



Finance / Financial Services Litigation ADVISORY ■

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A Big Win for Servicers, Trustees, and Certificate Administrators Safeguarding Their Right to Indemnification from a CMBS Trust

by [John Doherty](#), [Bill Macurda](#), [Elizabeth Murphy](#), and [Chris Riley](#)

In December 2018, CWCapital Asset Management, as special servicer, directed Wells Fargo, as master servicer, to establish reserves of \$38 million for the WBCMT 2007-C30 trust.¹ At the time, the special servicer was involved in two litigations relating to two loans previously held in the trust. The trust had five loans remaining, all in special servicing. The special servicer directed the master servicer to establish the reserves approximately three days after the funds had been distributed to certificateholders via the Depository Trust Company. As a result of the direction, the paying agent clawed back \$38 million of the distributed funds and the master servicer placed them in reserve. The clawback impacted the distribution to the junior certificateholders of the trust.

The Junior Certificateholders Challenge the Creation of the Reserve, and Litigation Ensues

Shortly thereafter, the impacted junior certificateholders challenged the creation of the reserves and demanded release of the \$38 million to them. They alleged that the plain language of the pooling and servicing agreement (PSA) did not authorize the special servicer to direct the creation of such a reserve for future anticipated litigation expenses. They argued that:

- The reserves were unauthorized because they were taken at a pool level rather than from loan-level proceeds.
- The master servicer did not conduct adequate analysis to determine if remaining cash flows would be sufficient to meet the anticipated \$38 million in litigation expenses.
- The trust had sufficient assets to cover its future indemnification obligations.
- The reserves constituted impermissible servicing advances in breach of the PSA.

¹Alston & Bird represented Wells Fargo in this case in Minnesota state court. *In the Matter of the Trust Established Under the Pooling and Servicing Agreement Relating to the Wachovia Bank Commercial Mortgage Pass-Through Certificates, Series 2007-C30*, Nos. 62-TR-CV-19-33 and 62-TR-CV19-19 (Dist. Ct. Ramsey Cnty. Oct. 26, 2022). The order remains subject to appeal.

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Lastly, they contended that if the reserves were properly taken, any unused portion of the reserves should be distributed retroactively to the junior certificateholders that would have otherwise received the funds in the December 2018 distribution if the funds had not been clawed back and reserved. The senior certificateholders, U.S. Bank as trustee, Wells Fargo as master servicer and paying agent, and other deal parties disagreed with these contentions.

In mid-2019, U.S. Bank, as trustee, and Wells Fargo, as master servicer and paying agent, filed separate trust instruction proceedings (TIPs) relating to, among other things, the creation of the reserves and the timing of the distribution of any unused reserve amounts. The parties to the TIPs (including deal parties, the junior certificateholders, and the senior certificateholders) engaged in extensive fact and expert discovery, ultimately leading to the filing of competing motions for summary judgment on the disputed issues.

The Order

The Minnesota state court ruled on the parties' summary judgment motions on October 26, 2022. In its order, the court held that trust parties are entitled to create reserves to meet anticipated future indemnification obligations of the trust. The court reasoned that the PSA provided deal parties with broad rights of indemnification from the trust, and those rights have a higher priority than certificateholders' rights to distributions.

The court held that trust parties' right to indemnification would be "nearly meaningless" unless the trust had sufficient funds to satisfy its indemnification obligations: it was "[i]mplicit in the indemnification right and its higher priority" that these parties had the right to hold back funds necessary to meet the trust's indemnification obligations—even anticipated, future obligations. The PSA afforded the master servicer and special servicer with broad authority and discretion to do what they "deem necessary or desirable," which included "the authority to create trust reserves to meet significant anticipated future trust expenses." In addition to examining the PSA, the court credited expert witness testimony affirming that the creation of such reserves conforms with custom and practice in the commercial mortgage-backed securities industry. Finally, the court noted that reserves were necessary to ensure that indemnified trust parties are fully able to protect the trust's interests.

