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Distressed Hotel Properties – Five Take Aways

There are hundreds of hotel properties in special servicing or foreclosure and even more that are on the brink. When dealing with a distressed hotel property, there are several issues and opportunities to consider.

Receivership

The use of a receiver to control a hotel property after a borrower defaults can work very well for a lender—but the availability of this legal tool is entirely dependent on state law. In some states, having receivers appointed is fairly simple (New York) and in others it can be very difficult. However, some borrowers may be willing to enter into a consensual receivership (in some ways equivalent to mailing the keys in to the lender). For a Commercial Mortgage Back Securities (CMBS) servicer, receivers are particularly appealing because, if the servicer forecloses the debt is wiped out; however, with a receiver the servicer can restructure the loan and the receiver can sell the property subject to the debt without violating REMIC rules. Hotel buyers should consider looking at hotel properties in receivership—these hotels can be purchased with re-sized debt in place which should have more favorable terms than any available debt in the market.

Termination of Franchise

Defaults by borrowers and exercise of remedies by lenders can trigger certain termination rights. Most comfort letters provide that upon foreclosure or receipt of a deed in lieu, the lender may terminate a franchise agreement and, occasionally, comfort letters will provide the lender a termination right upon a borrower default. Beware of franchisors looking to refresh a brand who may use a default, an expiring franchise agreement or new franchise applicant as an opportunity to get a sub par property out of their system.

Termination of Management Agreement

The management agreements or SNDAs for most third-party managers (i.e., non-brand) provide lenders with a termination right upon a borrower default. Under brand management agreements, borrower defaults do not typically give a lender the right to terminate a brand management agreement; however, in bankruptcy the owner can terminate a management agreement as an executory contract. Buyers under Section 363 sales in bankruptcy can insist on a termination of the management agreement as a condition of their bidding. The wave of actual and possible hotel management agreement terminations has caused many brand managers to

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now give termination rights without the usual large termination fees.

PIPs/FF&E and Repairs

For distressed borrowers, many franchisors have agreed to significantly delay and/or reduce PIPs or FF&E refresh requirements. Franchisors have also occasionally agreed to reduce FF&E reserve and/or tax and insurance escrows. This is happening at the same time that some brands are implementing brand upgrades requiring investment of significant new capital. If you're looking at hotel collateral or if you're looking to acquire a hotel property, these requirements and reserve balances deserve additional attention and negotiations prior to purchase.

Buying Distressed Hotel Loans

Buying a hotel loan puts a buyer into the lender's shoes. If the intent is to foreclose on the hotel property and terminate the existing franchise agreement and/or third-party manager, buying debt is one way to accomplish that goal. Buying hotel debt has proven difficult in the market because of the gap between lenders' perceived value and buyers' desired discounted purchase price.

There are many additional considerations, and we will explore some of them in more detail in future client alerts. Hunton & Williams' hospitality practice is currently working with owners and lenders to develop strategies for dealing with distressed hotel properties. For more information about our hospitality practice or and how we might help you, please contact us.