PREPARING HOSPITALITY PROPERTIES FOR THE TROUBLED ASSETS RELIEF PROGRAM

With the passage of Public Law 110-343 on October 3, many lenders have adopted a wait and see approach to determining whether the new Office of Financial Stability will extend the benefits of the Troubled Assets Relief Program to their non-performing hospitality loans.

Regulators are apt to be wary of buying into the negligent management of distressed credits. Whether or not your distressed hospitality loan is eligible for the benefits of the Troubled Assets Relief Program may well depend on the care taken to shore up any issue during the next two to three fiscal quarters.

The following steps should be taken now to enhance the eligibility of the loan for inclusion in the Troubled Assets Relief Program. Indeed these measures should be taken in any event, because these rehabilitation procedures have worked in past recessions are the only reliable examples a lender can have for weathering the current cycle if the loan is destined to remain in the lender's portfolio.

Keep in mind that the pre-REO hospitality property will usually be found to afford more opportunities for turnarounds and exiting the credit than many other traditional asset based or real estate loans.

All hotel loans should be reviewed from three perspectives in order to prepare for any issues and to minimize the risk of loss as the economy declines. First, the documentation held in the loan portfolio should be reviewed from a legal standpoint to insure that the expected benefits of the lender's security positions will in fact be achieved. Second, a physical evaluation of the operations should be taken by an experienced hotel operator or turnaround expert. Finally, an evaluation of the improved operations, security positions and financial performance should be taken in order to determine that the property is marketable, or to be more precise, financeable in a resale.

The average lender will not have the expertise to do all of these evaluations, but with the right legal, operational and marketing expertise, a lender may avoid many of the pitfalls of losses from foreclosure and long holding periods of REO. Although legal and practical considerations will impact the lender's ability to turn the property around while it is still is on the Borrower's books, the following discussion should apply regardless of whether the property has been recently taken into ORE or if it is being rehabilitated with the consent and cooperation of the Borrower.

LEGAL

Most of the legal audit will consist of the usual items reviewed in connection with any distressed real estate loan. First and foremost will be the deed of trust or mortgage, and a quick evaluation of the time required to complete a foreclosure action in the applicable jurisdiction. States which require a judicial foreclosure of the redemption will in general take a longer period of time to foreclose than power of sale states. Also, where a state requires an election of remedies, there may be good reasons to avoid foreclosure and take the remedies of appointing a receiver or bringing action upon the obligation without taking action under the mortgage.

A further consideration will be the treatment of the borrower as a single asset entity. In general, the ability of the lender to take control of the operations of the borrower and actually run (or contract to have run) the hotel is greatly facilitated and insulated against the supervision of a bankruptcy or other moratorium proceeding if the borrower is a single asset entity. Some original loans have additional requirements to further insulate the borrower with bankruptcy remote provisions and with lender powers over the actions of the board. We can expect to see some litigation testing these provisions in the immediate future. While the establishment of the borrower as a single purpose entity is usually part of the original loan proceeding, it is conceivable that some adjustments may afford some of these purported protections

Finally in determining the available security for the debt, care should be taken to assure that an accounts receivable UCC filing has been timely placed against the Borrower entity, as hotel occupancies have been traditionally treated as licenses and not estates in land (i.e. leasehold interests). Consequently, a local assignment of rents filed may not afford the lender the full security needed to operate the hotel and retain the receivables.

The ability to go after hard assets is only a part of the necessary documentation needed to control the turnaround of the property and achieve value. In addition, there should be in the file certain third party agreements which afford the lender an opportunity to assume the position of the Borrower, cure defaults, and move forward with the workout.

A subordination of the management agreement is essential because often, the management of the hotel is done by a party related to the ownership entity. Without the subordination of the management fees, services in the day to day operation of the hotel will have to be re-contracted (assuming there is a terminable breach in the existing management agreement) and the related manager will have a claim for fees which are not terminated by the foreclosure, receivership or other action.

