereby rendering the Special Servicer conflicted and unable to adequately represent certificateholders.[9] Finally, the Certificateholder argued that the language of the No-Action Clause did not preclude or even implicate the Certificateholder's participation regarding the Stalking Horse Motion as it was not taking "action" in seeking to be heard on the Stalking Horse Motion.[10]

After hearing argument, the Court disagreed with the Certificateholder, and ruled in favor of the Debtors, for a variety of reasons. *First*, the Court held that the claims belonged to the C-6 and C-7 Trusts themselves—not to the individual certificateholders who purchased the beneficial interest in the loans as part of the asset securitization and who had no privity with the Debtors.[11] Specifically, the Court explained that "the investor's relationship [was] with the special purpose vehicle holding the assets (in this case, the C-6 and C-7 Trusts) and the right to payment [came] from the cash generated by the assets, not from the debtor as originator of the assets itself . . . . This result comports with the Second Circuit's holding in *Refco*[12] that a creditor of a creditor is not a party-in-interest within the meaning of Section 1109(b) of the Bankruptcy Code."[13] *Second*, the Court considered the public policy implications of allowing certificateholder standing, stating "it would also encourage and embolden other certificateholders to hire their own counsel to challenge the special servicer's authority and to advance their individual and conflicting pecuniary interests"[14] and "to hold otherwise would, in the view of the Court, potentially cause chaos in the already tumultuous CMBS market."[15] *Third*, the Court held that the Certificateholder was contractually bound by the No-Action Clause and none of the conditions precedent to action had been met entitling the Certificateholder to circumvent the Special Servicer and obtain independent standing to be heard on the Stalking Horse Motion.[16] *Finally*, the Court was persuaded by the servicing standard contained in the Servicing Agreement—a significant "check" on servicers' conduct—which contractually bound the Special Servicer to consider the interests of all certificateholders as a collective whole and which enabled certificateholders to take separate action under the terms of the Servicing Agreement in the event of an alleged breach of duty.[17]

Impact of Innkeepers Ruling

With over a trillion dollars in commercial real estate mortgage loans coming due over the next several years and much of that debt being securitized into the CMBS market then subsequently transferred to special servicing, standing (or lack thereof) in chapter 11 cases for certificateholders will likely become a pressing bankruptcy law issue. As the *Innkeepers* Court stated in its opinion on the matter, allowing certificateholder standing "would dramatically alter the CMBS landscape and render the delegation to a special servicer meaningless."[18] Notably, the *Innkeepers* opinion may also extend to investors in other asset-backed securities—prohibiting them from influencing modifications to loans in the securitized asset pool backing their investments when the borrower under such a loan is a chapter 11 debtor. Time will dictate the appropriate scope of this groundbreaking decision.

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[1] Kirkland & Ellis LLP represented Innkeepers and certain subsidiaries in their chapter 11 cases.

[2] Section 1109(b) of the Bankruptcy Code broadly 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 any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter." 11 U.S.C. § 1109(b).

[3] *See, e.g.*, Maureen Milford, *Next bubble; Commercial real estate*, The News Journal, March 14, 2010 (Congressional Oversight Panel has recognized that there is a "commercial real estate crisis on the horizon . . . ").

[4] *See Bank of America, N.A. v. PCV ST Owner L.P.* No. 10-1178 (S.D.N.Y Mar. 19, 2010): Brief of Amici Curiarum LNR Partners, Inc. and American Capital, Ltd. in Support of CWCapital Asset Management LLC's Opposition to Motion for Leave to Intervene as a Party-Defendant Filed by Appaloosa Investment L.P. I, Palomino Fund Ltd., Thoroughbred Fund L.P., and Thoroughbred Master Ltd., filed on March 19, 2010 [Docket No. 71].

[5] Marc Weider, *Securitized Mortgages in Commercial Real Estate Signal Trouble Ahead*, Real Estate Weekly, Jan. 20, 2010.

[6] No. 10-13800, 448 B.R. 131 (Bankr. S.D.N.Y. 2011).

[7] *See* Mem. Law of Appaloosa Investment L.P.I, Palomino Fund Ltd., Thoroughbred Fund L.P., and Thoroughbred Master Ltd. in Supp. of Their Status as Parties in Interest Entitled to Standing, *In re Innkeepers*, 448 B.R. 131 (No. 10-13800)..

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *In re Innkeepers*, 448 B.R. at 144.

[12] *Krys v. Official Comm. of Unsecured Creditors of Refco Inc. (In re Refco, Inc.)*, 505 F.3d 109, 2011 BL 118933 (2d Cir. 2007) ; *see also In re Shilo Inn*, 285 B.R. 726 (Bankr. D. Or. 2002).

[13] *Innkeepers*, 448 B.R. at 145.

[14] *Id.* at 144.

[15] *Id.* at 145.

[16] *Id.* at 144.

[17] *Id.* at 145.

[18] *Id.* at 144.