JMBM

The Lenders Handbook for Troubled Hotels

Essentials and Advanced Techniques - A Practical Guide

BY JIM BUTLER
CHAIRMAN, JMBM GLOBAL HOSPITALITY GROUP®

We wrote the book™ series:

- The Developer's EB-5 Handbook for EB-5 construction financing
- The HMA & Franchise Agreement Handbook
- How To Buy And Sell A Hotel Handbook
- The Lenders Handbook for Troubled Hotels
- The ADA Compliance and Defense Guide

This handbook is provided for informational purposes only.
Legal advice should be based on your specific information
and provided by a qualified attorney.

Dedicated to the men and women of the Global Hospitality Group® of
Jeffer, Mangels, Butler & Mitchell LLP
and the wonderful hospitality industry that we serve.

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Introduction

Hotels are different. And so is dealing with them – whether in development, purchase and sale, or in workouts, bankruptcies or receiverships. They require different experience, strategies and documentation.

The lawyers of JMBM's Global Hospitality Group® are constantly dismayed to see how often world-class lenders stumble badly with hotel assets. Lenders are often guided by some of the "best law firms in the country" – top Wall Street law firms with international reputations. These legal giants may be ideal for taking on an anti-trust case or guiding an international mega-merger because they have more experience in these areas than other firms. But however large they may be, or however good in other areas of law, these law firms' lack of hotel-specific experience continues to fail them – and their clients – when it comes to hotel loans and distressed hotel assets.

We continue to see value that is irretrievably lost, due to this lack of industry inexperience. Unfortunately, strategies and campaigns launched on the battlefield of troubled hotel assets are too often irreversible. Once you tripped past a decision point, you cannot go back!

The Lenders Handbook for Troubled Hotels is intended to be a reference tool for all lenders confronting troubled hotel assets – whether novice or expert, whether dealing with one-off loans or billion dollar portfolios. We hope it also introduces lenders to new and creative techniques for approaching the same old difficult problems.

The Handbook is drawn from articles which have appeared on www.HotelLawBlog.com, with edits required to ensure that all the information provided is still current as of May 2010 (it was) and to suit the format of a practical handbook.

When I launched the Hotel Law Blog in 2006, I promised my readers that I would write on timely topics with an emphasis on practical, useful information that answers the question "what does it all mean?" Little did I know at that time just how soon "troubled loans" would become a critical topic for all hotel lenders, owners and investors.

Fortunately, it is a topic in which JMBM's Global Hospitality Group® members have great experience and expertise. (For our team's credentials, see "About Jeffer Mangels Butler & Mitchell LLP on page 89.)

We began to provide the readers of the Hotel Law Blog with a comprehensive foundation of the essentials for lenders dealing with the complex issues surrounding troubled hotel loans. We then added our thinking on some advanced techniques and threw in a measure of strategic advice. The industry, the market and the law are dynamic, and as things change, we continue to share our knowledge, perspective and experience in the Hotel Law Blog.

All the hotel lawyers of JMBM's Global Hospitality Group® join me in hoping that *The Lender's Handbook for Troubled Hotels* will be useful to you and your colleagues. Please contact us with any experiences or thoughts you would like to share. We always love to talk with our industry friends on "what it all means" to you and your company, and to see if there is any way that our resources and experience might help you accomplish your goals.

~ Jim Butler

May 2010, Los Angeles

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About the Author:

Jim Butler is one of the top hospitality lawyers in the world. (GOOGLE™ "hotel lawyer" and you will see why.)

The author of the Hotel Law Blog (www.HotelLawBlog.com), founding partner of Jeffer Mangels Butler & Mitchell LLP (JMBM), Chairman of JMBM's Global Hospitality Group®, and Founder and Conference Chairman of Meet the Money®, Jim and his team have represented hotel lenders, owners and investors for more than 20 years.

Jim and the members of JMBM's Global Hospitality Group® have helped their clients find business and legal solutions for more than $71 billion of hotel transactions, involving more than 3,800 properties all over the world. JMBM's troubled assets team has handled more than 1,000 bankruptcies, receiverships and workouts.

Jim and his team are more than "just" great hotel lawyers. They are also hospitality consultants and business advisors. They have developed unique proprietary approaches to unlock value in troubled hospitality properties that can benefit lenders, borrowers and investors.

Whether it is a troubled investment or new transaction, JMBM's Global Hospitality Group® creates legal and business solutions for hotel owners and lenders. They are deal makers. They can help find the right operator or capital provider. They know who to call and how to reach them.

~ Jim Butler

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Global Hospitality Advisor®
Workouts and Special Servicing for Hotel Mortgage Loans
What is so different about troubled hospitality loans?

Hotel Law Blog: 30 October 2008

http://hotellaw.jmbm.com/2008/10/whats_diff_about_hotel_loans.html

JMBM's bankruptcy lawyers say that they have not been this busy in 20 years.

JMBM's team of troubled loan veterans have dealt with more than 1,000 receiverships, bankruptcies and workouts over the years. We have handled some of the biggest real estate, timeshare and hotel assets for banks and the U.S. Government (both the FDIC and the RTC in the last great meltdown). As we swing into action again, we have dusted off and updated all of our checklists, polished our troubled asset technology. We are ready to provide for our clients decades of experience that has been largely lost by most institutional players from too many prosperous years.

For most of 2008, the torrid performance the hotel industry displayed for the past several years slowed significantly, but the industry was still doing quite well as it came off historic highs. Of course, since August 2007, those with larger hotel loans coming due worried about being unable to refinance them, and new financings grew increasingly more difficult. But in September 2008, the events surrounding the Global Financial Crisis apparently broke the dam that was holding back a flood of loan defaults where the underlying assets are hotels or other special purpose real estate closely intertwined with an operating business.

For almost a year, lenders have talked about a "flood" or "tidal wave" of troubled loans that were "coming." But until now, few loans defaulted and few bankruptcies were filed. Suddenly, it appears that has changed. As lenders and investors deploy their special servicers, workout teams, and turnaround specialists to deal with the defaults on these assets, it is wise to remember that hospitality loans are different.

What is so different about TROUBLED HOTEL LOANS?

Let's take a quick review.

— *Jim*

What is so different about troubled hospitality/hotel loans?

by Jim Butler

Special purpose real estate assets associated with operating businesses present unique problems. Examples include loans secured by hotels, timeshares, casinos, gasoline stations, convenience stores, restaurants, and the like. These assets involve an operating business that is integrally intertwined with special purpose real estate, and that operating business comprises a large component of the asset's value.

It is the *operating business* that raises some thorny problems. The operating business often needs management and franchise affiliations, licenses and permits, extensive vendor relationships, marketing efforts and a significant work force. Many of these aspects of the operating business are critical to the value and success of the asset and the recovery to be realized. They can evaporate very quickly during the handling of the troubled loan.

For example, what is the value of the underlying real property of a Marriott, Holiday Inn, Hilton, Hyatt or Four Seasons if it loses the brand and professional management? It becomes just a big box hotel with no name, no reservation system and no professionally run staff. What impact does it have on the lender's collateral if a breach of a management or franchise agreement exposes the owner to the expected profit of the brand or operator for a remaining 20 or 30 year term, or more? What damage is done to the public image of the asset if quality is not maintained, rumors of bankruptcy taint expectations of service, inventories fall below acceptable levels, and relations with critical vendors are damaged?

