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SEPTEMBER 2022

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Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)

ISBN: 978-0-7698-7988-8 (eBook)

ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S JOURNAL OF BANKRUPTCY LAW [page number] ([year])

Example: Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the "Rescue and Recovery" Culture for Business Recovery*, 10 PRATT'S JOURNAL OF BANKRUPTCY LAW 349 (2022)

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POSTMASTER: Send address changes to *Pratt's Journal of Bankruptcy Law*, LexisNexis Matthew Bender, 230 Park Ave. 7th Floor, New York NY 10169.

Need to Foreclose on a Mortgage? Where Can You Bring Your Action?

*By Keith M. Brandofino and David V. Mignardi**

Despite an abundance of case law establishing the citizenship of a commercial mortgage-backed securitized trust, some borrowers are taking a different approach to challenge the federal court's diversity jurisdiction aimed at causing delay. The authors of this article discuss a recent case, Wilmington Trust, N.A. v. 115 Owner LLC et al., in which the borrower defendants filed a pre-answer motion to dismiss based on their allegations that the citizenship of the CMBS trust's directing certificateholder ("DCH"), as well as the entity that controls the DCH, is determinative.

In response to the COVID-19 pandemic, many states enacted, by executive order or otherwise, rules that have created both legal and procedural hurdles to a lender's ability to exercise its contractual rights, including the commencement of a foreclosure action. Those hurdles, coupled with delays inherent with the foreclosure process in judicial foreclosure jurisdictions, have prompted many lenders and special servicers to consider federal court as an alternative forum for the enforcement of remedies requiring judicial intervention. Because foreclosure is a state-law remedy, access to state courts to commence foreclosure proceedings is largely unfettered, of course, once you move beyond the incessant foreclosure moratoria.

However, in order to commence a foreclosure proceeding in federal court, the party commencing the action must establish that the federal district court has diversity jurisdiction to adjudicate the foreclosure action, meaning that the action is between citizens of different states and the amount in controversy exceeds \$75,000.¹

Even assuming this monetary threshold is met, access to federal court will be denied unless the foreclosing plaintiff, which may be a commercial mortgage-backed securitized ("CMBS") trust, is a citizen of a state different than each and every contemplated party defendant. That is, each party on the opposite sides of the "v" must be a citizen of a different state.

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¹ 28 U.S.C. § 1332(a)(1).

BACKGROUND AND CASE LAW

The citizenship of the borrower entity² and individual guarantors should be readily identifiable through organizational charts and closing documents. Determining the citizenship of a CMBS trust requires a more involved analysis. In determining the citizenship of a trust, the U.S. Supreme Court's 1980 decision in *Navarro Sav. Ass'n v. Lee* is instructive. Therein, the Supreme Court held that, where a trustee has legal title to and possesses the customary powers to hold, manage and dispose the trust's assets, it effectively controls the litigation, is the real party to the controversy and, therefore, can invoke the diversity jurisdiction of federal courts based upon its own citizenship, rather than that of the trust's beneficial shareholders.

In 2016, the Supreme Court reaffirmed in *Americold Realty Trust v. Conagra Foods, Inc.* that the citizenship of a traditional trust—meaning a trust whose trustee may operate and sue or be sued in its own name—is the state to which its trustee belongs.

Determining whether a trustee of a CMBS trust wields sufficient control over the trust's assets so as to be considered the real party in interest requires courts to look to the terms of the governing pooling and servicing agreement ("PSA") to discern the scope of the trustee's power. Adhering to the Supreme Court's precedent in *Navarro* and *Americold*, the U.S. District Court for the Southern District of New York ("Southern District")³ has consistently held that the citizenship of a trustee of a CMBS trust is determinative where the controlling PSA demonstrates that the trustee possesses the requisite degree of control over the trust's assets, regardless of whether it relies on agents such as a master servicer or special servicer.

During the previous economic downturn, borrowers sought to delay foreclosure actions commenced in federal court by challenging the court's subject matter jurisdiction. These challenges often included claims that the citizenship of certain entities, other than the trustee of the CMBS trust, determines the citizenship of the CMBS trust and, therefore, destroys diversity of citizenship. Perhaps most favored by CMBS borrowers was the claim that the citizenship of the special servicer of the CMBS trust, rather than that of its trustee, controlled. Yet the Southern District has repeatedly held, including in

² Of note, many borrowers are limited liability companies ("LLCs"). Voluminous case law holds that an LLC is a citizen of each state in which its members are citizens (whether an individual or corporation).

³ CMBS loan documents commonly identify the Southern District as the chosen forum for commencement of litigation involving CMBS loans.

several recent cases, that the special servicer's citizenship is not determinative, notwithstanding the fact that the PSA often memorializes the trustee's delegation of the right to institute suit on the trust's behalf to the special servicer.

THE 115 OWNER CASE

Despite the abundance of case law establishing the citizenship of a CMBS trust, some borrowers are taking a different approach to challenge the federal court's diversity jurisdiction aimed at causing delay. Illustrative of these efforts is a recent case, *Wilmington Trust, N.A. v. 115 Owner LLC et al.*, in which the borrower defendants filed a pre-answer motion to dismiss based on their allegations that the citizenship of the CMBS trust's directing certificateholder ("DCH"), as well as the entity that controls the DCH, is determinative. The borrower defendants also sought the ability to take pre-answer discovery to determine the identity of the DCH.

