STANDARD FORM OF HOTEL LOAN AGREEMENT -- 2007

Annotated with Introduction

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Current Issues in the Negotiation of Hotel Loan Agreements

Hotel loan documents, as in use among major commercial lenders, have changed relatively little in recent years due to issues of law, regulation or commercial lending practice. Loan documents, however, have had to respond to substantial changes in the business of the hotel industry, and in how capital and debt financing are raised for investment. Financing and investment for mid-size and smaller projects have increasingly found their funding in the CMBS or securitization markets, whose requirements add to the standardization of the documentation. Conventional or regional bank lenders continue to be active in hotel lending, but also follow the CMBS style of documentation format. This is done to protect exit strategies, which may include future participation or sale of the debt to other lenders. The most substantive issues in 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 most basic structure for a conventional loan secured by an existing hotel remains the standard package of note, mortgage, UCC security agreement, and documents sufficient to establish collateral interests in bank accounts in which hotel revenues may be held. Where the hotel is operated under third party franchise or management, additional collateral pledges and security instruments are added, most commonly with the franchisor or management entity becoming a signatory to a "comfort letter" and/or "tri-party agreement". Other material contracts may become collateral for the loan or subject to three party agreements with the contract party. If true leases form part of the collateral or business of the hotel, there may be an assignment of leases and rent separate from the assignment of revenues of hotel operation. These separate documents and collateral arrangements are integrated by and refer back to a loan agreement, which deals with procedural issues, information reporting and covenants applicable to multiple classes of collateral, such as insurance.

A surprising number of lenders, including some in the CMBS market, have documented hotel loans without separate loan agreements. Looking back from experience after default, foreclosure and bankruptcy, this may not be the best practice. Absent a loan agreement, the lender must rely on the note default remedies like foreclosure as the primary control on borrowers. This may be necessary or advisable in jurisdictions applying a one-action rule. A lender is, however, unlikely to see foreclosure as the generally preferred path after an actual default. The lender will then take the view that foreclosure will not maximize its recovery on hotel assets. For small hotel loans or lenders who make few loans secured by hotels, the logic of proceeding without a loan agreement has been that the costs of administering the covenants of a hotel loan agreement would result in a cost to the lender that is likely exceed what is lost by not having the alternative remedies and powers of a formal corporate loan agreement. These lenders prefer to go to foreclosure without any attempt to restructure or work out the loan. Some of these lenders are currently active in the hotel market. However, rising rates of default – usually due to failure to refinance upon debt maturity -- may be driving these lenders back to more conventional real estate lending. They may also change their views on loan agreements as they encounter the reality that bankruptcy judges and courts dealing with foreclosure are not inclined to 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 bankruptcy. The power to enforce information, reporting and other covenants through a loan agreement are seen as increasingly valuable.

Attorneys counseling lenders now face their greatest challenges in the structure of the underlying investment. As the hotel market matures, developers of new projects push into new areas elements of unconventional hotel financing and new exit strategies are incorporated in the documents. Of these projects, the condo hotel is one notable example. New-build luxury hotels projects have been increasingly difficult to justify where the development plan is the one used for decades in conventional development: raise conventional debt and a construction loan, acquire land and complete the project, replace the construction debt with a short term permanent loan, stabilize the operation of the hotel, and sell or refinance the permanent loan at or before the maturity of the permanent loan. This plan, typical a few years ago, does not result in adequate return on investment in most luxury projects. Among other issues, the amount of equity needed for a luxury project, the low margin of profit on luxury properties, and the five to seven years needed to sell or refinance a hotel projection in the ordinary cycle all result in a prohibitively low return on the equity. To make a luxury project work, there must be an earlier exit for the equity investor, so that its ROI can be calculated on a shorter period. Early condo sales theoretically allow this, because they accelerate the return of capital. So, if the equity in the overall project can be repaid from the condo sales, an unworkable luxury hotel project may become financeable and able to attract equity. Of course, the change in format also adds sale risk, marketing issues, third party advisers and sales agents, securities and regulatory concerns, and issues of demand for condos. There is also a tension between equity investors and the lender, in that the equity investors are seeking to retire their investment before the debt is repaid. The lender must factor in all of this uncertainty.

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 other facilities in relatively densely built-up areas. This pattern has now expanded to suburban and resort projects linked to specific facilities such a theme parks, hospital centers, and colleges. Complex connections have been planned 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 international 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.

Public-private projects have become popular, in part because they may include below-market financing or land costs essential to make marginal deals successful. They 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. All of these, with their attendant costs and complexities, may be used because the underlying project is not feasible if it must depend on conventional sources of funds. Also, these projects usually relate to some form of public amenity or facility expected to provide some financial return -- such as a convention center or sports arena – but which are notoriously hard to run profitably and generate only erratic demand to support hotels. 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 a public authority on its home ground or in regard to a politically sensitive high-profile project.

We see also expanded use of multiple levels of debt or "preferred equity" in addition to the first lien mortgage. This pattern exists in both new development and redevelopment projects, and is to some degree a sign of the overheating of hotel development. The debt issues may arise prospectively, as when equity investors ask the lender for advance consent to investors taking a mezzanine position in the event that they are required to advance more funds into the 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 is becoming a routine part of the initial documentation of a hotel development loan.

Brand-affiliated collateral also continues to raise new issues. Forms of management agreements drafted by management companies are primarily focused on restricting or frustrating the rights of owners against the management company, but as a practical matter the same terms may equally impede the lender. 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, and decision maker on capital calls. All this may be done without coherent and separate documentation of the rights and roles. Many key services and risk of liabilities left to unnamed and unknown affiliates. The rapid expansion of the projects and their complexity often seem to leave some or all of the parties scrambling to analyze how the structures will hold up in the event of a delay, overrun, or adverse market, and how to approach the risks in loan documentation.

An emerging issue for lenders is the quality of financial reporting. Hotel loan documentation has made use of a rapid expansion 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 real estate financing transactions, deal volume and development pipeline. These sources of information have brought hotel lending to a higher level of financial sophistication, but have also contributed to underwriting that is overly dependent on theoretical models that ignore or obscure reality. 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 underwrite loans on more narrow pricing and margins. Lenders also became more focused on the ratio of available cash flow to debt service as the basic metric of value. They are much less interested in traditional metrics such as appraised valuation and loan-to value ratios. These have been reduced to checklist items with less real 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. 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 perceived to have been distorted by its authors, an accounting standards group dominated by brand-affiliated management and franchise companies and their accountants. The Uniform System presents GAAP information under headings specific to the hotel industry. The terms are routinely used in contracts throughout the industry, but may not adequately present the information that owners and lenders need and expect. 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.

There is also concern that hotel audits have not been conducted with the independence and thoroughness expected and needed, with several large audit firms serving as primary auditors of major brand groups in regard to SEC reporting while also doing audits of the accounts given by those same companies to owners and lenders. A new wave of litigation has begun against accounting firms, and may force substantial reconsideration of 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 enjoyed a long period of improving performance and low interest rates. New developments, renovations and conversions have made use of new forms of financing. There are some indications that the upward curve of performance is coming to an end, with occupancies beginning to decline year to year in even major markets. Historically, this has been a precursor of declining room rates. Such a decline would be consistent with the oversupply of rooms in some markets. It is generally thought that established lenders with large portfolios have anticipated the major issues, 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. As 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 will create new legal precedent. 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.

HOTEL LOAN AGREEMENT

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