Understanding the "structure" of hotel ownership and operation

Many lenders and servicers are unfamiliar with the business and legal "structure" of these special assets, so we will first use a hotel example to illustrate the franchise and management overlay that complicates working with many of these assets. The typical hotel is owned by an individual, institutional investor or investor group, and this owner is usually the borrower on a hotel loan. Complications grow geometrically when the operator also has a joint venture or other investment interest in the ownership, and such arrangements are common with many hotels. The hotel company – Marriott, Starwood, Hilton, Hyatt, or whatever – is a separate entity that will manage or franchise the owner's hotel.

Hotel franchise or management agreement

When you drive by a hotel and see a big red Marriott sign on top, the chances are overwhelming that Marriott does not own that hotel bearing its name. More likely, an owner has entered into a franchise or management agreement with Marriott to brand the hotel and plug into Marriott's reservation system and expertise. In many instances, the hotel is managed by the branded hotel company. But often the hotel will have a franchise from Marriott (or one of the other branded hotel companies), and an independent management company – unaffiliated with the brand – will manage the hotel under a separate agreement.

Independent operators

In the jargon of the hotel industry, these independent management companies are often called independents or "third party managers" because they do not own a brand and are a third party to the owner-franchisor relationship. In any event, these arrangements are governed by complex and critically important franchise agreements and management agreements that can add or subtract millions to the value of the hotel.

Other licenses and agreements

Depending upon the nature of the property, there are also likely to be a host of important agreements, licenses and permits. Resort properties often have "use agreements" or perhaps leases that provide access for hotel guests to use golf, tennis, marina, spa or other facilities. Licenses may include cabaret and business licenses, liquor licenses, and many other permits such as FCC licenses for base-to-shuttle or ship-to-shore communications for shuttle buses, marina and similar operations. The ability of a foreclosing lender or buyer to continue to enjoy rights under these agreements and licenses can be critical.

One can imagine the impact on value when a resort hotel loses its golf, tennis, beach club or other amenities, or can't serve liquor at large group meetings, banquets, weddings and events. And, of course, it is almost certain that there will be a significant work force that may be technically employed by either the owner or the operator, but for which the owner will have full legal responsibility and extensive indemnity obligations. There may even be union contracts and potential labor claims and liabilities.

Complications for the owner and lender

The lender's choice of options in dealing with a troubled loan on a hotel is complicated by the typical hotel management or franchise agreement. It tends to give tremendous control and many exclusive rights and powers to the operator and franchisor. The owner's (and thus the lender's) access to information, the work force, and the asset itself may be greatly limited. It is also common for the lender's position on the loan to be subordinated to the hotel management and franchise agreements so that upon a foreclosure, the lender or its successor will continue to be bound by the old management or franchise agreement. Alternatively, and sometimes worse, the lender may lose the benefit of the franchise or management agreement and find itself with an unbranded and unmanaged asset.

Four "special issues" for Lenders with troubled hospitality loans

Hospitality loans (and loans on other special assets with operating businesses) present at least four categories of issues that lenders don't usually encounter with traditional real estate loans such as those on office buildings or apartment houses. These special issues should all have been addressed in initial loan underwriting, but need to be reconsidered as a loan gets into trouble. They include:

1. **Subordination and the SNDA.** Subordination agreements and SNDAs are frequently encountered with branded hotel management agreements. The lender's rights are often vitally affected by the terms of a subordination agreement or a common variation called the SNDA which the owner, lender and operator may have executed. Such agreements typically provide comfort to lenders that upon a

foreclosure, deed-in-lieu or sale in bankruptcy, the lender or its successor in interest will continue to enjoy the benefits of the management agreement. (For more on SNDAs, See *Hotel Law Blog: 2 April 2009: Ask the Hotel Lawyer: How do you terminate a long-term hotel management agreement without liability?" published on page 14 of this book.)*

This may be of great value in some circumstances. However, as many surprised lenders learned during the last downturns, approximately 80% of the buyers for properties selling for $10 million or more were either other hotel companies or joint ventures of capital sources and hotel companies. In either event, these buyers would only purchase assets they could brand and manage, so the ability to terminate existing management and franchise agreements could make the asset attractive to a larger universe of buyers and could add tens of millions of dollars to the hotel's value.

But the typical SNDA contractually obligates the lender to the terms of the management agreement, by providing that if the lender or anyone succeeding to the property by foreclosure, deed-in-lieu or otherwise ever comes into possession of the hotel, the lender or its successor shall immediately be bound by the agreement or be obligated to execute a new one on identical terms to the original for the remaining term of the original agreement. The lender faces liability for breach of contract if it does not fulfill its obligations and ensure that successors are similarly bound.

While this would seem to suggest that long-term, no cut management contracts and franchise agreements cannot ever be terminated, the use of a court appointed receiver will generally not constitute a breach of an SNDA by the lender, and certain sales pursuant to a plan of reorganization in bankruptcy will also likely avoid breach of a lender's obligations under even the most stringent SNDA. Long-term management agreements will generally be viewed as executory contracts that can generally be rejected in bankruptcy, and the operator then becomes an unsecured creditor in the bankruptcy to the extent of damages sustained for rejection of the contract. Thus, where the lender is properly secured and there is no equity, the rejected operator will take nothing for its damages.

2. **Management and Franchise Agreements.** Most hotels in the United States operate under a brand name. They acquire the right to use that brand name in one of two ways: (a) as part of a "bundled" deal with a branded management company (like Marriott, Hilton, Starwood or InterContinental) where the management agreement typically provided the operator will manage the hotel and include branding rights for free as long as the operator runs the hotel, or (b) in a separate franchise or license agreement with the brand, and not including management. Where a hotel has a franchise agreement, it

will also likely be self-managed or have a "third party" management agreement with an independent (i.e. unbranded) operator. An industry rule of thumb is that the right brand and operator can easily raise or lower the nominal value of a hotel by 25% or more. In other words, a hotel nominally worth $10 million might be worth only $7.5 million or as much as $12.5 million, depending on the management and franchise agreements – and these numbers are "scalable", so add as many zeroes as you want. Dealing with the management and franchise agreements can be very technical and tricky.

3. **Need for access to more information.** Because hotels and other special assets have operating businesses, there is a vast amount of information that can and should be provided by the operator on a monthly or other regular basis that will greatly assist a lender in monitoring developments with the asset-events that may happen months before the effect is seen on the income statement or balance sheet. The prudent lender will be certain that it has access to such vital information, and hopefully the loan documents were drafted so that a default occurs if there is deterioration in certain operations or procedures reflected in the borrower's financials.

4. **Lender liability.** There is a much better balance today than 10 or 15 years ago between the lenders' needs to protect their collateral and realize its value and aggrieved borrowers to obtain redress for excesses and abuses of over-zealous lenders. But lender liability should still be a significant concern or focus for the careful lender, and these concerns are likely to be aggravated by dealing with a more active operating business such as a hotel than a passive real estate asset like an office building. Binding arbitration and jury trial waivers continue to be important elements in the lender's defensive arsenal.

What does it all mean?

Before lenders and investors deploy their special servicers, workout teams and turnaround specialists to deal with troubled hotel, time-share or other hospitality loans, it is critical they understand that troubled special purpose asset loans present unique problems due to the asset's operating business – and it is that operating business that comprises a large component of the hotel's, timeshare's or other special purpose asset's value! Enhancing that value can make a huge difference for all parties involved. In future articles on the Hotel Law Blog, we will offer some techniques for value enhancement.

