In Brief: CMBS Certificate Holders Lack Standing in Chapter 11

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In a ruling that has been described as "very important" and the "first decision of its kind," bankruptcy judge Shelley C. Chapman of the U.S. Bankruptcy Court for the Southern District of New York held on April 1, 2011 in *In re Innkeepers USA Trust*, 2011 WL 1206173 (Bankr. S.D.N.Y. April 1, 2011), that a certificate holder with a beneficial interest in a securitized trust established by chapter 11 debtors' prepetition lenders was not a "party in interest," and therefore, lacked standing to object to bidding procedures proposed by the debtors for the sale of their assets outside the ordinary course of business.

Prior to filing for chapter 11 protection in July 2010 in New York, Innkeepers USA Trust ("Innkeepers"), a real estate investment trust and a leading owner of upscale and extended-stay hotel properties throughout the U.S., borrowed more than $800 million from certain lenders under a fixed rate mortgage loan collateralized by 45 of Innkeepers' hotel properties.

The lenders transferred their interests in the notes evidencing the loan to trusts, each of which was organized as a real estate mortgage investment conduit (a "REMIC")—an investment vehicle that holds mortgage loans and residential and commercial mortgaged-backed securities ("CMBS") in trust and issues securities to investors in the secondary mortgage market in the form of certificates representing beneficial interests in these trusts. Appaloosa Investment L.P. I and certain other investment funds (collectively, "Appaloosa"), held approximately $265,000 in face amount of trust certificates.

REMICs are governed by pooling and servicing agreements that spell out in detail the duties of the servicers that are responsible for administering the loans and allocating cash flows to different classes of certificate holders. Typically, upon an event of default under a mortgage loan held by the REMIC, the servicing agreement provides that the loan shall be transferred to and administered by a so-called "special servicer" appointed to represent the interests of the certificate holders with respect to that loan.

Midland Loan Services ("Midland") acted as special servicer for the trusts in *Innkeepers*. Under the trust servicing agreements, certificate holders agreed to allow Midland to administer and service the loans in the certificate holders' collective best interests, including, where appropriate, to exercise remedies on behalf of the certificate holders. The servicing agreements also contained a standard "no action" clause prohibiting a certificate holder from instituting any suit, action, or proceeding under the servicing agreement or relating to loan unless: (i) a certificate holder gives the trustee written notice of a default under servicing agreement; and (ii) certificate holders holding at least 25% of the voting rights make a written request to the trustee to act, and the trustee neglects to do so for at least 60 days.

In January 2011, Innkeepers filed a motion for authority to sell substantially all of its assets under section 363(b) of the Bankruptcy Code, and sought court approval of bidding procedures. Appaloosa objected to the proposed bidding procedures, claiming, among other things, that they were "an impediment to competitive bidding" and "improperly mandate[d] terms of a plan of reorganization." Innkeepers and Midland responded by arguing that, in its capacity as holder of

interests in the trusts, Appaloosa had no standing to appear and be heard with respect to the motion.

Judge Chapman ruled against Appaloosa, emphasizing that Appaloosa is merely an "investor in a creditor" and is bound by the terms of the "no action" clauses in the servicing agreement. According to the judge, her ruling is "based entirely on controlling law as well as the applicable language of the [servicing agreements]," and that "to hold otherwise, would, in the view of the Court, potentially cause chaos in the already-tumultuous CMBS market. Judge Chapman flatly rejected Appaloosa's argument that "shutting [it] out of the Bankruptcy Case inevitably will result in litigation in other venues, which ultimately may impede the implementation of a confirmable plan." She also rejected Appaloosa's contention that Midland was "hopelessly and impermissibly conflicted" and engaging in "self-enriching" behavior. If Appaloosa believed that to be the case, the judge wrote, "Midland is surely acting at its peril and is answerable to Appaloosa if Appaloosa pursues an action for breach of the servicing standard."

Judge Chapman concluded that Appaloosa had no privity or other relationship with Innkeepers that would confer standing on Appaloosa to be heard. Rather, she noted, in a securitization, the investors' relationship is with the special purpose vehicle holding the assets, and the right to payment comes from cash generated by the assets, not from the debtor as the originator of the assets itself. Judge Chapman explained that this comports with the Second Circuit's holding in *Krys. v. Official Comm. Of Unsecured Creditors of Refco Inc. (In re Refco Inc.)*, 505 F.3d 109 (2d Cir. 2007), that a "creditor of a creditor is not a 'party in interest' within the meaning of section 1109(b) of the Bankruptcy Code."