In support of this theory, the borrower defendants cited to Section 3.09(a) of the governing PSA which provides that "[t]he Special Servicer shall, . . . subject to the Directing Certificateholder's rights pursuant to Section 6.08, . . . exercise reasonable efforts . . . to, at any time, institute foreclosure proceedings. . . ." In turn, Section 6.08(i) of the governing PSA identifies "any proposed or actual foreclosure upon . . . the ownership of properties securing . . . the Mortgage Loans[]" as being among the "Major Decisions" necessitating the DCH's consent.

Based upon these sections, the borrower defendants concluded that the subject PSA requires the DCH's consent to institute foreclosure proceedings that the DCH effectively controls the litigation and, therefore, is the real party in interest. The borrower defendants went on further to argue that if the citizenship of the DCH controls and if the DCH is the citizen of a state in which any of the borrower defendants is a citizen, then there could be no diversity jurisdiction, which would necessitate the immediate dismissal of the foreclosure action.

In its Memorandum Opinion and Order dated November 2, 2021, the *115 Owner* court rejected the borrower defendants' contention, finding that the mere fact that the governing PSA entitles the DCH to advise the special servicer with respect to the initiation of foreclosure actions does not dictate that the trustee of the CMBS trust, Wilmington Trust N.A. ("Wilmington"), is not the real and substantial party to the controversy. In support of this holding, the Southern District noted that Section 13.03(b) of the subject PSA prohibits the

DCH from managing the trust's assets and that Section 13.03(c) of the subject PSA highlights the DCH's lack of authority to sue on behalf of the trust in its own name.

Instead, and in accordance with *Navarro* and other Southern District case precedent, the *115 Owner* court found Wilmington to be the real party to the controversy. Specifically, the Southern District found that, while the governing PSA charged the master and special servicers to manage trust assets, their powers, including the power to initiate litigation on behalf of the CMBS trust, flowed from Wilmington. Specifically, under Section 3.01(b) of the governing PSA:

[T]he Master Servicer and the Special Servicer . . . [are] authorized and empowered *by the Trustee* to execute and deliver . . . complaints or other pleadings to initiate and/or to terminate any action, suit or proceeding on behalf of the Trust.⁴

Moreover, in the event of termination of the master and special servicers, Section 7.01(b) of the PSA dictates that "all authority and power of the [Special Servicer or Master Servicer] shall pass to and be vested in the Trustee." Based on the foregoing language, the *115 Owner* court found that Wilmington does not act as a mere conduit for a remedy flowing to others; rather, Wilmington has legal title to and manages the trust's assets, controls this litigation and is therefore the real party to the controversy. In turn, the *115 Owner* court held that only the citizenship of Wilmington, a Delaware entity, is determinative for purpose of diversity jurisdiction.

The *115 Owner* court similarly rejected the borrower defendants' argument that Wilmington lacks control over the foreclosure proceedings because the action was brought "by and through" the CMBS trust's special servicer. Much like in other recent cases, the *115 Owner* court found that the language within the governing PSA allowing the special servicer to institute foreclosure proceedings is a mere delegation of authority by Wilmington, as trustee, and that such delegation does not vitiate Wilmington's customary powers to hold, manage and dispose the assets of the CMBS trust. Unlike Wilmington, the *115 Owner* court found that the special servicer does not hold any trust assets, lacks its own stake in the litigation apart from its duties under the PSA and, therefore, is not a real and substantial party to the controversy. Therefore, the citizenship of the CMBS trust's special servicer was found immaterial.⁵

⁴ Emphasis added.

⁵ Finding the CMBS trust to be a traditional trust, in accordance with *Americold*, the *115 Owner* court also rejected the borrower defendants' request that the court consider the citizenship

Recognizing the complete diversity existing between the Delaware citizenship of the CMBS trust plaintiff, as dictated by Wilmington, and the New York citizenship of each of the named defendants, the *115 Owner* court denied the borrower defendants' request for dismissal of the action on the basis of lack of subject matter jurisdiction and ordered the borrower defendants to interpose an answer to the foreclosure complaint. Further, in finding that diversity jurisdiction has been adequately pled, the *115 Owner* court also denied the borrower defendants' request to take jurisdictional discovery.

CONCLUSION AND CONSIDERATIONS

The Southern District's decision in *115 Owner* is instructive in that it preserves access to federal court for CMBS trusts seeking to enforce remedies under the subject loan documents.

Although the *115 Owner* court looked solely to Wilmington, and not to the CMBS trust's special servicer, DCH or members, in determining the trust's citizenship, its decision does not create a bright-line rule that such entities can never affect diversity jurisdiction of foreclosure actions.

Rather, in face of future challenges by borrowers, the onus remains on federal courts to analyze the terms of the governing PSA to discern the scope of the trustee's powers with respect to the CMBS trust and that of the trust's servicers and DCH.

Therefore, before considering federal court as a forum for the commencement of foreclosure proceedings, it remains the obligation of the special servicer and its counsel to review the governing PSA to determine the propriety of proceeding in federal court and whether the borrower would have sufficient grounds to wage a viable challenge to the federal court's subject matter jurisdiction to adjudicate such action.

of the members of the CMBS trust in determining the trust's citizenship.