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Hotel Loan Workouts

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For many hotel owners, it is an all-too-familiar story: occupancy is down, and even though operating expenses have been cut to the bone, there is just not enough money to go around. It seems there is always another bill: franchise fees, payroll, real property taxes, debt service—the list goes on. The unfortunate result is that either because of a failure to make a payment or a breach of some other covenant, the owner finds itself looking at a default notice from its lender. When dealing with a loan default, there are four things the hotel owner needs to understand.

1. Understand Your Loan Situation

Before the default notice even arrives, it is important for an owner to understand what its exposure is. Is the principal personally responsible for the debt (for example, under a personal guaranty)? Even if the loan is non-recourse, it is likely that there is a "non-recourse carve-out" guaranty, wherein the principal has personally guaranteed the losses that the lender might incur as a result of certain "bad acts." It is critical the principal understand what his or her personal exposure is at the first sign of financial distress. This is because the failure to make certain payments—such as the payment of franchise fees or ground rent—might trigger exposure under the non-recourse carve-out guaranty. When deciding who to pay, the hotel owner's inclination might be to pay everyone a little. However, if the failure to keep the franchise in good standing or the failure to pay ground rent triggers liability under the non-recourse carve-out guaranty, the owner's best course of action may be to pay everyone else **before** paying the debt service.

It is also important the owner understand the nature and the scope of the default or defaults. The type of default will impact what the owner is able to negotiate with the lender. For example, the hotel owner that is failing to make monthly payments will have to approach the lender differently than the hotel owner that has been making monthly payments but is faced with a maturity default because it is unable to refinance a loan that has come due. Similarly, an owner that has run afoul of other covenants (such as debt service coverage ratio requirements) may have more options available in attempting to make the lender comfortable with the hotel owner's situation.

2. Understand the Uncertainty Inherent in the Situation

Everyone has heard stories about what other hotel owners have been able to do when negotiating with their banks. An owner might have heard that another owner, seemingly in the same situation, was able to negotiate a favorable agreement with its lender. An owner might be inclined to think, "If they were able to do it, then I should be able to do the same thing, right?"

Unfortunately, the answer is "not necessarily." In fact, the owner's best bet is to forget what someone else did, because there is simply no way to tell whether the situations are comparable, even if they appear to be so on the surface. More than anything else, what will drive an owner's ability to reach an agreement with its lender are factors unique to the lender—factors of which the owner is probably not ever going to be aware. For example, if the loan was securitized, and the owner is dealing with a special servicer, then the position the servicer takes with regard to the owner's default might very well be driven by the status of the loan pool and whether the decision has been made to simply write off the loan or to foreclose and package the property with other foreclosed properties for sale.

When comparing two seemingly similar loan-default situations, one very basic and important difference might be who the lenders are. A local or regional bank that has held onto the defaulting loan (i.e., has not sold it on the secondary market) will likely approach a default differently than a special servicer that is servicing a pool of mortgages. To a local or regional bank, the loan might be a significant part of its portfolio, and the bank might have more incentive to renegotiate the terms of the loan to avoid taking a write-down. Because it is acting on its own behalf, the local or regional bank will also have greater flexibility to negotiate the terms of a workout. In contrast, a special servicer with fiduciary obligations to the holders of the mortgage-backed securities must follow strict guidelines governing possible modifications to the loans in the pool. Any agreement to modify the terms of the defaulting loan will likely come only after much review and after the servicer has obtained numerous approvals (such as rating agency approval and approval of the secured creditors).

3. Understand What You Might Have To Give

When trying to negotiate a loan workout, a lender is going to want to see a plan from the owner. Before agreeing to any modification of the loan terms (instead of simply proceeding with a foreclosure), the lender will want to see there is a realistic prospect the owner can perform in the future. In most cases, the lender will want to see something that gives it additional security: a pay down of principal, additional collateral, an additional guaranty—something that either reduces the lender's exposure or provides the lender with something it did not have before. In situations where a principal has multiple loans with the lender through different entities, the lender might require that the loans be cross-collateralized and cross-defaulted.

There are also certain basic terms the lender will demand. The lender will require the owner to ratify the loan documents and the lien of its security documents (such as the mortgage). The lender will also want the owner to certify it is in default and waive any defenses or counterclaims it might have against the lender. As a result, while the owner might reach a deal with the lender to delay the enforcement of remedies, the owner will have conceded there is a default and will not be able to assert any remedies or defenses against the lender if, as the result of a future default, the lender is once again free to exercise its remedies.

Ultimately, the best way to preserve some interest in a property might be to bring in an equity investor. Although it will cost the owner a piece of the property, the additional capital source might be enough to induce the lender to make a deal.

4. Understand What You Are Getting

An owner has to approach the negotiations with a realistic understanding of what it needs in order to perform under the loan. In many cases, the owner is looking for additional time, reduced monthly payments (such as interest only) or relaxed covenants. However, if the owner does not have realistic expectations about what relief it needs in order to perform under the loan, the owner might find it cannot perform even under the new, more favorable terms. Even worse, because the owner is now defaulting after renegotiating the loan, the owner has likely waived all counterclaims and defenses it might have against the lender (as described above). Now, the owner has no defense at all against the lender when the lender chooses to exercise its remedies.

Sometimes, the new terms offered by a lender are simply unworkable. For example, if an owner is behind on monthly debt service payments and the lender is only willing to offer to forbear from exercising its remedies for a one or two month period, the owner might be better off not negotiating an agreement with the lender at all. It is simply not wise to waive all defenses and counterclaims against the lender in exchange for a short extension of time if there is no realistic way the owner is going to be able to cure the default, refinance or sell the hotel by the new deadline. The owner will have waived all claims and defenses against the lender in exchange for a meaningless remedy.

The distressed hotel owner needs to have a firm grasp of all of the circumstances surrounding its loan before undertaking to negotiate a workout with its lender. An owner that fails to appreciate its circumstances, liabilities and prospects for recovery might find it has inadvertently made its situation worse for having “worked-out” its bad loan.