Current Issues in the Negotiation of Hotel Loan Agreements

Hotel loan documents in use by major commercial lenders have changed relatively little in recent years as a result of changes in law, regulation or commercial lending practice. Loan documents have changed primarily in response to the evolving business of the hotel industry and developments in how capital and debt financing are raised for the industry. Financing for mid-size and smaller hotel projects has increasingly been found in the CMBS or debt securitization market, whose requirements also drive a high degree of standardization of loan documentation. Conventional or regional bank lenders continue to be active in hotel lending and tend to follow the CMBS style of documentation. This form is used by such lenders to ensure that they have an exit available, and the use of standard documentation assists them in reselling loans into mortgage pools or to other lenders. The most substantive issues in the documentation of hotel lending now arise in new products such as condo hotels, in hybrid or multiuse projects combining multiple business types and ownership structures, and in the use of multiple tiers of debt and/or preferred equity to fund complex projects.

The basic structure for a conventional loan secured by an existing hotel remains a standard package of promissory note, mortgage, UCC security agreement[s], and other documents sufficient to establish collateral interests in bank accounts in which hotel revenues may be held. When the hotel is operated under third party franchise and/or management agreements, additional collateral pledges and security instruments are added. Commonly, the franchisor or the management entity becomes a signatory to a “comfort letter” and/or “tri-party agreement” also executed by lender and borrower. Other material contracts may become collateral for the loan or subject to additional pledges and tri-party agreements among the contract party, borrower and lender. If true leases form part of the collateral or business of the hotel, there may be an assignment of leases and rents separate from the assignment of revenues of hotel operation. These separate documents and collateral arrangements are often integrated by and refer back to a loan agreement, which deals with procedural issues of loan administration, informational reporting and covenants applicable to the borrower as an entity and to multiple classes of collateral, such as insurance on pledged assets.

A surprising number of lenders, including some in the CMBS market, have documented very complex hotel loans without separate loan agreements. Looking back from the experience of lenders after default, foreclosure and bankruptcy, this may not be an advisable practice. Absent a loan agreement, the lender must rely on the secured note default remedies such as foreclosure as the primary control on borrowers. This may be deemed advisable in jurisdictions applying a one-action rule. A lender is, however, unlikely to see foreclosure as the generally preferred path after an actual hotel loan default. Rather, recovery on a hotel loan is likely to depend on the ability of the lender to maintain and sell an operating business, and foreclosure (which is highly disruptive to normal operation) will not maximize the lender’s recovery. For small hotel loans or for loans by lenders who make only occasional loans secured by hotels, the logic of proceeding without a loan agreement has been that the costs of documenting and administering the covenants of a hotel loan agreement would exceed the benefits of having a formal corporate-style loan agreement. These lenders in theory elect to limit their recovery strategy to foreclosure without any attempt to restructure or work out the loan or maintain the hotel in operation. Some lenders of this type are currently active in the hotel market. However, rising rates of default due to failure to refinance upon debt maturity may be driving these lenders away from hotel lending. These lenders are also changing their views about loan agreements as they encounter the reality that bankruptcy judges and courts dealing with foreclosure may not in fact allow summary remedies such as foreclosure to roll out quickly when employees and local businesses may be affected. Hotels remain operating businesses and not real estate in many important ways, including treatment in bankruptcy. The power to enforce information, reporting and other covenants through a loan agreement may be seen as increasingly valuable.

Attorneys counseling lenders face their greatest challenges in creating loan documentation to deal with the increasingly complex structure of the underlying investments. New hotel projects are

pushing into unconventional combinations of elements, including gaming, educational, residential, medical and retail facilities in a single project with multiple ownership interests. New exit strategies for the participants – including partial re-sale, condo or interval sales, and delivery to long-term or public operators - are reflected in the loan documents by multiple release scenarios. The risk factors, permits, and material contract relationships continue to raise novel issues.

Condominium projects linked to hotels have received much recent publicity. Some hotel-condo projects have encountered problems both with pre-sales and lenders' requirements, bringing attention to these as a special complex class of developments. Condo facilities have been added to new-built luxury hotels projects because they were thought to make those hotels more feasible. Luxury hotels have been increasingly difficult to justify due to their high cost versus relatively constrained ability to generate cash flow in operations and support the investment needed to construct them. The amount of equity needed for a luxury project, the low margin of operating profit in luxury hotel properties, and the five to seven years needed to sell or refinance a hotel projection in the ordinary cycle all resulted in a prohibitively low and unattractive IRR return for investors. To make projections for a luxury hotel project appear more feasible, some developers added condominium towers or subdivisions. In theory, there would be a premium value to the condo units because they would have a luxury brand association. More importantly, condo sales would accelerate the repayment of loans and return of capital to the investors, raising the IRR in comparison with a conventional hotel project. If the investment in the overall project could be repaid more quickly from the condo sales, an otherwise unworkable luxury hotel project might become capable of being financed and attracting equity. Of course, the change in format also added to the lender's underwriting issues of sale risk, marketing, third party advisers and sales agents, securities and regulatory concerns, and continuing problems of demand for condos. Several of those factors have now come into play to leave many of these projects in doubt, and will test the quality of the loan documentation.

