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Considerations for 'loan to own' hotel investors

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As real-estate lenders and investors work toward recovering from the dramatic collapse of the credit markets in 2009, there has been significant activity in the purchase of real-estate mortgage and mezzanine debt by investors whose eventual goal is to succeed to ownership of the underlying assets, through either a foreclosure action or a negotiated transaction (such as a deed in lieu of foreclosure).

As real-estate lenders attempt to clean up balance sheets and dispose of certain distressed assets, investors often are presented with opportunities to acquire, often at a discount, debt secured by real estate, thereby inserting themselves into the "capital stack" of the real estate in a position with significant negotiating leverage. At the same time, a recovery in the hotel sector, evidenced by [increasing occupancy rates](#) and improved operating revenue, has made hospitality assets more attractive to institutional investors. This in turn has led to a significant increase in the number of hotel acquisitions conducted through such "loan-to-own" strategies.

When acquiring debt in a loan-to-own transaction, an investor must not only conduct his or her normal due diligence on the real estate, but also must carefully study the terms of the loan purchased, the governing loan and security documents, the financial condition of the borrower and any guarantors and the relevant local laws, including laws relating to foreclosure and transfer taxes, which vary by state and even county. These transactions become even more complex and additional issues often arise when the underlying asset is a hotel rather than an office building, apartment or other commercial property.

This article highlights the most material of these issues and how they might affect an investor's underwriting and due diligence when considering the acquisition of hotel debt.

A different animal

At the outset, it is important to note that a hotel asset is much more than just real estate. A hotel is an ongoing operating business and must be analyzed, underwritten and diligenced as such. Unlike other commercial properties, the day-to-day performance of this ongoing business is a significant driver (both positively and negatively) of value of the hotel and thus investor interest in considering acquiring debt secured by a hotel. It is a commonly heard axiom that, unlike apartments, each room is typically filled and vacated on a nightly basis.

Unlike most commercial properties with long-term leases in place, hotel revenue can fluctuate widely and is more susceptible to outside factors, including the general consumer market, seasonality and the cancellation of large group reservations. Thus, potential purchasers of hotel debt should expect to devote substantial time and resources to analyzing the past, present and expected future performance of the hotel (and accordingly budget for greater due diligence expenses than would be incurred when acquiring debt secured by other assets). More legal due diligence is often required to review critical third-party agreements, such as franchise and management agreements (discussed below). In addition, many investors retain consultants who specialize in hotel accounting, valuation, operations and marketing.

Furthermore, the investor will need to ensure that once it acquires the debt and begins to either exercise secured creditor remedies or negotiate with the borrower for a transfer of ownership, the hotel continues to operate in a manner that will not erode value. This includes, among other things, retaining employees on the property, maintaining the hotel's physical condition and desired occupancy and maintaining ongoing relationships with vendors. The investor must plan ahead to ensure a smooth transition of ownership by establishing bank accounts to manage the substantial daily cash inflows and outflows, making arrangements with credit card processors and obtaining all government permits and licenses required to operate the hotel.

Given this need to maintain the hotel's operating business, unlike with other commercial real-estate assets, a hotel debt investor rarely can afford for the borrower to "walk away" and forego the operation of the hotel. An uncooperative or adverse borrower who might discontinue operations at the hotel could have a greater negative impact on value than a similar borrower who operates other forms of commercial property.

Of course, this might give the borrower additional leverage in negotiating any transfer of title to the investor. This risk is somewhat mitigated if the investor acquiring the debt is himself or herself a capable hotel operator and can step into the borrower's shoes, or if the hotel is operated by a third-party manager, in which case operations should not be materially affected while the investor acquires title.

Third-party agreements

Hotels also are commonly subject to various agreements with third parties critical to the operation of the asset. While many hotels are owned by a special purpose entity formed by the sponsor or developer, most hotels are subject to management agreements and/or franchise agreements with unaffiliated third parties.

Hotel debt investors must consider these arrangements very carefully, as the third-party manager or franchisor is typically granted certain rights in the event of a loan default or change of control (which would occur upon a lender taking ownership of the underlying asset in a foreclosure or deed-in-lieu). In fact, it is typically the case that an investor acquiring ownership of a branded upscale or luxury hotel takes title to the hotel subject to the terms of the existing management agreement.

Therefore, it is necessary for a hotel debt investor to fully review and understand not only the terms of the applicable management or franchise agreement but also any subordination and non-disturbance agreement, so-called franchise "comfort letters," assignment of management agreement or other ancillary security document that could impact the rights of the parties.

Other issues

The existence of third-party hotel management and franchise agreements presents other interesting issues that are often at odds with one another.

On the one hand, as noted above, hotel managers and franchisors might have certain approval or cure rights that could trump the rights of an investor acquiring debt and rights to require the investor to complete extensive renovations upon taking title to the hotel.

On the other hand, maintaining the presence of a strong hotel manager or "flag" on the property could be beneficial for the investor in terms of utilizing existing marketing and

reservation systems, retaining the services of experienced professionals and minimizing disruption to operations upon the change of ownership.

In the case of a purchase of mezzanine debt that succeeds to ownership of the hotel ownership entity (as distinct from ownership of the asset itself), the investor would succeed to any liabilities the prior owner might have had under the third-party agreements, such as for unpaid fees or unfunded reserves.

Finally, hotel ownership often requires a more complex form of ownership for certain investors, including real-estate investment trusts and other investors sensitive to unincorporated business taxable income. For various reasons beyond the scope of this article, REITs and unrelated-business-income-tax-sensitive investors must structure the ownership of a hotel in a manner that will avoid "bad" income, such as income from an operating business such as a hotel. In order to avoid the characterization of income as "bad" income, many hotels are often owned by a REIT or UBTI-sensitive investor and then leased to an affiliated entity via an operating lease. The affiliated lessee collects revenue from the hotel, pays expenses (including management and franchise fees) and then pays "rents" to the REIT or UBTI-sensitive owner in order to re-characterize the income. Given the increased frequency of hotel debt acquisitions by REITs, these issues are more frequently encountered by the parties typically involved in these transactions.

In sum, the acquisition of hotel debt, while often very attractive to institutional real-estate investors, involves a host of complex issues that are not typically encountered in connection with the acquisition of other commercial real-estate assets. As lenders and real-estate investors attempt to navigate through the recovering markets, it is crucial to carefully analyze and consider all of these issues in order to complete a successful transaction.

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