

WHAT TO CONSIDER WHEN A HOTEL FALTERS

Stakeholders need to ask a series of questions about a distressed hospitality asset before proceeding with a loan workout or foreclosure

by Guy Maisnik and Jeffrey Steiner, 06/03/09

As hotel lawyers, we are receiving an increased number of calls from clients and friends about hotels in distress, including full service and limited service hotels, condo-hotels, resorts and mixed use projects with hotels, resorts and mixed-use projects with hotels. The assets are located in the United States and overseas. Some are finished and in operation and others are under construction.

Although each situation involving a hotel in distress is specialized, before any hotel mortgage- holders prepare a strategy to address workouts, receiverships and the potential borrower bankruptcies that ensue, certain detailed questions must always be asked so that lenders have a comprehensive understanding of the hotel project, the players and the issues.

First you must ascertain the following: ***Who are the key players and what are their interests?*** Who are the other interested stakeholders, their respective roles, objectives and rights? These other stakeholders can be the loan participants, mezzanine capital provider, the hotel operator, borrower's sponsors, a licensor, franchisor, the construction contractor, title insurance companies, surety bond providers, cash management bank, governmental authorities, and labor unions. In the case of condo-hotels, you will need to also consider owner's associations, unit owners and their lenders, and unit contract purchasers. Each of these

stakeholders can be a help or hindrance in turning around the hotel project.

When you are evaluating the important players and their interests, ask yourself these questions: What rights of approval do participants, co-lenders or bank syndicates have over actions to be taken to address the loan and project?

Are there any junior lien holders, including contractors and subcontractors, and what rights do they ultimately have? Have any optional advances been made that could be subordinate to any junior lien holders? Are intercreditor agreements or other agreements in place with any of the junior lien holders? If so, what bearing do such agreements have on a workout?

Are there other key players that are parties to contracts necessary to the hotel's success or to preserve the project value—such as an agreement with a signature restaurant or spa operator, branding or management of a golf course or other facilities, room night generators or condominium or residence brand marketing and licensing agreements?

Are these agreements pledged to the lender, and is the lender able to take over these agreements upon a foreclosure or deed in lieu of foreclosure? Is the lender bound to accept these agreements upon a foreclosure or deed in lieu of foreclosure? Does the lender have cure rights with respect to defaults of other parties to these agreements?

HOTEL MANAGEMENT'S ROLE

Next move on to this question: ***What can the Lender do to improve the hotel assets value?*** Quite often, the Lender simply proceeds to foreclose on the asset without having any idea how to increase the hotel asset's value.

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Unfortunately, those directing the foreclosure often do not understand hotels or critical things that can be done to improve value.

Has the hotel lender done an independent evaluation of the hotel? Has the lender reviewed the hotel's revenue management systems, cost containment, cap x budget? Is this the right brand for asset?

Additionally, has a thorough analysis of the hotel management agreement and franchise agreement been performed? The lender's choice of options in dealing with this loan may be complicated by the hotel management agreement in particular. Under hotel management agreements, the hotel manager is usually given tremendous control, rights and powers over the hotel, particularly if the manager is providing a brand for the hotel. Can and should the hotel management agreement be terminated, or can termination be avoided by carefully structuring the foreclosure process?

While the hotel management agreement may be regarded legally as a contract for services that is not binding upon the hotel or successor owners of it, in many cases, the lender's position on the loan will effectively be subordinate to the management agreement as the result of a nondisturbance or recognition agreement that was provided to the hotel management company.

In those cases, upon a foreclosure or taking of a deed in lieu of foreclosure, the lender and its successor will continue to be bound by the old management agreement. Alternatively, and sometimes worse, if the lender is not obligated to assume - and does not have a right to assume - the hotel management agreement, the lender could lose the benefit of the management agreement and find itself with an unbranded hotel and a significant further reduction of hotel asset value.

If the loan is subordinate to the management agreement, what incentives does the hotel

manager have to make concessions that would improve the value of the hotel?

Furthermore, what rights does the lender have to take over any hotel franchise agreement or receive a new one under a comfort letter or other agreement with the brand franchisor? Generally, major hotel brand franchise agreements may permit the franchise agreement to be pledged to the lender, but they do not allow the franchise agreement to be transferred to a new owner.

The comfort letter may permit the lender to continue to use the franchise, including brand reservation and other services, for the operation of the hotel post-foreclosure or deed in lieu of foreclosure for a limited period if the lender or other new owner makes prompt application to the franchisor for a new hotel franchise agreement.

Would the lender have to pay a full application fee to obtain a new franchise? Would the lender have to agree to complete a property improvement plan in order to obtain the new franchise?

Finally, is the brand the correct one for the hotel? What is the percentage contribution of brand marketing systems to guest room occupancy levels? How do the financial results, including revenue per available room and average daily rate of the hotel, compare with those of its competitive set?

BANKRUPTCY CONCERNS

For any distressed hotel case, you will want to consider this: **What is the project's physical and financial condition?** What is the status of construction completion, if applicable? Are there contractor defaults? What is the time schedule to complete construction? What is the cost estimate to complete construction?

Or, Are there serious deferred maintenance issues? Are there any outstanding brand requirements for upgrades of the hotel? If so,

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what is the deadline by which the brand requires completion of the upgrades? What is the cost estimate to complete the upgrades?

Are project revenues sufficient to meet basic operating expenses, so that the physical condition of the hotel can be maintained with taxes and insurance being paid? Are there union labor contracts in effect? To what degree will the lender be bound by them if it becomes the hotel owner?

If the project is a failed condo hotel, are the documents structured properly so that certain actions can be taken to enforce assessments against the existing condo unit owners? Will those documents permit a repositioning of the hotel, or does approval of condo unit owners need to be obtained? (See, "Condo Hotel Workouts and Turnarounds: Opportunity for the Well-Informed," *Commercial Mortgage Insight*, June 2007)

In addition, what are the potential bankruptcy issues? How "special purpose" and "bankruptcy remote" is the hotel owner? Are there principal guarantees that are triggered by a bankruptcy filing of the borrower, which may deter such a filing by the borrower?

If the hotel owner is able to file bankruptcy, is the hotel owner really a single asset entity (which affects the timing of the lender's ability to obtain relief from the automatic stay in bankruptcy)? Are there other creditors that might file an involuntary bankruptcy petition against the hotel owner? Will the hotel owner be able to reorganize in a bankruptcy, and if so, what would that mean to the lender's cash flow and the value of its loan?

Moreover, how realistic and immediate is the hope for a restructured success? Are there opportunities for a pre-packaged bankruptcy plan that would increase the value of the hotel, benefitting all parties concerned?

ENTERING FORECLOSURE

Next, examine the questions associated with a possible foreclosure situation. **What about other recourse/capital/revenues?** What guaranties are in place to which there is any recourse? What is the likelihood of enforcement of those guaranties, including the financial condition of the guarantor? Is the hotel part of a mixed use project whose revenues depend on the operations of the hotel? How does a hotel mixed-use project affect the single asset nature of the hotel?

What cash management controls are available to the lender? What are the reputational impacts to the hotel owner if the lender forecloses? What impact does this have on the reputation of the hotel manager? Will this provide any leverage to the lender?

Critically, you will want to know exactly what foreclosure-related issues will be involved. What are the process, timing and cost to foreclose on the project in the jurisdiction where the hotel is located?

If the lender were to foreclose, will it be able to use all the existing entitlements, permits and licenses issued in the name of the borrower or others necessary for the successful development and operation of the project?

One common issue is the matter of control of liquor licenses. Who holds any liquor licenses necessary for the lawful operation of hotel restaurants serving alcoholic beverages, bars, room service and guest room mini-bars? If the lender forecloses, will it be able to obtain the transfer of liquor licenses held by the borrower or its hotel manager? State laws may prohibit the collateral assignment of liquor licenses to a lender as loan security.

If the lender chooses to commence a foreclosure, should a receiver for the project be sought? What are the timing and procedures, including evidentiary showings, to obtain a

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receiver in the jurisdiction in which the hotel is located?

Given all of the other factors at play, what are the pros and cons of accepting a deed in lieu of foreclosure instead of foreclosing judicially or nonjudicially? What other factors will affect the course of the action taken? What accounting and tax considerations affect the plan and course of action? What regulatory

considerations affect the plan and course of action?

Financiers should use all these questions as a framework for collecting the information necessary to formulate a plan for addressing the troubled hotel loan. The characteristics of the hotel in question may raise other questions that need to be focused upon.



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