Contact Jim Butler at 310.201.3526 or jbutler@jmbm.com.

If there is a way to maximize the value of your hotel, we will find it. If there is not, we will tell you. Our goal is always to find alternatives to increase hotel asset value. We usually succeed.

JMBM's Global Hospitality Group®

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Ask the Hotel Lawyer™
Do you know the 8 Dos and Don'ts of handling troubled hotel mortgage loans?

Hotel Law Blog: 10 October 2008

http://hotellaw.jmbm.com/2008/10/8_dos_n_donts_troubled_hotel_loans.html

As special asset teams and special servicers start to receive a new wave of troubled loans in the wake of the Global Financial Crisis that erupted in September 2008, it is a great time to "get back to fundamentals" and review the "Dos and Don'ts of Troubled Hotel Loans".

If you were around for the last big round of troubled hotel loans in the early 1990s, these "dos and don'ts" may test your memory. If this is your first time navigating these stormy waters, the list below will be invaluable.

— *Jim*

The 8 Dos and Don'ts for working with troubled hotel loans

by Jim Butler

1. **Prevention.** Prevention is the first step in a well planned approach to troubled loans. Proper underwriting, documentation and provisions for access to information may help a lender facing a troubled loan. In the event the loan does get into trouble, the lender will be in a stronger position to protect its interests. Prevention includes careful underwriting of the collateral and the borrower. In underwriting the borrower, the lender should obviously look to the usual credit report and financial statements, but should often go beyond them to get a better feel for the borrower's reputation, character, fortitude, expertise, consistency and creativity. The lender should ask: Has this borrower built or managed this kind of project before? Are the market and feasibility studies realistic? Are the projections consistent with these factors and do they provide adequately for a "worst case scenario"?

   Once the credit decision has been made, the transaction should be fully and carefully documented with prevention in mind. Use the checklist approach to be sure nothing is overlooked. (JMBM's Global Hospitality Group® uses our proprietary HIT list – acronym for "Hospitality Investment Task" list.) Be sure all desired title and liability insurance is in place, with endorsements to cover the lender's interests. Particularly with construction loans, negotiate all necessary controls for the project – to cover both the ordinary course of building and the possibility of default. A lender will never have a better opportunity to protect its interests than the period before it has disbursed the loan proceeds.

2. **Monitoring and early warning.** Information control is paramount. A lender must carefully monitor its loans until they are paid off. Early warning systems should be established to alert the lender to problems with the borrower, the collateral, or the project's feasibility. Is the construction or marketing of the project being delayed? Is the property being wasted? Are materials disappearing from the job site? Have the demographics and economics of the market changed adversely? If trouble signs appear, the special asset group should be consulted at an early stage, even if the project stays in the hands of the loan servicing department.

   Many institutions have been "bitten" by their good faith efforts in a workout situation. The pre-workout agreement is designed to minimize these risks.

3. **Use a Special Assets Group for troubled assets.** The CMBS world figured this out and locked it down with special servicing. But other lenders should remember that, whatever the name and acronym, a specialized group should be used for handling troubled assets. A specialized division for working on troubled assets (for convenience we will refer to this group as a specialized asset group or "SAG") brings greater objectivity in dealing with troubled loan issues, thereby minimizing the peril of an approach drawn from past dealings with the borrower that may be either too sympathetic or too harsh and raise lender liability issues.

   The SAG should also bring (or will develop) specialized expertise in handling the unique problems of troubled assets. It should be provided with expedited access to senior management for policy decisions and allocation of resources. It should also have authority to implement crucial procedures and policies such as settling customer complaints, bringing in special counsel, hiring consultants, executing pre-workout documents and documenting negotiations to avoid liability for unsuccessful workouts. Bringing the SAG into the situation also provides notice to the borrower that the lender is serious about collecting the debt and that this is not "business as usual."

4. **Comprehensive Situation Analysis – information update.** The Special Asset Group with its experienced, detached personnel, should gather, analyze and summarize all relevant information on the loan, the borrower, the collateral and relevant documentation and history; update the borrower's financial statements, tax returns, litigation history and credit rating. In addition to gathering all loan documents, promissory notes, guaranties, evidences of advances, notices, a complete written history of the loan should be prepared. When the history is compiled, care should be taken to protect as much as possible from discovery so that any candid descriptions of problems and proposed solutions to such problems will not be a part of the evidence at trial, should you choose litigation. This can be done by

engaging outside counsel or involving the bank's in-house legal department. Loan service personnel should be interviewed, and waiver and estoppel issues must be evaluated. Consider interviewing witnesses with counsel present, to protect sensitive information obtained from disclosure later on if litigation is filed. The impact of conversations, correspondence, and course of conduct must be given careful consideration. Appraisals, projections and feasibility studies should be updated as necessary. (See *Hotel Law Blog, October 30, 2008: "The Comprehensive Situation Analysis," published on page 11 of this book.*)

Two final cautions on information updates. First, the update of collateral information should include a physical inspection of the premises. Walk the project! Don't settle for a "drive-by" or the borrower's guided tour. The physical inspection may suggest problems to be dealt with or new approaches to the project.

Second, the information, documents and summaries gathered by the Special Assets Group should be reviewed by counsel experienced in troubled loan matters and lender liability. This review should analyze the validity of the notes, security interests, guaranties and other important documents with an eye toward identifying defects that might be cured or curable. From this review lenders should also be able to determine the potential of any borrower defenses or counter claims. Counsel should find out from the lender if there are any potential tort or strict liability claims that may go along with any transfers of ownership in real property, such as an apartment owner's duty to pay for tenant injuries or a landowner's duty to pay the costs of cleaning up contaminated property.

5. **Evaluate the information and alternatives.** All the gathered information needs to be evaluated by appropriate business and legal personnel. Fully armed with this information and evaluation, the lender can then assess whether to do nothing, commence a workout or restructure of the loan, seek a receiver, initiate foreclosure or initiate involuntary bankruptcy proceedings. (See related *Hotel Law Blog , 30 October 2008, "Lenders and Borrowers: Alternative strategies for troubled hotel loans: published on page 18 of this book.*

6. **Develop a "Game Plan" and stick to it!** Once an alternative course of action has been selected, the lender should develop a game plan or blueprint for executing its course of action. There may be valid reasons to wait until specified events have occurred or time periods have elapsed. However, in general, once the course of action has been decided, delay is ill-advised. The most successful lenders are those who stick with their game plan, except as changed circumstances may warrant.

7. **Pre-workout agreement.** Before commencing workout negotiations, a pre-workout agreement should be executed. Such an agreement offers the advantage of protecting the lender from liability from claims arising from the workout process itself. Many institutions have been "bitten" by their good faith efforts in a workout situation. They report that desperate debtors or their unscrupulous representatives have either misunderstood statements made in workout negotiations, or intentionally misrepresented positions taken. Whatever the motivation or cause of the problems, these institutions find themselves the victim of claims that oral agreements, representations, or waivers made in the course of a workout entitle the borrower to rights or damages never contemplated by the lender upon entering workout negotiations. The pre-workout agreement is designed to minimize these risks.