Equally important is the comfort letter of the franchisor which permits the Lender to use the existing flag during the workout period. Although this seldom extends to concessions from the franchisor with respect to a resale of the property after turnaround, it is not unreasonable to request such agreements in order that the property might be sold with the existing flag without incurring excessive termination fees to the franchisor. A lender should also be aware that many states statutorily require franchises or distributorships to be non-terminable, and in the event there are breaches of the franchise agreement, the borrower may still be able to operate under the franchise. The franchisor may become more amenable to the lender's request to step in, upgrade, and put the property back into the system.

Other items to look for in the file would include information on other third parties with an interest in the operation of the hotel. For example, a lessor or fee owner of the ground would have to be afforded the same considerations as a superior lien holder. A joinder of the fee owner granting a lien in the property, or at the very least, an unconditional right to cure and assume the lease should appear in the file. In the event that the hotel sits in a planned development with property owner obligations, the right to foreclose without subjecting the lender to past due assessments should be clearly spelled out. While the terms of the borrower's organizational documents should have been fully examined at the inception of the loan, it may be wise to check for the rights of investors with respect to actions to be taken by the borrower in handing over operations as well.

In addition third party interests in the operations should be identified, and reviewed if possible such as any union contract associated with the staff, block guests with long term agreements, and major supplier and utility contracts.

One important caveat: The Troubled Asset Relief Program is authorized to purchase loans originated or issued prior to March 14, 2008. There is no guidance on the issue, but refinancing debts which would otherwise qualify for purchase might disqualify those loans from consideration. The safer approach at this point is to shore up or amend existing credits, rather than originate new loans. The "amended and restated" loan is usually considered to have existed prior to the amendment for filing priorities, indebtedness taxes and title insurance purposes (subject to the fact issue of "novation", which as a fact issue, has no clear line answer).

PHYSICAL AND OPERATIONS

A complete physical and operational evaluation of the hotel property is essential to developing a turn around plan. The primary physical issue will almost certainly be deferred maintenance, although if misappropriation of hazard insurance proceeds has occurred, casualty damage may apply as well. The types of operational issues which may be uncovered are limited only by the creativity of the Borrower.

In conducting the physical evaluation, it is important to have the property inspected by someone with experience in operations and ownership. Some “management” companies do not have ownership experience and especially with the types of properties most likely to be the subject of this process. Missing televisions and bedding may be obvious. The need for additional turns of linen or towels, the condition of the HVAC and the operation and bandwidth of wireless internet connections are examples or items requiring much more experience to evaluate. Most inspectors will conduct a room by room examination of the property and maintain a uniform list of items inspected. Familiarity with the requirements of the franchise is also important, as the continuation (or re-establishment) of the flag will be essential to any turn around.

A careful face to face meeting with all parties listed as employees paid on the books of the hotel is equally important. If these employees are part of a related management company even further inquiry may be needed as discussed in the Accounting section below. Indeed, direct expenses to labor paid by the Borrower should be carefully evaluated, as the Borrower seldom is responsible for employer obligations where there is a management company, but actually reimburses these expenses to the manager. Related management companies operating without budgeted authority are relatively easy ways to misdirect revenues and weaken the credit.

Also a check of the standing of the hotel with the franchisor may be informative. Franchisors keep careful records of complaints and inspection results. The borrower’s credit with suppliers of utilities, propane, yard services, maintenance vendors and the like are also good indication of the care used in operations.

Another area of concern is the concentration of guest revenue. Where a majority of the guest revenue comes from a few long term guests (“Group Room Revenue” or “Contract Room Revenue” as defined under the tenth edition of the Uniform Systems of Accounts for the Lodging Industry), as may be the case with construction company or military contracts, the opportunity for maintaining occupancy rates beyond the terms of the contract is diminished, and the potential wear on rooms is increased. Indeed, high occupancy at low rates generally means shortened asset life without any effect on the bottom line. Better maintained properties which are able to increase rates at the expense of occupancy serve as a better source of debt retirement where the revenue remains substantially unchanged.