Condo-hotel projects were similar in their business plan to other hotels developed with a link to time-share or "interval ownership" projects. Rather than relying on simple condo sales to return the investment, hotels linked to time share projects looked to sales of units, and also to continuing management fees, resales and sale of consumer debt paper from the unit sales to return the investment. These more complex projects typically burden the hotel with costs and restrictions meant to enhance the ability of the sponsor to sell time share units, and lenders often do not have collateral in all aspects of the project. Thus, there was and is a tension between the goals and interests of the sponsor, the equity investors in the non-hotel elements and the lender secured only by the hotel collateral and subject to the burdens of the time share project. The lender must deal with all of this uncertainty, and there is no clear model for lending to these complex and evolving forms of development.

Multi-use projects also raise new issues. A number of major urban hotel projects have been undertaken as part of larger commercial developments with office, residential, parking, medical, sports and/or other facilities in relatively densely built-up areas. This pattern has now expanded to suburban and resort projects linked to specific facilities such theme parks, hospital centers, and colleges. Complex connections have been contemplated or exist *de facto* between the operating segments of these projects, with substantial interdependence of the parts needed to achieve overall economic success. Lawyers are asked to create enforceable legal connections between separately owned and financed projects to preserve their value for the lender. As examples of this, there have been theme parks linked to surrounding hotels, hotels built in sports facilities, and hospitals seeking to establish for-profit centers for services to patients with hotels linked to supply the needs of patients and their families. The lawyer's job is made more difficult by the legal reality that, the more operating conditions or covenants are added, the less likely that the overall transaction will remain a real estate transaction for foreclosure and bankruptcy purposes. There is also a greater risk that elements of the project will be recharacterized as a joint venture or other arrangement. with hazardous implications for the lender seeking to foreclose on assets as if all interests were real property.

Public-private projects have become popular, in part because they may allow some below-market financing or reduction of land costs essential to make possibly marginal deals more successful. These projects raise additional issues if a portion of the land, permitting or financing depends on some element

of governmental affiliation. We are seeing hotels use TIF (tax incremental financing), infrastructure financing and guarantees, development bonds, public subsidies and other sources of government-linked financing. Several of these sources of financing, with their attendant costs and complexities, may be used in a single project to bring the cost within what is feasible and acceptable to investors and conventional lenders. A lawyer representing the lender may need to take into account the reality of what it means to have the public authorities in multiple roles and the practical difficulty of moving to enforce any rights against the interests of a public authority on its home ground or in regard to a politically sensitive high-profile project. These are particularly difficult projects to underwrite successfully, because typical projects for public-private investment, such as convention centers and sports arenas, are notoriously hard to operate profitably.

We see also expanded use of multiple levels of debt or "preferred equity" as part of a hotel financing package. This use of debt appears in both new development and redevelopment projects, and is to some degree a sign of the overheating of hotel development with leverage straining to very high levels. Issues may arise when equity investors ask the lender for advance consent to investors taking a mezzanine position in the event that more funds are required for a project. Unless the first-lien lender is prepared to fund all overruns itself, it must deal with whether and how new debt or equity might be added and how it may be held, transferred or foreclosed. For this purpose, and whether the mezzanine debt exists or may be contingent on future events, an intercreditor agreement between the first lien holder and any actual or prospective mezzanine lender or equity contributor is becoming a more common part of the initial documentation of a hotel development loan. Complex deal structures are, in their overall structuring, a network of intercreditor relationships.

