# DISTRESSED HOTEL LOANS–OUTLINE OF SELECTED ISSUES

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This outline summarizes early questions a lender or its counsel may wish to ask, and issues they may wish to consider, for a hotel loan that is in distress or in default, or heading in that direction. This outline ends just before the foreclosure begins. Part of the outline discusses issues unique to (a) "workout" proposals that might involve additional investment in the property; and (b) construction or development loans.

This outline is based, to a limited degree, on the author's "Heavenly Gardens Hotel" case study on distressed hotels, and is intended to highlight briefly and generically issues raised there.



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# I. Hotel Issues.

## A. Financial Analysis.

1. Occupancy rates.
2. Market position -- existing and future competition.
3. Operating costs.
4. Reserve accounts. Adequacy. Practical control. Ability of manager to apply against manager loans.
5. Operational problems.
6. Capital improvement and upgrade requirements, including code compliance retrofitting.

## B. Management Arrangements.

1. Terms of Existing Management Agreement.
    a. Pricing, term, other economics.
    b. Termination rights, and who controls them?
    c. Cash controls.
    d. Contracts with affiliates -- scope and terms. For what types of functions? Any limit? Reporting, disclosure, and approval.
    e. Interest in real estate? Recorded? Implications for a lender.
    f. Appropriateness of this manager for this property in this market.
    g. Amendments.
    h. Economic impact of comp rooms, frequent guest program, etc.
    i. Manager loans – amount, terms, source of repayment.
2. "Nondisturbance" protection of existing manager.
    a. Treatment of any manager loans post-termination.

b. "Nondisturbance" protections for management agreement amendments.

c. Redirection of cash to lender.

d. Other lender-manager issues. Adequacy of a chain store SNDA for a hotel manager.

3. New management.

a. Alternatives available?

b. Would anything change?

c. Use of lender affiliate as manager?

**C. Flag or Lack Thereof.**

1. Problems with licensor -- quality standards, noncompliance with license agreement, nonpayment of fees, etc.

2. Licensor's compliance with "licensor comfort letter." What measure of damages for failure to give lender notice and opportunity to cure before terminating? Defenses? What does this say about the value of licensor comfort letters?

3. Ability to obtain replacement brand name for hotel.

4. Competing hotels licensed by the same licensor. Different brand names?

5. Interaction between management agreement and preservation of brand name.

**D. Security Package.**

1. Missing assets.

2. Rental income.

3. Hotel operating income.

4. UCC filings; scope of collateral.

5. Credit enhancement (letters of credit, guaranties, etc.).

**E. Preservation of Project.**

1. Litigation, claims, correction of defective work, etc.
2. Interim operations of amenities.
3. Payment of taxes, operating losses.
4. Status of liquor and other licenses.
5. "Collateral that eats."
6. Nearby rezoning; possible investment in zoning litigation process.

**II. Borrower-Lender and Internal Issues.**

**A. Loan Document Compliance Generally.**

1. Economic obligations.
2. Prohibited transfers.
3. Required standard of operations.
4. Preservation of license.
5. Late and missing financial and other reports.
6. Compliance with law (code violations, ADA).
7. Vice squad activities.

**B. Regulatory and accounting issues.**

1. Recognition of losses.
2. Creation of reserves.
3. Bifurcation of loan.
4. Accounting or regulatory requirements to be "performing."

**C. Third parties.**

1. Participant consent requirements.

2. Does lender still own the loan?

3. Are any servicers involved? Should they be replaced?

**D. Documentation.**

1. Missing documents.

2. Untied “loose ends” from closing.

   a. Lockbox arrangements.

3. Continuation statements.

   a. Effect of only one continuation filing in a dual filing state.

4. Amendments, modifications, waivers.

5. Analysis of personal liability.

   a. Nonrecourse carveouts.

   b. Fraud and waste.

   c. Whose liability?

6. Adequacy of documents regarding lender’s acquisition of loan:

   a. Notices to manager.

   b. Notices to licensor.

   c. Recorded assignments.

   d. Delivery/transfer/continuation of letter of credit.

**E. Value.**

1. Cash flow analysis.

2. Appraisal.

   a. What basis to appraise?

   b. Do you really want to know?

c. Appraisals are incendiary documents.

d. Risks -- potential creation of issues in foreclosure litigation or bankruptcy (“lender tried to steal the project”). Possible use of privilege to protect appraisal.