The junior certificateholders' additional challenges were rejected. The court held that the trust's indemnification obligations are not tied to specific loan proceeds and rejected any contention that pool-level proceeds could not be used to create reserves or fund the trust's indemnification obligations. The special servicer justifiably relied on its outside litigation counsel's estimates of future legal expenses and potential judgment/settlement exposure. The court further held that the PSA does not obligate trust parties to conduct an analysis of anticipated future cash flows of the trust to determine whether a reserve is necessary or whether the amount of the reserve is reasonable.

Recognizing the inherent uncertainty in attempting to estimate future trust cash flows, the court noted the difficulty to "predict with any kind of certainty" when and for what amounts specific assets would be liquidated. Servicers, as the master servicer's brief put it, "lack the proverbial crystal ball concerning the future performance" of loans in the trust, but "per the servicing standard use good business judgment in the face of the unknown." Therefore, the reserves were not "impermissible advances" under the PSA; there is a distinction between setting aside money for a purpose and paying money for that purpose. And based on the PSA definition of "servicing advance," a reserve is not a cost or expense incurred by the trust.

The court concluded its rejection of the junior certificateholders' arguments by stating that the master and special servicers had a duty to ensure that the trust could meet its obligations going forward and, therefore, must necessarily have the discretion to determine whether it is "prudent and necessary" to establish a reserve.

The court then addressed the final issue of how to distribute any unused portion of the reserves upon release, adopting the argument of the paying agent that the reserves should be distributed pursuant to the waterfall to the then-current certificateholders at the time of release and not to the junior certificateholders of record as of December 2018, when the reserves were created. Because the creation of the reserves did not constitute an event of default under the PSA, the junior certificateholders of record as of December 2018 were not entitled to any released reserves as a matter of equity. The court acknowledged that although the equitable nature of TIP proceedings may grant the court authority to restore certificateholders to the position they were in before an improper distribution, “there was nothing inappropriate or improper in the actions of” the trustee, master servicer, special servicer, or paying agent.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or the following:



[John Doherty](#)
+1 212 210 1282
john.doherty@alston.com



[Bill Macurda](#)
+1 704 444 1335
bill.macurda@alston.com



[Elizabeth Murphy](#)
+1 704 444 1080
elizabeth.murphy@alston.com



[Christopher A. Riley](#)
+1 404 881 4790
chris.riley@alston.com

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WWW.ALSTON.COM

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ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
 BEIJING: Hanwei Plaza West Wing ■ Suite 21B2 ■ No. 7 Guanghua Road ■ Chaoyang District ■ Beijing, 100004 CN ■ +86.10.85927500
 BRUSSELS: Rue Guimard 9 et Rue du Commerce 87 ■ 3rd Floor ■ 1000 Brussels ■ Brussels, 1000, BE ■ +32.2.550.3700 ■ Fax: +32.2.550.3719
 CHARLOTTE: One South at The Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
 DALLAS: Chase Tower ■ 2200 Ross Avenue ■ Suite 2300 ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
 FORT WORTH: Bank of America Tower ■ 301 Commerce ■ Suite 3635 ■ Fort Worth, Texas, USA, 76102 ■ 214.922.3400 ■ Fax: 214.922.3899
 LONDON: 4th Floor ■ Octagon Point, St. Paul's ■ 5 Cheapside ■ London, EC2V 6AA, UK ■ +44.0.20.3823.2225
 LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213.576.1100
 NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
 RALEIGH: 555 Fayetteville Street ■ Suite 600 ■ Raleigh, North Carolina, USA, 27601-3034 ■ 919.862.2200 ■ Fax: 919.862.2260
 SAN FRANCISCO: 560 Mission Street ■ Suite 2100 ■ San Francisco, California, USA, 94105-0912 ■ 415.243.1000 ■ Fax: 415.243.1001
 SILICON VALLEY: 1950 University Avenue ■ Suite 430 ■ East Palo Alto, California, USA 94303 ■ 650.838.2000 ■ Fax: 650.838.2001
 WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.239.3300 ■ Fax: 202.239.3333