Assets of the hotel in the borrower’s name should be inventoried. An excess of non-utility automobiles, vacant real property, and payments for services off-site and family names on the payroll are common red flags.

ACCOUNTING AND FINANCE

The ultimate rehabilitation of the property will involve the completion of deferred maintenance to the point where reflagging can be achieved and the property can be sold as an operating entity on an ongoing basis. Often, the amount of capital required to achieve this is not great, considering the effect on cash flow. Estimations by one expert in the business of rehabilitating underperforming hospitality properties is that poor management or outright fraud is the prime factor in 80% of the properties rehabilitated.

It is important that the party inspecting the property is able to provide management services on a temporary basis. No matter how carefully the books and property are reviewed, it often become evident where abuses and poor management are employed only in the day to day operation of the hotel. Most importantly, the use of ordinary cash in the operation usually does not become apparent until a month of operations has been experienced. Then, the true extent cash discounts and "no sales" can be accurately determined, (especially in limited service hotels, where the cash is for rooms and services rather than resold goods which can be inventoried (e.g. restaurant or bar).

As mentioned above, a review of the assets on the books of the borrower also can reveal the misdirection of funds towards shareholders or family members. Airplanes may be out of fashion as too obvious at this point, but premium or luxury vehicles, maintenance equipment or electronics and computers often may have dual (i.e. business and personal) uses and repeated replacement of these items could indicate use off the hotel premises. Even more egregious are the missing assets (chandeliers, better furniture) as well as the existence of assets without evidence of payment for the same (including contiguous "expansion" real estate) indicating cash purchases made to the detriment of debt service, franchise percentages, or other misappropriations.

Of course the review of the books must be made by someone familiar with the Uniform System of Accounts for the Lodging Industry, but it is important that the auditor also be experienced or have access to experience in the tricks referred to above. Usually, companies in the business of doing hotel rehabilitations have their own comptrollers, but independent hotel "forensic" accountants are available as well. These parties will often work had in hand with the temporary manager in discovering the use of funds, payments to related parties, the use of cash in the operations, and the creditworthiness of the hotel as an operating property in its local community.

REMARKETING

Assuming that the physical and financial improvements are completed and that franchise and management have been established, the property can be marketed by parties familiar with the sale of hospitality properties (who often work with the rehabilitator in presenting the property to the correct market. The primary concern in the sale will be the availability of financing and certain benchmarks are probably key to making that decision.

Given that the financial markets are tight, some additional restrictions may apply, but many lending entities consider a 5-10 year old hospitality property to be capable of performance and financeable under a 60-65% loan if it has a debt service coverage ratio of 1.3 or better and if a national franchise is maintained. Consideration of occupancy rates and revenue per available room can be misleading especially if more than 10% of the rooms are not available for any reason or if the hotel is being "block rented" like an extended stay property, without being set up to meet the increased maintenance needs associated with such arrangements. As mentioned above, properties with a lower occupancy can be more desirable if the revenues are maintained by higher rates. In such cases, there is more room for growth and there is less wear and tear on the capital assets.

ADDITIONAL EXPERTISE

In addition to the three main concerns, experienced rehabilitation experts will have good contacts with real estate brokers, loan brokers and loan originators not only familiar with, but dedicated to hospitality property rehabilitation. These people are usually in touch with the fluctuations in the market and cap rates expected of properties and know how to evaluate unique attributes of any particular property.

With a knowledgeable team, a lender stands a much grater chance of turnaround in an operating hotel than in asset based lending, or in strict real estate (e.g. warehousing), where the variables are much fewer and consequently less improvable. The important decision is to start at the earliest sign of distress and to define the legal and operational issues immediately.

For additional information, please feel free to contact one of our attorneys. We are happy to give you a start in regaining control of the credit.