**F. Borrower Fraud.**

1. Analysis of scope, exposure, losses, etc.

2. Can lender leave developer/borrower in place on any basis? Is developer/ borrower just a “bad guy” who cannot continue to be supported? Or is developer/borrower merely a “good guy” under pressure?

3. Any lender exposure? History of relationship. Due diligence and file review to try to find “the smoking gun”?

4. Interaction with nonrecourse.

**G. Lender Liability.**

1. Oral modifications.

2. Excessive control of the situation.

3. Infirm but not dead.

4. “Perils of imprudent writing.” Internal memos, characterizations, etc.

5. Conversations between loan officers and borrower – commitments, assurances, “relationships.”

6. Constraints regarding discussions with possible purchaser found by borrower?

**III. Redevelopment and Repositioning Possibilities.**

**A. Feasibility of Borrower’s Plans.**

1. Practical issues.

2. Financial issues.

**B. Overall Capital Structure – Debt vs. Equity.**

**C. Is This the Right Redeveloper?**

**D. Risks of Installing Artwork.**

**E. Alternative or Additional Uses.**

1. Spin off land and develop separately?
2. Coordination and control.

**IV. Special Concerns for Construction, Development or Conversion Projects.**

**A. Money Issues.**

1. Interest reserves.
2. Existing and projected overruns and contributions to cover same.
3. Status of any escrow accounts (e.g., for timeshare sales).
4. Working capital coverage (early losses).

**B. Entitlement Concerns.**

1. Any loose ends, remaining approvals, defects in approvals?
2. Compliance.
3. Deadline problems.
4. Political context (change of administration, etc.).

**C. Status of Construction.**

1. Cost to complete.
2. Audit of project costs and documentation to date.
3. Claims against contractors.
4. Pending disputes.
5. Punchlist or other construction work still to be done? Lien claims?
6. Status of management and administration.
7. Problems or issues re: certificates of occupancy.

**V. Lender's Options and Actions.**

**A. Pre-Workout Agreement.** (Note: Lender should have obtained in case study.)

**B. Foreclosure.**

**C. Personal lawsuit against Borrower/Developer.**

**D. Partial takeout (new financing for selected parts of project). (Assuming a multi-use project.)**

**E. More Loan Advances (Good Money After Bad?) to Reposition and Save the Asset?**

**F. Guaranties, Letters of Credit, Etc.?**

**G. Deed in lieu.**

**H. Third-Party Purchase of Hotel.**

1. Lender-purchaser relationship and communications.
2. Feasibility.
3. Borrower and manager cooperation and role.
4. Interaction with foreclosure process (bidding).

**I. Sale of Loan.**

1. Transfer restrictions.
2. Due diligence and coordination.

**J. Sue the Lawyers.**

**K. Workout.**

1. Economic concessions with future upside.
2. Cash controls.
3. Interest deferral or reduction; other financial terms.
4. Waiver of claims, estoppel, acknowledgment that lender is in no way responsible for borrower's problems..

5. Improvement of loan documents and collateral.

   a. Springing/defeasible guaranties.

   b. Collateral package.

   c. Cash flow or appraisal requirements.

   d. Margin calls.

   e. Performance standards.

   f. Concessions from manager.

   g. Deed in escrow? (Prepackaged bankruptcy?)

6. Changes in management.

7. Replacement of construction consultants and contractors. Too late?

8. Lender's approval process, including internal sign-offs, participant(s), servicer(s), disclosures, reporting, etc.

**VI. Lender's First Few Steps.**

**A. Title and other searches.**

1. No title search conducted in case study.

2. Analysis of competing UCC filings.

3. UCC filing by borrower affiliates? Against what? How big a problem? Lender response?

**B. Tax search.**

**C. Physical security/condition overview.**

**D. General file review** (the "smoking gun" for lender liability exposure).

**E. Insurance coverage?**

**F. Expiring letters of credit, UCC financing statements?**

**G. Banker's Right of Set-Off.**

**H.** **Right to redirect cash?** What notices need to be given?

**I.** **Other pro-active steps to be taken for any defaulted mortgage loan**, not necessarily hotel-specific**.**