   The pre-workout agreement typically recites that the parties are about the commence workout negotiations and that the agreement is a material inducement for the lender to participate. Loan documents can be attached as exhibits and acknowledged to be legally binding on the parties. It is usually agreed that the loan documents continue in full force, unless modified in the specific manner permitted by the pre-workout agreement. Sometimes, egregious problems which exist in the lender's loan documentation can be corrected in a pre-workout agreement, when the borrower is usually in a very cooperative mood. The confirmation of the loan document's binding effect, recital of loan history and acknowledgment of defaults may greatly simplify collection efforts later if the negotiations fail or the workout falls apart. Consider inserting a confidentiality provision in the pre-workout agreement, to try to prevent the borrower from using the media to increase its negotiating leverage, especially if the borrower is in a business that may attract media attention.

   The key provision of the pre-workout agreement recites that discussions and negotiations between the parties may be lengthy and complex, however, no discussions or oral agreement have any effect whatsoever unless all parties execute a written agreement. This critical provision helps prevent a party from claiming a binding agreement was reached on certain issues in the absence of satisfactory resolution of all disputes in the workout process.

   The pre-workout agreement should provide that only amendments in writing have any effect, state that the pre-workout agreement is the entire agreement of the parties on the subject matter, specify the governing law and provide for attorneys' fees to the prevailing party in the event of any dispute. The agreement should also provide that no negotiations or other acts taken in the workout process constitute any waivers by the lender of its rights except to the extent specifically identified in writing. The pre-workout agreement should also confirm

that the attorneys' fees to be incurred by the lender in the workout will be reimbursed by the borrower.

The most controversial issues on pre-workout agreements usually involve whether to include a mandatory arbitration provision for any disputes concerning the credit (with corresponding waiver of jury trial and court process) and any release provisions. Some lenders say they would rather proceed with the "main event" if they cannot obtain an arbitration provision and release for any action up to that date. Others would rather engage in the workout process to cure defects in the loan documentation in exchange for concessions to the borrower and are less concerned with the benefits of arbitration or waivers.

8. **Document the transaction completely.** It goes without saying that once negotiations have resulted in a restructuring or workout, all aspects of the agreement should be thoroughly and fully documented promptly.

What does it all mean?

Understanding fundamentals allows you to put together a strategic game plan that allows players to move around the court, pass the ball and take shots, as well as defend their position. Whether you are a Lender or Borrower, you will want to make sure everyone on your team knows the "8 dos and don'ts" of handling troubled hotel mortgage loans before they play for your team.

Contact Jim Butler at 310.201.3526 or jbutler@jmbm.com.

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The Comprehensive Situation Analysis
Critical foundation for decisions on lender alternatives for distressed hotel loans

Hotel Law Blog: 30 October 2008

http://hotellaw.jmbm.com/2008/10/comprehensive_situation_analysis.html

When Special Assets Teams and special servicers see troubled hotel loans coming onto their screens, they should quickly perform a "Comprehensive Situation Analysis." The Comprehensive Situation Analysis forms the critical foundation for a lender choosing among its alternative strategies of workout, receivership, deed in lieu or bankruptcy (seeking involuntary bankruptcy and appointment of a trustee).

What is included in the Comprehensive Situation Analysis? Read on!

— *Jim*

The Comprehensive Situation Analysis for Troubled Hotel Loans
by Jim Butler

Early Warning System

For the same reason a lender needs access to information, it needs an excellent early warning system. In addition to obvious items such as a default under a franchise agreement or material contract, knowledgeable industry people are likely to know or be able to detect when a geographic area, market segment or particular hotel is getting into trouble-long before it shows up in the profit and loss statement. A decrease in inventories, failure to maintain the property, a cutback in marketing and other changes in the annual plan, budget, and marketing plan may all be early warning signs. Many prudent lenders have consultants watch their asset portfolios for significant trends and changes that indicate problems. The Special Assets Team should become involved early in the process. But special assets generally also require availability and advice from industry-savvy consultants and counsel.

Without good early warning systems, lenders are being surprised by borrowers calling to say, “We are giving the property back. Payroll is due Friday, and there isn’t any money in the account. . .” Lenders cannot rely on last quarter’s budgets or projections. They need current information to avoid these nasty surprises.

Information Update

The concept of updating all information for troubled hotel assets is the same as for any troubled assets. However, in the case of a hotel, one will typically look for items such as hotel franchise agreements and amendments, management agreements and amendments, any agreements, leases and other arrangements with golf pros, concessionaires and the like, recreational use agreements for golf, tennis, aquatics, equestrian or other amenities, and tax information and returns including occupancy, sales and use, employment, personal property and real property taxes. A checklist approach is helpful.

Comprehensive Situation Analysis

What is the value of the asset and how do you optimize it? The "Comprehensive Situation Analysis" is the cooperative effort by the lender's Special Assets Team, experienced hospitality lawyers and hotel consultants. It examines the hotel-specific business and legal factors affecting the asset – the complexities of which are captured by Bruce Baltin of PKF Consulting and which many of us know as Baltin's Law:

> "Each hotel or other special purpose asset is a unique combination of physical plant, available market, location, brand identification, management, contractual arrangements and capitalization. The mix of these factors is different for each asset, and therefore the value of a hotel or other special purpose asset will be optimized by implementing intelligent, property-specific plans and management for both the asset's business and real estate."

In other words, to understand the value, potential and problems with the hotel, one has to look at all these factors affecting the hotel real estate and the operating business itself.

Physical plant assessment. In the physical plant assessment, one should look at the intrinsic value of the building, as well as how it enhances or limits operations, rebranding opportunities, and marketing alternatives. One has to look at inventories, FF&E, and a host of systems for food and beverage, labor management, reservations, marketing and other operations. How sound are the building, elevators, boiler, HVAC, roof, and other systems? Is there water intrusion and mold? Are there cracks in walls, floors, walkways and parking lots? How dated or modern is the design? The market and the property will each affect the other and the upside potential. Is this property properly positioned? Would value be optimized by taking it upscale or downscale? Are product improvement plans (PIPs) warranted to maintain a certain franchise? What capital improvements are necessary or valuable?

Rebranding and new management opportunities. Is the current brand or management right for this property? Can it be changed and what will it cost to change, both in terms of exit fees or damages and in terms of rebranding or repositioning? Who is a logical and optimal buyer of the property through foreclosure, a deed-in-lieu or bankruptcy? Can the universe of buyers be expanded and improved? In short, what is the highest and best use for this property and what are the costs and limitations on positioning the property for such use?

What are the contractual and business constraints? If the Situation Analysis is to be more than an intellectual exercise – if it is to have practical value – it must consider the web of complex agreements affecting the property: the franchise, management, amenity and use agreements, leases, licenses and the like. Management or franchise agreements tend to be very long term agreements (say 10 to 50 years) and often have limited or even no termination rights. They are usually not assignable by the borrower without consent, and transfers to "competitors" are frequently prohibited, although there are usually exceptions for transfers upon foreclosure or deed-in-lieu.

Best use analysis. It is always important to look at alternate uses for the hotel or certain components of the hotel. Is it more valuable as an apartment complex, condominiums,

corporate residential or something else? Particularly with failed condo hotel or troubled hotel mixed-use projects, this analysis should be very helpful.

What does it all mean?

Before determining which alternative to pursue for a troubled hotel loan – workout, receivership, deed in lieu or bankruptcy – lenders need to understand all the issues and variables involved by performing a Comprehensive Situation Analysis. The failure to complete a full analysis can result in pursuing a course of action that fails to maximize the value of the asset.

