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Behind a Bankruptcy Brouhaha

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June 24, 2009 - David Lichtenstein is facing challenges to the plan that took his Extended Stay Hotels chain into bankruptcy protection. At stake for the real-estate investor: Whether the filing could trigger \$100 million of personal liability that he has tried to avoid.



The controversy over the bankruptcy filing and Mr. Lichtenstein's potential liability has thrown the commercial-property world into an uproar, because the filing also is laying bare many of the technical features of commercial mortgage-backed securities, or CMBS, that have never before been tested on a large scale. As the Extended Stay case is showing, the protections for investors may be less solid than expected, according to CMBS lawyers and bankers.

The case could have repercussions for the broader economy. Without clarity on their rights and recoveries, hundreds of billions of dollars in CMBS loans could be caught in legal limbo. This could, in turn, hamper banks' ability to clear bad paper off their books and jump-start this \$700 billion securitization market, market participants said.

Under a reorganization proposal endorsed by some creditors, including Cerberus Capital Management LP and Centerbridge Partners LP, Extended Stay would wipe out \$4.8 billion in existing debt. This stands to benefit holders of the four most-senior slices of Extended Stay CMBS bonds, which were divided into 18 different components. The deal also helps Mr. Lichtenstein because it would indemnify him from making \$100 million in "bad-boy" payments. Such payments are supposed to incentivize borrowers to avoid bankruptcy, by making them personally liable for debts owed.

Mr. Lichtenstein declined to comment through his _representative.

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. In the days leading up to the filing, the company was running out of money. That left Mr. Lichtenstein with a dilemma, these people said: File for bankruptcy protection and trigger the "bad-boy" clause or close the company and risk being sued for failing to fulfill his duty as a company director.

In all, holders of about one-quarter of the \$4.1 billion in first-mortgage debt supported the

deal when it was pitched by Extended Stay before it filed for bankruptcy protection last week.



But now, some creditors are saying the deal is invalid. Five Mile Capital Partners LLC, an investor owning \$77 million of a junior piece of Extended Stay CMBS bonds, argued in a New York lawsuit that the deal Mr. Lichtenstein struck with creditors, including Cerberus and Centerbridge, awarded these creditors "a higher rate of return" at the expense of other bondholders. The CMBS loan agreement "makes clear that no individual may take any action...in an effort to improve its position vis a vis the positions" of other bondholders, the suit said.

Proponents of the deal argue that the lawsuit has 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.

For Five Mile and others, this is a technical, but crucial point that undergirds the CMBS market. Under most CMBS loan agreements, a borrower is supposed to negotiate only with an issuer's loan servicer, which is responsible for looking after the interests of all investors. Owners of the most risky slice of the CMBS debt also have special rights to appoint the servicer for the entire group when the debt goes into default. Citigroup Inc., which owns a portion of the \$100 million junior-most slice of the Extended Stay CMBS bonds, has appointed TriMont Real Estate Advisors as special servicer.

The likes of Cerberus and Centerbridge had no standing to speak for all the first-mortgage holders, according to the lawsuit. In general, to make any loan modifications, a servicer must win the support of the vast majority, if not 100%, of bondholders, according to lawyers not involved in the case.

"The [bankruptcy] filing surprised no one," said Moody's Investors Service in a report on the deal. "It was who appeared in bankruptcy court claiming to represent the securitized lenders that raised eyebrows." Supporters of the plan said the creditors who agreed to the company's proposal were the only ones who were willing to talk to the company.

This is different from most other situations, where borrowers have latitude to negotiate with whom they choose. And they also can win concessions without unanimous support.

"Back in the 1990s, we were in most cases able to get all the lenders in one room and talk about restructuring," said Alan J. Pomerantz, a partner at law firm Orrick, Herrington &

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Sutcliffe LLP, who represented bank lenders to Donald Trump and other developers in the last real-estate collapse. "Today, because of the way the CMBS debt was structured, you don't even know who holds the debt if there is a problem."

Extended Stay's woes also highlight the complicated way Mr. Lichtenstein financed his buyout of the 680-property hotel chain from [Blackstone Group](#) LP two years ago. Besides the first mortgage, the \$8 billion deal was funded with a \$3 billion mezzanine, or junior, loan, which also was carved up into slices with different levels of risks and returns. Wachovia Corp., now owned by [Wells Fargo & Co.](#), Bear Stearns Cos., [Bank of America](#) Corp. and its Merrill Lynch unit provided the original financing and still hold billions of dollars of the debt. Bear's stake was taken over by the Federal Reserve after the firm collapsed in March 2008, potentially exposing U.S. taxpayers to the outcome of the restructuring talks. Defenders of the deal said the company is valued at far less than even its first-mortgage debt, and the proposal is an attempt to salvage some parts of the company. The company itself estimates its value at \$3.3 billion.

"Any bankruptcy is a deal where there is not enough money to satisfy everyone," said a person involved in negotiating the transaction. "It simply is not worth the mortgage debt. We are trying to elevate substance over form."

If the court strikes down the proposed restructuring plan, Mr. Lichtenstein could be back on the hook for the \$100 million, according to lawyers not involved in the case. That would imperil the rest of his real-estate empire, which includes outlet centers, office buildings and warehouses throughout the country.