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CMBS MARKET DODGES A BULLET

Extended Stay Hotels Plan Confirmation Leaves CMBS Structure Intact

Extended Stay Inc. and numerous of its affiliates filed for bankruptcy protection in June 2009, the result of a highly leveraged acquisition at the top of the market. That left the company to operate under an extremely heavy debt load, just as a global recession caused a severe reduction in business travel. Extended Stay operates over 650 hotels under various brands, including Extended Stay Deluxe, Homestead Studio Suites, StudioPLUS Deluxe Studios, and Crossland Economy Studios.

On July 20, 2010 the United States Bankruptcy Court for the Southern District of New York confirmed Extended Stay's proposed plan of reorganization, allowing the Company to be sold for approximately $3.9 billon to a private equity group including Centerbridge Partners, Paulson & Co. and Blackstone. The sale price resulted from an active auction that pitted the Centerbridge group against Starwood Capital, and was close to the $4.1 billion of CMBS mortgage debt the company had outstanding. It was also vastly higher than the $2.5-$3 billion value that news reports placed on the company just months earlier. The planned sale was endorsed without objection by virtually all constituencies, prompting the bankruptcy judge to remark that given the complexity of the case, he was impressed by everyone's efforts to resolve any objections and negotiate such a workable exit from Chapter 11.

Part of what may have prompted the judge's remark was the contentious nature of the case early on, and his recognition that the decisions he made in the case might have a significant precedential impact on the CMBS market generally.

The Extended Stay case is of interest to the CMBS industry for a number of reasons. For one thing, it involves a test of the enforceability of so-called "bad boy" guarantees which trigger upon a company's filing for bankruptcy. This is a common feature of CMBS deals, and the issue is still being litigated in Extended Stay. The case also raises issues about various provisions contained in typical pooling and servicing agreements. For example, such agreements ordinarily prohibit CMBS trustees or special servicers from turning over the list of CMBS certificate holders to borrowers, yet in Extended Stay, the judge ordered disclosure of that information. Also, when some senior CMBS certificate holders negotiated a bankruptcy plan with the borrower before the commencement of the bankruptcy and filed that plan jointly with the borrower on the first day of the case, a more

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junior certificate holder sued under the subordination provision of the pooling and servicing agreement claiming that certificate holders could not take actions that harmed other more junior holders. The judge found the provision (which is typical of those found in many pooling and servicing agreements) to be unenforceable in a bankruptcy proceeding as to the issues before him, and made some reference to its violating the Constitutional rights of assembly and free speech.

Yet the "main event" insofar as far as the CMBS industry was concerned fortuitously never materialized. From the outset, the case pitted some of the fundamental tenets of CMBS deals--particularly those embedded in the common pooling and servicing agreement--with the law and rules of the U.S. bankruptcy process. Pooling and servicing agreements have constructs of value and agreed-upon methods of decision making, which may collide with valuation methodologies and voting concepts under the Bankruptcy Code. And perhaps the largest question looming over any CMBS deal that ends up in bankruptcy is how a plan of reorganization might be confirmed, given the potentially conflicting rules of CMBS versus bankruptcy.

As background, in CMBS, the mortgage(s) are transferred to a trust. Effectively the trust is the holder of the debt. When investors buy CMBS certificates, they are buying interests in the trust, and agreeing to the provisions of the pooling and servicing agreements governing the transaction. Among the constructs in those documents is that: (1) a special servicer will be appointed to deal with defaulted loans in order to protect all of the certificate holders--from the most senior to the most junior--pursuant to a market defined servicing standard; (2) a well-defined waterfall will govern the proceeds received upon foreclosure or other asset resolution; and (3) the certificate holders hold only beneficial interests in a trust, and not underlying mortgage(s) or debt, thus have no standing as holders of debt to show up in court--whether in foreclosure, bankruptcy or otherwise--to protect their interests. Responsibility for dealing with the underlying debt and enforcing the mortgage(s) is delegated to the special servicer. This arrangement differs from what one finds in syndicated lending arrangements, and more traditional bond deals, where the paper held by each holder evidences a portion of the indebtedness of the underlying borrower. In CMBS, the only parties contractually permitted to speak for the entire debt stack, and consequently the only parties who should be able to vote in favor or against a bankruptcy plan of reorganization, are the CMBS trustee and special servicer (in consultation with the "controlling class" of certificate holders and/or an "operating advisor" or similar party speaking for that class). Under CMBS documents, individual certificate holders, or certificate classes, do not have standing to vote on such a plan.

In bankruptcy, a class of creditors can accept a plan of reorganization if creditors holding at least two thirds in dollar amount and one half in number vote in favor of the plan. This raises a host of issues to be grappled with in bankruptcies involving CMBS loans. For example, notwithstanding that there are multiple certificate holders (and multiple classes of certificate holders) in a CMBS deal, the pooling and servicing agreement only permits one party to vote, namely the special servicer. But the special servicer itself is subject to the voting requirements contained within the pooling and servicing agreement, which might differ materially from the two-thirds and one-half requirements of the Bankruptcy Code. What happens if the special servicer determines that it's in the best interest of the certificate holders to vote in favor of a plan, yet the special servicer does not receive the required votes of the certificate holders under the pooling and servicing agreement to permit the special servicer to cast such a vote? Or conversely, what if the special servicer does not favor a plan, yet is directed to do so by the requisite certificate holders under the pooling and servicing agreement? Even worse, what if the special servicer receives no direct guidance by the required constituents under the pooling and servicing agreement? How should it vote?

The concern in the Extended Stay case from the outset had been how a plan of reorganization could be voted on and confirmed if the CMBS structure impeded voting for such a plan in a manner consistent with the Bankruptcy Code. Needless to say, the judge was well

aware of this risk from the beginning, when several triple A certificate holders showed up in court on Day 1 to protect what they perceived to be their interests. The judge repeated throughout the case that even though he was permitting certain certificate holders to be represented and speak their views, he would not decide if such parties had the right to vote on a plan of reorganization until the end of the case. Fortunately, the final plan contemplated a cash payment of roughly $3.9 billion to the CMBS certificate holders, paying off around 95% of the debt at par, and thereby permitting the special servicer under the pooling and servicing agreement to obtain the necessary approvals to vote in favor of the plan without dissent. But had the final bidding for the company yielded a significantly lower value, or one that would be paid partly in cash and partly in debt or equity, as the competing Starwood Capital plan had proposed, the result likely would have been quite different, and the court would have been faced with the prospect of overriding the voting mechanisms within the pooling and servicing agreement in order to move forward on a workable plan of reorganization. Whether that would mean the judge would have permitted classes of certificate holders to vote as if they were debt holders, we will never know. CMBS dodged a bullet in Extended Stay because the bankruptcy judge in the end was not faced with the decision of whether to blow up a pooling and servicing agreement in order to effectuate a plan of reorganization, or whether to treat CMBS certificate holders with no ostensible standing like ordinary creditors before him. If such a result had occurred, it would alter the very nature of buying into a structure where enforcement is delegated to the special servicer, and returns of enforcement are governed by a pre-negotiated waterfall. The risks investors thought they were taking when buying certificates would be inextricably altered, and each bondholder would be incentivized to hire it's own counsel to challenge the authority of the special servicer and to protect its own interests, just like other creditors in the bankruptcy.

It is unclear how future courts may rule when this issue next arises. Cautious investors should be aware that the next bankruptcy court to handle a complicated CMBS-financed borrower might not respect the CMBS structure, and price their investments accordingly.

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