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Hotel Law Blog: 2 April 2009

http://hotellaw.jmbm.com/2009/04/hotel_lawyer_hotel_bankruptcy.html

As Marty Collins, CEO of Gatehouse Hospitality, likes to say, "the brands never invite Jim Butler to their Christmas party." The reason? Although JMBM's Global Hospitality Group® has virtually never failed to consummate a hotel management agreement or other transaction with a brand when the client wanted to do so, we focus on representing owners and lenders, and we preserve our independence vis-à-vis the brands.

Is there any other firm of lawyers or consultants that has built its position in the hospitality industry by focusing on representing owners and lenders? We don't think so. Most of them can't afford to be adverse to the brands. Most are conflicted.

We have negotiated, re-negotiated, litigated or arbitrated and advised on more than 3,800 hotel management agreements. We have dealt with the most complex issues of hotel managers as fiduciaries, and advised on virtually every aspect of hotel management agreements. We understand how the contract relates to the operations of the hotel business associated with the real estate. We know the players, the norms and customs, and the practices of the industry.

The hotel lawyers in JMBM's Global Hospitality Group® have received a lot of questions lately from hotel owners and hotel lenders about the termination of hotel management agreements. So, to get some straight talk on some sensitive questions, we went to one of the most experienced hotel attorneys in the world on this subject – Jim Butler.

Jim got started in the hotel business more than 20 years ago when the economy and hotel values were suffering. That's when Jim Butler and our Global Hospitality Group® started working with troubled hotel projects and helping owners and lenders understand their options to optimize asset value – often by terminating (or at least re-negotiating) long-term, no cut, hotel management agreements without liability to owner or lender. Here is how Jim answered some of the important questions asked by hotel owners today.

— *The hotel lawyers of JMBM's Global Hospitality Group®*

Hotel Management Agreements Can be Terminated Without Liability
The right management agreement can add tremendous value to a property

Q. Jim, is it true that you guys got into the hospitality business by breaking long-term, no-cut hotel management agreements?

Jim Butler: Yes, terminating these long-term hotel management agreements (HMAs) was virtually unheard of in the late 1980s and early 1990s, and the hotel industry was an "old boys" network. All the brands already had their lawyers, and the brands wielded incredible

authority. It just didn't look right or seem fair to me, and we saw an opportunity to really help our lender and owner clients. The best place for us was to go represent owners and lenders against the brands. And we did! We have been there ever since.

Q: Jim, it's been said that owners and lenders can double the value of their hotel by terminating the management agreement. Do you agree?

Jim: Yes, I have seen a number of real-life situations where hotel is worth up to TWICE as much without the branded HMA. It's no secret that the right management agreement can add a lot of value to a property. Face it, in times like these, a long-term, no cut, HMA can be a big "encumbrance" on value.

Q: Why is that?

Jim: One reason is that over the past 25 years, more than 80 percent of the buyers for hotels with a purchase price of more than $10 million are either competing hotel companies or joint ventures of a hotel company and a capital source. If the branded management agreement cannot be terminated, then the seller loses 80 percent of the potential buyers of the property.

Q: That is big motivation! Why don't more owners opt for terminating the HMA?

Jim: Most of the branded HMAs came along with **Subordination Non Disturbance and Attornment Agreements (SNDAs)**. These are the troublesome agreements which bind lenders to honor the terms of the branded management agreement if the lender should ever become the owner of the property, or if the property is sold by or through the lender, whether by foreclosure, deed-in-lieu of foreclosure, bankruptcy, or otherwise.

Q. So you can terminate a hotel management agreement even with a SNDA in place? Without liability?

Jim: Yes. But first, you must realize that termination is not always the right answer. Often, simple discussions or renegotiation of the management agreement are more appropriate. Who wants to re-brand, unless it's really necessary?

Second, you really have to look at each individual client's goals. Again, termination is often not the answer. But one does need to recognize the available options in making intelligent decisions. Sometimes, you just can't get the brand's attention or cooperation, and termination is the answer.

We help our clients identify and evaluate the options and select the right one. This is the benefit of understanding hotels from a business standpoint in addition to a thorough understanding of the legal issues.

Q. OK, but when termination is the right approach, how do you do it?

Jim: There are at least three ways to terminate a long-term, no cut, hotel management agreement – other than pursuant to express terms (e.g. by expiration of term, termination on sale, termination windows or options, and the like). In general, they are as follows:

1. Talk to the operator and see if they will walk away as a matter of honor, or fairness, or possibly a trade-off of value.

2. Terminate the hotel management agreement for breach of contract or breach of fiduciary duty. These are subjects far deeper than one might initially suspect, and really are the subject of a whole separate discussion. We specialize in evaluating situations in these areas, and have written many articles on these subjects over the past decade.

3. Terminate the hotel management agreement by "rejection" in owner's bankruptcy. A management agreement will almost always be an "executory contract" as defined in the bankruptcy laws. Such contracts can be rejected, as a matter of law, in bankruptcy by a borrower, and on rejection, the injured party (i.e. the management company) becomes an unsecured creditor in the bankruptcy. Where the value of an asset is less than the amount of the senior encumbrance, the hotel operator stands in line with all the other unsecured creditors and receives nothing or whatever amount is negotiated to facilitate the bankruptcy. By this process, potentially tens of millions or hundreds of millions of dollars of damages are converted to nothing or pennies on the dollar.

Q. So it is really that simple? A borrower rejects a hotel management agreement in bankruptcy and sheds the management agreement for free?

Jim: That is an oversimplification, but it is the basic approach. There can be a lot of complications and questions, and you need someone who's been through this before to run the traps for you, or you can get tangled up.

A borrower can reject a hotel management agreement as an executory contract without liability, and the lender will not be bound by the SNDA – at least if the asset is sold through a bankruptcy, or a prepackaged bankruptcy. This can add tremendous value to an asset for both the borrower and the lender.

Q. In other words, the borrower and the lender recover substantial value for the hotel asset that has otherwise been sucked out of the asset by the operator through the long-term, no cut, management agreement?

Jim: Yes. I am sure that operators would like to put it another way, but much of the suppressed value is recovered by the borrower (and, indirectly, the lender) when a long-term hotel management agreement is terminated.

Q. So why doesn't every hotel borrower and lender take the option to terminate the agreement?

Jim: As I said, termination is not the right answer in every case. It is always preferable to discuss the options and problems with the hotel operator to see if a business solution can be reached. But it is important to know your options. Hotel operators can be tough and don't usually tell you what your other options are.

The bankruptcy rejection solution also requires that the hotel be "underwater" – with the value of the hotel is less than the value of the senior debt. Otherwise, the unsecured damage claim of the hotel operator for breach of contract will come out of somebody's pocket. So this resolution is generally reserved for cases where the hotel value is depressed.

And in these cases, one tries to avoid the bankruptcy trump card, if possible. In other words, it is preferable to arrive at the end solution without going through the "bankruptcy process" if possible. Sometimes, when checkmate is obvious in three moves, operators may accommodate the result without going through the process of all the plays to get the checkmate.

Q. Any last words of advice on this, Jim?

Jim: Yes. As economic pain in the hospitality industry drives deeper and deeper, more owners and lenders will look to parties to share their pain. An obvious party that usually is "above the fray" is a branded hotel operator, hotel brand, or union. All are susceptible to rejection of their executory contracts in bankruptcy along the lines discussed above.