Brand-dependent collateral also continues to raise new issues. This collateral ranges from management and franchise rights to specialized software to tradenames of special facilities, such as restaurants. Forms of management agreements drafted by management companies are primarily focused on restricting the powers of owners against the management companies. As a practical matter the same terms may also impede the lenders. Understanding, defining and controlling the roles of the brand group in, for example, a condo hotel project can be extremely difficult. The group or its members may be partner, developer, service provider, vendor, construction representative, permit holder, technical advisor, arbiter of brands standards and budget requirements, marketing rep, trademark owner, sales rep, broker where securities are involved, timeshare sponsor and decision maker on service levels and capital calls. The hotel may be obligated to provide support and sales incentives that in substance are subsidies to the time share activities. All this may be done without coherent, separate documentation of the rights and roles of the various entities. Many key services and risk of liabilities left to future determination and to be dealt with by unnamed and presently unknown affiliates. The rapid increase in the number of these projects and their complexity seem to leave some or all of the lenders unclear about how to analyze the consequences of delay, overrun, or adverse market, or how to approach the risks in loan documentation and underwriting. This is exacerbated by the reality that lenders are often the last party added to the negotiation, and often much deal with documents and arrangements already in place.

An emerging issue for lenders is the quality of financial reporting. Hotel loan underwriting and documentation has relied heavily on improvement in the availability and quality of statistical information about hotels and their performance. Such information has been developed primarily from databases of Smith Travel Research (known in the industry as "STR" a/k/a "Star" reports) and other reporting sources that track hotel performance, real estate financing transactions, deal volume and development pipeline. These sources of information have brought hotel industry statistical data to a higher level of financial sophistication, but have also contributed to underwriting that is overly dependent on theoretical models. Lenders accustomed to modeling value based on long term commercial leases began to have greater confidence in their ability to quantify and project hotel performances. Wisely or not, they are underwriting loans on more narrow pricing and margins and on the basis of models that may not fit with the evolving reality of transactions.

Lenders also have become more focused on the ratio of EBITDA to revenue and debt service as basic metrics of hotel value. Lenders seem much less interested in traditional metrics such as appraised valuation and loan-to value ratios. These have been reduced to checklist items with less underwriting

significance. By this change, hotel lending is moving in the direction of conventional lending to operating businesses, and away from traditional real estate lending models. Loan documentation has followed this with more emphasis on accounting, audited information and information reporting obligations, which are the backbone of commercial lending to corporate borrowers. This has been a consistent trend in hotel financing for at least two decades.

Running contrary to this trend is increasing concern that the accounting standards of the industry are inadequate. The accounting presentation format most commonly used by hotels – known as the Uniform System of Accounts – is increasingly perceived to have evolved away from investor issues as a result of its governing body being dominated by brand-affiliated management and franchise companies, their consultants and their accountants. The Uniform System of Accounts has long been a format for the presentation of GAAP data under headings specific to the hotel industry. The most recent version appears to attempt to define accounting principles as well as the reporting format. The terms defined in Uniform Systems are routinely used in contracts throughout the industry, but may not adequately present the information that owners and lenders need and expect and may conflict with the accounting principles that they would choose as a matter of GAAP. We are seeing more effort by lenders and owners to clarify the significance of operating results and to get behind the reality of accounting practices, particularly as those practices may obscure related party transactions, true levels of cash flow, and the base on which fees are paid. Getting the accounting and reporting right is a now a key issue in documentation.

There is also concern that hotel audits have not been conducted with the independence and thoroughness expected and needed by lenders. Several large audit firms serve as primary auditors of major brand groups in regard to SEC reporting, but have also performed audits of the accounts given by those same companies to owners and lenders. From this conflict of interest, a new wave of claims has begun to emerge. There is some reconsideration underway as to the accounting provisions in loan underwriting and documentation. This will require, at a minimum, that lawyers to become more informed about specialized issues of hotel accounting.

The hotel industry has now enjoyed several years of improving performance and low interest rates. Both trends appear to be winding down with increased supply coming on line and greater competition in the market. Occupancies have begun to flatten or decline year to year outside the strongest markets. Historically, this has been a precursor of declining room rates and therefore declining value in the short or intermediate term. It is generally thought that established lenders with large portfolios have anticipated these changes, have sufficient liquidity, are well placed to administer their collateral and prepared to take over projects if needed. But it is also thought that the lenders to some of the more aggressive and complex hotel projects -- incorporating some or all of gaming, condo, multiuse and convention or sports facilities as elements of the hotel business plan -- face greater challenges. Some projects have already been restructured by private agreement. Others continue to try to resolve problems of performance, value and failure to meet projections necessary to refinance upon maturity. Some of these are the projects most likely to have used public market debt, government-enhanced credit, municipal ground leased land, mezzanine debt, affiliate guarantees, and other creative structures. Their successes or failures are certain to create new legal and business precedents. These cases may show us whether financing of such hotels should still be analyzed as real estate lending. In the opinion of some, we have crossed over to something much more like traditional project financing and to a more complete integration of corporate and real property financing.

HOTEL LOAN AGREEMENT

BY AND BETWEEN

and

DATED AS OF: