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## Fed Grapples With Extended Stay

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*August 12, 2009* - The Federal Reserve, with \$900 million on the line, is getting actively involved in the biggest hotel bankruptcy, an awkward role for the central bank as it tries to shore up the financial system.

On one hand, the Fed is clearly concerned that the bankruptcy of the 680-property Extended Stay Inc. chain has exposed major fault lines in the commercial real-estate market, which threatens to drag down the economy just as it is starting to show signs of recovery.

On the other, the Fed's role is tricky because it is facing off against financial firms it has to deal with in other rescue matters. For example, Cerberus Capital Management LP is on the other side of the Fed in the Extended Stay bankruptcy, but the firm had to work closely with the Fed and the government in the bailouts of Chrysler and GMAC, which Cerberus controlled.



The Fed, through a fund called Maiden Lane, wound up holding about \$900 million in Extended Stay debt in the wake of Bear Stearns's failure. A team at the New York Fed is working with [BlackRock](#) Inc. and other private-sector advisers to try to maximize its recovery on that debt. But under a controversial plan proposed by Extended Stay and endorsed by a small group of creditors, the Fed's position could take big hits.

Now the Fed is walking a fine line as it tries to balance its dueling interests. The Fed is trying to draw lessons from the bankruptcy that it can use to help rebuild a market for commercial mortgage-backed securities, or CMBS, a source of financing that real-estate developers and investors have heavily relied on until the credit-market crisis.

But before investors trust the CMBS market again, the flaws need to be understood and corrected. Many of these flaws are being exposed by the Extended Stay bankruptcy, and the New York Fed is looking into the complex financing arrangement that sits at the core of the company's demise.

Most recently, the Fed moved to support an effort by the U.S. Trustee Diana Adams, who is overseeing the bankruptcy, to appoint an examiner to probe the collapse. Among other

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things, the examiner would delve into the pre-Chapter 11 negotiations between Extended Stay Chief Executive David Lichtenstein and some creditors. In court papers, Ms. Adams notes that other creditors have alleged "fraud and dishonesty" in those talks. Therefore, "the appointment of an examiner is warranted," she said.

Fed Chairman Ben Bernanke recently told lawmakers that the potential wave of defaults on hundreds of billions of dollars of commercial mortgages presents a "difficult" challenge. Many observers believe the first step to fend off the looming threat is to restart the CMBS market, which used to provide one-third of the financing to owners of office buildings, hotels, stores and other commercial property.

Wall Street firms created CMBS by slicing and dicing commercial mortgages into layers of debt with different levels of risk and rewards. In theory, holders of all layers would be represented by a debt servicer who would negotiate with the borrower for them in case of a default.

When a group of investors led by Mr. Lichtenstein acquired Extended Stay for \$8 billion -- about \$4.1 billion of that coming from CMBS -- the deal was structured with a "bad-boy" provision to keep him from putting the company into bankruptcy. Under that provision, Mr. Lichtenstein would have been personally liable for \$100 million if he did that.

But none of the measures designed to protect CMBS investors worked as expected. First, in the days leading up to its Chapter 11 filing on June 15, Mr. Lichtenstein struck a deal with only a small group of big CMBS holders, including Cerberus and Centerbridge Partners LP. The deal, which needs to be approved by the bankruptcy court, would give little to nothing to the majority of other creditors including the Fed.

At the same time, the small group of investors that supported the deal agreed to shield Mr. Lichtenstein from the "bad-boy" provision. That deal "must be investigated in order to preserve the integrity of the Chapter 11 process," said **Stephen Meister, an attorney at Meister Seelig & Fein LLP**, who represents two junior creditors who filed a lawsuit.

In a bankruptcy-court filing, the Fed noted that "the factors that led to the collapse [of the company] may aid the financial markets and policy makers in their efforts to avoid similar situations as the securitization market attempts to restart."

Defenders of Extended Stay's bankruptcy filing argue that the complex debt structure made it all but impossible for the company to get all its creditors to agree on a plan. The proponents also argue that the creditor lawsuits have no merit because there is no legal contract binding Cerberus and Centerbridge to the plan proposed by Extended Stay, even though they verbally agreed to it.

Mr. Lichtenstein "understood that a bankruptcy filing could result in lawsuits against him personally, but he put [the company's] interests first," said David Friedman, an attorney at Kasowitz, Benson, Torres & Friedman LLP, who represents Mr. Lichtenstein.

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Maiden Lane, the fund created by the Fed, took over \$30 billion of assets from the Bear Stearns collapse and hotel debt accounts for 79% of the commercial mortgages held by that fund. In addition to the Extended Stay hotel debt, the fund also holds about \$4 billion backed by Hilton Hotels, according to people familiar with the matter.

The Fed provided a 10-year, \$29 billion loan to the fund to acquire the Bear assets. While it might take a loss on the Extended Stay debt, the Fed doesn't expect to suffer a loss on the loan. If there is a loss on the loan, [J.P. Morgan Chase](#) & Co., which bought Bear Stearns in March 2008, would be on the hook for the first \$1 billion of loss.

The Extended Stay bankruptcy is just the latest real-estate collapse to roil the \$700 billion market for CMBS. The market also went into an uproar earlier this year in the wake of the bankruptcy filing by mall giant General Growth Properties Inc.