Contact Jim Butler at 310.201.3526 or jbutler@jmbm.com.

If there is a way to maximize the value of your hotel, we will find it. If there is not, we will tell you. Our goal is always to find alternatives to increase hotel asset value. We usually succeed.

JMBM's Global Hospitality Group®

Access this article, and our rich library of resources, on www.HotelLawBlog.com.

(For a related article, see *Hotel Law Blog: 25 November 2008, "Defaulted hotel mortgage loans: turnarounds, restructurings and bankruptcies, Making a bigger pie for everyone", published on page 38 of this book.*)

Global Hospitality Advisor®

Lenders and Borrowers: Alternative Strategies for Troubled Hotel Mortgage Loans

Hotel Law Blog: 30 October 2008

http://hotellaw.jmbm.com/2008/10/alternate_strategies_for_troub.html

When a hotel loan gets in trouble, a lender should immediately perform a Comprehensive Situation Analysis. (See Hotel Law Blog: October 30, 2008: "The Comprehensive Situation Analysis," published on page *11* of this book.)

This Comprehensive Situation Analysis is the foundation for making some of the most important decisions that the lender will face on what to do with the borrower and the loan. The borrower should also look at these considerations to formulate its strategy to accomplish its goals.

When the Comprehensive Situation Analysis is completed, what's next? What are the considerations of each party and what are the alternatives for dealing with a troubled hotel loan?

Basically, the alternatives for a lender with troubled hotel loan are:

1. Do nothing (or sell the loan)
2. Workout the loan
3. Appoint a receiver
4. Seek a deed-in-lieu
5. Commence foreclosure
6. Seek Relief in bankruptcy proceedings

What are the lender and borrower considerations for each of these alternatives?

The matrix below is a cooperative effort with input from the entire JMBM team. The considerations of lender and borrower are summarized for each alternative listed above.

Why would a lender or borrower prefer a particular alternative? When is it indicated? What are the thoughts or concerns that should be taken into account? They are all summarized in this matrix.

Please let me know if you have seen any significant considerations we have missed.

— *Jim*

JMBM's Global Hospitality Group®'s Alternate Strategies for Troubled Hotel Loans: Lender and Borrower considerations for choosing Workout, Receiver, Deed in Lieu, Foreclosure and Bankruptcy		
Strategy	**Lender Consideration**	**Borrower Consideration**
Workout	Lender lacks the expertise, personnel and other resources to manage the asset. Lender believes borrower has such expertise, personnel and other resources. Lender has a philosophy favoring workouts. Workout is not discouraged by applicable regulatory considerations or issues. Borrower has adequate integrity, financial resources, expertise which will enhance the value of the asset. Borrower's track record is satisfactory (within the industry, in living up to commitments, and in meeting terms of any previous workout). Value of the collateral is inadequate for the credit but there may be additional collateral or guaranties that can be obtained. Lender needs to perfect problems with loan documentation or security instruments and arrangements. Lender wants to restructure the entire transaction to enhance its position in a possible subsequent bankruptcy. Lender may obtain concessions from the hotel management company or	"Hope springs eternal in the debtor's breast . . ." (i.e., more capital, increased business, a market turnaround, a better purchase price, or some other major improvement is just moments away if only the lender will defer action now.) Forbearance and time to find new money, buyers, better markets, partners, etc. Extension of maturity. Reduction of interest rate. Reduction of principal. Advance of new money. Subordination to new money. Deferred fees. Borrower believes it can realize greatest value by a voluntary sale of the asset as a going concern. Borrower does not wish to give up control of the asset. Borrower believes that appointment of a receiver will destroy borrower's ability to voluntarily sell the asset. Borrower is concerned that receiver will discover the "skeletons in the closet" that borrower has successfully hidden from lender for years.

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Strategy	**Lender Consideration**	**Borrower Consideration**
	wishes to keep a good manager in place. Lender may obtain concessions from hotel franchisor or wishes to keep a good franchise. Credit is in trouble because of a weak market (and not some fault of the borrower or the manager or others). In other words, the lender could not do any better with the asset under its control and the borrower and other parties are cooperating to do everything that the lender would like to see done. Lender wants to obtain a waiver of credible and sufficiently worrisome lender liability claims. Lender seeks to avoid liability for environmental hazard. Lender wants to avoid the delay, expense and risks of bankruptcy under acceptable guidelines (conformance with a business plan, operating plan, plan of asset disposition, etc.).	Borrower hopes the lender's appointment of a receiver will improve relations with the lender and potentially may lead to a consensual resolution of its dispute with the lender.
Receiver	Lender lacks confidence in the management skills of the borrower. Lender does not have the expertise to work with the borrower to try to turn around its operations.	Borrower is concerned that appointment of a receiver will destroy its relationship with its suppliers and may adversely affect borrower's other assets. Borrower may use its relationships

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Strategy	**Lender Consideration**	**Borrower Consideration**
	Lender believes the borrower has committed financial defalcations and needs a thorough review of the borrower's operations and financial record keeping. Receiver can maximize cash because not liable for pre-appointment obligations, and does not make regular mortgage payments to lender. Receiver brings new "neutral" professionalism to often tense situation. Government officials and others may be more amenable to receiver's requests. Receiver awaits lender taking control or possession with possible attendant liability – particularly when issues of waste, deterioration, health and safety, and environmental. Receiver can provide accurate operating financial and other information. Will appointment of receiver breach existing management or franchise agreements? Receiver may be able to raise cash with receiver's certificates-superpriority lien against collateral. Lender is concerned about the expenses of a receiver, his attorney and the lender's own attorneys.	with parties who hold contracts that are critical to the operation of the asset to attempt to subvert the receiver's ability to operate. Receiver may harm image of the operating business with the public and business community. Borrower may file Chapter 11 to avoid a receivership.

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Strategy	**Lender Consideration**	**Borrower Consideration**
	Lender wants to take advantage of powers given to the receiver to reject burdensome contracts of the borrower and sell property free and clear of junior liens as ongoing business without using the traditional foreclosure process which will give the lender title to the property and potentially depress the value of the asset. Lender is concerned that the receiver will be too independent, will not carry out the wishes of lender and will be an adversary in addition to the borrower. Can the receiver gain approval to assume contracts that are critical to the operation of the asset to operate it profitably (i.e., liquor licenses, franchise agreements, management agreements). Can the borrower turn its operations around through a non-litigation workout, to avoid the risks associated with a receiver. Will the appointment of a receiver be the "last straw" that drives the borrower into bankruptcy.	
Deed-in-Lieu	Faster and cheaper than foreclosure or bankruptcy. Avoid delays, costs and cram down risks of bankruptcy. Obtain release of claims to avoid	Avoid foreclosure on record. Preserve best possible relationship with lender.

