

## CMBS CERTIFICATEHOLDERS DENIED STANDING IN INNKEEPERS BANKRUPTCY: IMPLICATIONS FOR STRUCTURED FINANCE PARTICIPANTS?

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To Our Clients and Friends:

In a recent decision, the Bankruptcy Court for the Southern District of New York ruled that a holder of commercial mortgage-backed securities (“CMBS”) was not a party in interest in, and thus did not have standing to be heard in connection with, the bankruptcy proceeding of the borrower on the underlying mortgage loan.<sup>1</sup> The case, *In re Innkeepers USA Trust*, 2011 WL 1206173 (SCC) (Bankr. S.D.N.Y. Apr. 1, 2011), is the first to address the standing of CMBS holders.

### BACKGROUND

In CMBS securitizations, investors purchase certificates representing beneficial interests in trusts (or other vehicles) that hold mortgage loans or mortgage-backed securities. In the event of a default on the underlying loans or securities, a special servicer is usually authorized to take action on behalf of the trust as a whole. The special servicer is typically given broad powers to act on the trust’s behalf, but is also subject to various restrictions and consent requirements. For example, the special servicer is sometimes required to take direction from a class of certificateholders known as the “controlling holder” that is identified based on valuations of the distressed assets. Such valuations can be time-consuming and uncertain, particularly in turbulent or opaque markets. As a result of such requirements and limitations, in recent bankruptcy proceedings, special servicers have sometimes been unable to take prompt and effective action on behalf of the trust.

Innkeepers owns and operates a portfolio of hotels. Its capital structure includes \$1.29 billion of property-level secured debt, of which approximately \$825 million is held in two CMBS trusts. Following defaults on several of its loans, Innkeepers filed for bankruptcy protection in July 2010. After attempts to reorganize on a standalone basis failed, Innkeepers decided to seek new equity investors. In January 2011, Innkeepers filed a motion for approval of an equity commitment agreement with a stalking horse and related

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<sup>1</sup> The published decision is available at [http://www.nysb.uscourts.gov/opinions/scc/200201\\_1077\\_opinion.pdf](http://www.nysb.uscourts.gov/opinions/scc/200201_1077_opinion.pdf)

procedures for soliciting higher and better offers. The equity commitment agreement provided for a substantial reduction in the debt held by the CMBS trusts—a term to which the special servicer for the trusts had agreed. Multiple parties objected to Innkeepers’ original motion.

#### COURT’S DECISION

In prior cases involving CMBS securitizations, including the recent proceeding involving Extended Stay Hotels, bankruptcy courts had permitted CMBS holders to appear and be heard without having to rule on whether they were parties in interest. *See In re Extended Stay Hotels*, Bankr. S.D.N.Y. Case No. 09-13764 (JMP). In *Innkeepers*, the Court had also been able to avoid determining whether holders had standing for much of the case. However, when all objections to the debtors’ revised motion to approve the agreement with the stalking horse and related bidding procedures were resolved other than an objection lodged by a substantial holder of CMBS certificates, the Bankruptcy Court felt compelled to address the issue.

Section 1109(b) of the Bankruptcy Code governs standing in Chapter 11 proceedings and grants any “party in interest” the right to be heard on any issue in the case. Section 1109(b) provides a non-exclusive list of those considered to be parties in interest, including creditors. Courts generally interpret section 1109(b) broadly to ensure that the bankruptcy process will include all those needed for a comprehensive resolution to disputes over a debtor’s assets. But this broad approach to standing is not unlimited.

For instance, Bankruptcy Courts generally deny standing to “creditors of a creditor.” Thus, a debtor’s supplier has standing, but the lenders to that supplier do not. In *Innkeepers*, the Bankruptcy Court held that this line of cases governed the matter before it, concluding that, in fact, CMBS certificateholders are not direct creditors of the debtors but only creditors of the CMBS trust.

In so ruling, the Court relied on a number of cases that, though not identical, involved structures that the Court found to be substantially similar. In *In re Shilo Inn*, 295 B.R. 726 (Bankr. D. Or. 2002), a Bankruptcy Court denied standing to certificateholders of a pooled real estate loan trust that was similar in many respects to a CMBS trust. In *Refco*, creditors of non-debtor affiliates of a debtor were denied standing in the debtor’s bankruptcy, despite the fact that they stood to gain or lose based on the outcome of the bankruptcy. *In re Refco Inc.*, 2006 WL 3409088 (S.D.N.Y. Nov. 16, 2006), *aff’d*, 505 F.3d 109, 110 (2d Cir. 2007). And a CMBS certificateholder was recently denied standing to intervene in a non-bankruptcy

foreclosure action in the Southern District of New York. *Bank of America, N.A. v. PCV ST Owner L.P.*, Case No. 10-1178 (S.D.N.Y. Apr. 30, 2010).

The Bankruptcy Court separately considered the “no action” clause in the CMBS agreements and concluded that it also barred objections by a certificateholder acting solely in that capacity. “No action” clauses are often found in CMBS agreements and prohibit a certificateholder from taking action unless it has significant support from other certificateholders and the special servicer has been unresponsive to requests to act. In addition, the Court observed that granting standing in bankruptcy to certificateholders might undesirably interfere with the workings of the CMBS structure.

*Innkeepers*, however, may not have shut the door to certificateholder standing in all situations. The Court’s decision was focused on the standing of those acting solely as certificateholders that had not satisfied the strictures of applicable “no action” clauses. Certificateholders with special status, such as “controlling holders,” or certificateholders that have met the requirements of the “no action” clause, may still be able to argue that they have standing. Furthermore, the Court found the presence of an active special servicer significant in *Innkeepers*. Where, by contrast, the special servicer is absent or stymied (as was initially the case in *Extended Stay*) certificateholders may be able to argue that permitting their voices to be heard is better than leaving the CMBS trust without effective representation.

#### IMPLICATIONS OF DECISION

The holding of *Innkeepers* that a CMBS certificateholder lacks standing will dramatically limit the ability of CMBS holders to influence the course of borrowers’ bankruptcy proceedings—particularly where the holders’ goals and interests diverge from those of the special servicer. In addition, if strictly applied, *Innkeepers* may, in some bankruptcies, leave CMBS holders without any meaningful voice given the complex rules governing special servicers in CMBS securitizations.

Participants in non-CMBS securitizations that involve an intermediate trustee, or a special purpose entity analogous to a CMBS trust, may also be affected by the holding in *Innkeepers*. For example, in past bankruptcy proceedings, investors in aircraft securitizations such as holders of enhanced equipment trust certificates (EETC) have been permitted to appear and be heard without substantial dispute. Such creditors may now face arguments, based on *Innkeepers*, that they are not parties in interest and lack standing.

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