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Strategy	**Lender Consideration**	**Borrower Consideration**
	lender liability. Obtain assets or rights which lender might not otherwise be entitled to (because of defective security arrangements or intentionally not included as part of original security). Consider initiating foreclosure to keep pressure on to conclude deed in lieu so lender will be further advanced if the deed-in-lieu falls apart. Negotiate for cooperation of borrower on matters such as representations and warranties (at least "to best knowledge"), transfer of easements, rights of way, use agreements and liquor licenses, warranties and other permits or licenses. Acquire assignments of all tangible and intangible personal property (including plans and specifications, license and permits, trade names, trade marks, etc.). May provide basis for renegotiation or termination of management or franchise agreements. Individual partner or guarantor liability may be resurrected if borrower files for bankruptcy or if there is a fraudulent transfer or preference claim, environmental liability, breach of representations and warranties or other points negotiated in connection with the deed-in-lieu.	Obtain concession from lender such as release or partial release from personal guarantees, retention of smaller or subordinated interest in the asset, or payment by lender of "walk away" money. See value of collateral maximized. Obtain cooperation of lender to minimize borrower's adverse tax consequences (i.e., Recapture of depreciation, interest or other deductions). Avoid tax on forgiveness of debt income.

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Strategy	**Lender Consideration**	**Borrower Consideration**
	Deed-in-lieu is really like a purchase by the lender (or successor) of the property and involves all the issues that would be considered in a normal buy-sell – use JMBM's HIT List® or similar complete buy-sell checklist. Cooperative approach may minimize damage to operating business and value of collateral.	
Foreclosure	Start the "inevitable process" (i.e., start the clock running on initial time periods in case a workout or deed-in-lieu fails). Keeps the pressure on the borrower if working on other alternatives such as a workout or a deed-in-lieu. Provide the basis for a receivership action. Cut off junior lien holders. Terminate management agreement and franchise agreements (unless through SNDA or otherwise, the management agreement is senior to the lender's lien or the lender has agreed to reinstate). Avoid assuming labor liabilities. Avoid other burdensome contracts and liabilities. Put control of the property in the hands of someone other than the	Not a borrower option, but borrower may initiate bankruptcy to stop foreclosure. Generally means loss of investment and future potential. May trigger adverse tax consequences including significant recapture of interest, depreciation and other deductions and credits. Black mark on credit record. Look to lender liability.

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Strategy	**Lender Consideration**	**Borrower Consideration**
	borrower-potentially someone knowledgeable about the property and inclined to work with the lender. Look to successor issues. Look to lender liability.	
Bankruptcy	Often not a favored lender choice because of delay, expense and risks. May offer means for borrower to reject or renegotiate burdensome management and franchise agreements or other executory contracts – thereby enhancing value. Bankruptcy can have an adverse affect on an operating business and its image and value. Pre-packaged bankruptcy may offer relatively fast way to clean up asset and wipe out burdensome contracts and junior liens. Lender faces risk that bankruptcy code can be used to strip down lender's secured claim if value of asset is worth less than debt. Lender can use its right to approve of cash collateral budgets prepared by borrower to exercise control of borrower's business operations and business decisions without facing lender liability "control" claims that would exist outside of a bankruptcy.	May preserve borrower's equity and provide time for borrower to sell or refinance the property or rehabilitate the project through new investor, improved conditions or otherwise. Extension of maturity. Reduction of interest rate. Reduction of principal. Upon cure, elimination of default interest, penalties and late charges. Subordination to new money. May shred burdensome contracts. Provides negotiating card with lender and other parties. Absent unusual circumstances, will permit the borrower to control asset at least for the first 120 days (and often longer) as a debtor in possession. If value of asset is less than debt, borrower can restructure lender's loan by paying 100 cents on the dollar

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Strategy	**Lender Consideration**	**Borrower Consideration**
	If lender forces borrower into bankruptcy, lender needs to be sure that its liens are properly perfected to avoid the possibility of lien avoidance actions and lender having it claim being treated as an unsecured claim. Lender needs to be prepared to deal not only with borrower as an adversary, but also the committee of unsecured creditors (if one is appointed), thereby making consensual restructure of loan more difficult. Lender can attempt to shorten 120 day plan exclusivity period or wait until exclusivity period expires, to file and attempt to confirm its own creditors plan of reorganization, whereby lender can control the future operations of the borrower, arrange for a sale of the asset and place a management company of its choice in control of the asset. Value of lender's collateral may decline through borrower's use of cash Collateral if borrower obtains sympathetic bankruptcy judge that permits the use of lender's cash collateral without a sufficient showing that lender is adequately protected.	(over time) only as to the secured portion of lender's loan. Borrower faces a loss of its ability to run its business as it did prior to its bankruptcy filing, as bankruptcy court and/or lender must approve of borrower's expenditures of lender's cash collateral for virtually every post-petition expenditure. Borrower can use provisions of bankruptcy code to avoid lender's liens if they are not properly perfected, thereby potentially leaving lender with an unsecured claim which can be paid at less than 100 cents on the dollar. Unless borrower is prepared to pay unsecured creditors 100 cents on the dollar or unsecured creditors agree to accept less, borrower must invest new money in the project in order to retain its equity interest – actual amount to be determined by the bankruptcy court and the realizable value of the interest being retained. Borrower can use committee of unsecured creditors to assist if in forcing concessions from lender. Borrower may wish to negotiate with lender to avoid filing bankruptcy, where borrower faces the risk that lender will file and confirm a creditors plan of reorganization which will effectively cause borrower to lose control of its asset and destroy

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Strategy	**Lender Consideration**	**Borrower Consideration**
		interests of borrower's equity holders in asset.

What does it all mean?

Alternatives must be weighed carefully when determining how to best maximize value for a troubled hotel loan. Having a checklist that forces a systematized approach to choosing the best option is almost always better than "doing what we always do."

Contact Jim Butler at 310.201.3526 or jbutler@jmbm.com.

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Global Hospitality Advisor®
Butler's Matrix: A Hotel Lawyer's Analytical Tool
For hotel mortgage loan defaults, workouts, bankruptcies and receiverships

Hotel Law Blog: 30 October 2008

http://hotellaw.jmbm.com/2008/10/butlers_matrix_key.html

OK. You handle troubled real estate loans for a lender. You are in special servicing or special assets. A troubled hotel loan comes on your screen. You have been reading the Hotel Law Blog and you know hotel loans are different (*see page 1 of this book*), and you have just brushed up on the Dos and Don'ts of troubled hotel loan workouts (*page 6 of this book*). You have done your Comprehensive Situation Analysis (*page 11 of this book*) so that you have all the relevant business and legal information you need to make a decision, and you have even mulled over the Lender Alternatives for a Troubled Hotel Loan (*page 18 of this book*).

But you think that there must be another way to get your arms around this situation to make a decision on which way to go . . . and there is: Butler's Matrix for choosing Lender Alternatives in troubled hotel mortgage loan workouts and defaults.

I developed this matrix in the early 1990s as an analytical tool for lenders. The matrix STARTS with the subjective evaluation of certain borrower or asset characteristics, and then suggests which alternative each such evaluation should indicate to a lender.

— *Jim*

The Key to Evaluating Lender Alternatives: "Butler's Matrix".
by Jim Butler

The lender alternatives – issues of possession and control

As a lender with a hospitality mortgage loan default, you know that you have several courses of action available. Your options include:

- Doing nothing or selling the loan "as is"
- Workout
- Receiver
- Deed-in-lieu of foreclosure
- Foreclosure
- Bankruptcy

From one important point of view, **these lender options all boil down to one of two alternatives** electing to either:

1. **Leave the borrower in control** (as in the "do nothing," sell the loan as-is or workout options); or

2. **Change control to someone other than the borrower** (which all the other lender options do – and respectively, they move control and possession of the asset to a receiver, the lender, a buyer of the property, or a bankruptcy trustee).

A different way of looking at things

The Lenders Alternatives article (*page 18 of this book*) provides a detailed list of relevant considerations affecting the Lender and the Borrower in a troubled mortgage loan. But the analysis is structured or ordered by scenario – in other words, it first gives all the considerations of the parties for the workout scenario. Then it gives all the parties' considerations for a receiver scenario, and so on for deed-in-lieu of foreclosure, foreclosure and bankruptcy. Wouldn't it be nice if there were another way to get the 30,000 foot aerial view perspective before deciding which scenario to pursue?

That where "Butler's Matrix" comes in.

How to use Butler's Matrix

Here is Butler's Matrix . . . and to get you started, look down the first column at the relevant borrower or hotel asset characteristic. For example, the first item in this column is the criterion of "collateral." Reading across the matrix from left to right, you see that "limited or problematic" collateral suggests a lender should choose a workout or loan sale, while "full or satisfactory" collateral may permit or encourage alternatives that remove the borrower from control and possession of the hotel.

Similarly with the second criterion of loan "documentation." If there are defects in the hotel loan documentation which are problematic, that suggests the lender should consider a workout or loan sale, whereas "full or satisfactory" documentation provides the lender with greater flexibility to seek a receiver, negotiate a deed-in-lieu, or commence foreclosure.

BUTLER'S MATRIX

Analytical Tool for Choosing Lender Alternatives with Troubled hotel mortgage loan workouts and defaults

CRITERIA Borrower or Collateral Criteria	**EVALUATION** in this column suggests leaving borrower in possession: **Workout, Loan Sale, or Do Nothing**	**EVALUATION** in this column suggests removing borrower from possession **Receiver, Deed-In-Lieu, Foreclosure or Bankruptcy Trustee**
Collateral	Limited or problematic	Full or satisfactory
Documentation	Problematic	Full or satisfactory
Borrower • Integrity • Financial strength • Managerial strength	 High Strong Strong	 Questionable Weak Weak
Management (hotel operational)	Strong	Weak
Marketing	Focused	Diffuse
Franchise or brand affiliation	Correct	Wrong image
Asset • Design • Physical condition	 Good for market Well maintained	 Poor Deferred
Market	Weak	Strong

No single factor is determinative and some factors may be more important than others

Remember! No single factor – or group of factors is necessarily determinative, although a single factor could be. The lack of a critical mass of motivations on one side or the other will normally suggest that the lender will want to take possession by foreclosure or deed-in-lieu of foreclosure or at least displace the borrower from possession through use of a receiver.

For example, in the absence of other controlling considerations, inadequate collateral value for the debt, defective documentation, a good borrower, a strong management company and weak market would all suggest a workout instead of the possessory alternatives. However, if the property is severely damaged by a hurricane or other disaster, that factor alone might outweigh all the others and swing the evaluation in favor of one of the other "possessory" alternatives.

What does it all mean?

A high level view of how varying issues relate to available alternatives for dealing with troubled loans can help Lenders make decisions as to which alternative is best for each specific asset.

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Special Purpose Entities getting approval to file bankruptcy
"Speed bumps" in the road to bankruptcy for hotels and resorts

Hotel Law Blog: 15 November 2008

http://hotellaw.jmbm.com/2008/11/hotel_speed_bumps_1.html

As we have discussed in earlier Hotel Law Blog articles – making hotel mortgage loans and dealing with troubled hotel loans is always more complex than with other real estate assets.

A lot has changed since the mid 1990s when there was an estimated wave of some 2,000 hotel bankruptcy filings. The veteran hotel lawyers in JMBM's Global Hospitality Group® represented many major lenders, the FDIC and RTC, and also a number of noteworthy borrowers in cleaning up that mess.

The Bankruptcy Reform Act of 1994 adopted several substantial changes, including a "fix" to the vexatious "rents vs. accounts" issue that plagued hotel lenders through the mid 1990s.[1]

Another of these changes related to what constitutes a "single asset" bankruptcy entitling the secured creditor to expedited relief from the bankruptcy stay. While a single hotel in a special purpose entity might intuitively seem to be a single asset entity, there appear to be two views on this subject, perhaps depending on the facts, or perhaps depending upon the jurisdiction considering the issue. But this fascinating subject will be discussed in another article (see *page 35 of this book*).

This article focuses on a practice that became very common in the mid 1990s and continues today – borrowers putting each hotel asset into a special purpose corporate entity. However, with a long period of good economic times, this practice has not been tested in the crucible of bankruptcy litigation. There are significant implications for all hotel turnarounds, workouts, bankruptcies and receiverships, and for other asset classes as well.

Read!

— *Jim*

How can a "Special Purpose Entity" borrower ever file bankruptcy if independent directors appointed by the lender must approve the filing?
by Jim Butler and Bob Kaplan

[1] If you don't know what the "rents vs. accounts" fracas is all about, then don't worry about it, because you are unlikely to encounter it today. But prior to the 1994 amendments, some courts (like the court in the infamous Northview case in 1991) held that revenues derived by hotels were not "rents" (income from real estate) capable of being secured by a note and deed of trust. Instead, they were in the nature of "accounts" or accounts receivable, and therefore were personal property requiring UCC filings, a "security agreement" and appropriate personal property descriptions. And even if properly described and secured by UCC-1s and security agreements, post-petition revenues were exempt (and are still exempt) from the security interest, like the revenues from any operating business (but unlike the rents derived from real estate). However, this issue can be addressed with a proper cash collateral order.

Since the mid 1990s, the typical hotel loan has required the borrower to put each hotel asset into a special purpose corporate entity (or SPE). The corporate entity's organic documents typically require that for a bankruptcy filing to be made, approval must first be obtained from "independent" directors (e.g., independent of the borrower) appointed by the lender. The expectation was that the lender-appointed directors would NOT approve the filing of a bankruptcy, because bankruptcy would delay a lender completing foreclosure in the event of a hotel loan mortgage default.

JMBM's hospitality lawyers are currently representing a lender in a matter where the debtor completely ignored the requirement of getting independent director approval for bankruptcy filing. Here's how this issue shapes up.

This is a question of first impression!

The concept of requiring special approval for a corporation to file bankruptcy is embedded in many thousands of hotel and other real estate secured loan structures. In recently undertaking an engagement representing a hotel lender, we found that there was no reported bankruptcy case in the United States evaluating the validity of a requirement that in order to file bankruptcy, a corporate entity must either get the approval of certain "independent" directors, or must have a unanimous approval of all directors.

The variations of this theme will undoubtedly be tested in the Great Recession as more lenders seek to foreclose on their hotel collateral and to prevent borrowers from delaying their process with bankruptcy filings, or as borrowers seek ways around the requirement to save their projects or extract lender concessions.

JMBM's hotel lawyers represent both hotel lenders/creditors and hotel/borrowers. So we will follow the development of legal principles in this area with great interest in the many jurisdictions where it is likely to evolve.

What borrowers will say

Debtors will argue that the approval requirement for a bankruptcy filing is void because it is against the public policy of permitting bankruptcy reorganizations by blocking access to the bankruptcy courts. They may also argue that requiring unanimous approval of the board, or approval by the outside directors appointed pursuant to the loan documents is unenforceable as too high a requirement and void under corporate governance policies as well.

What lenders will say

Creditors will argue that this is enforceable under state law governing the organization and operation of corporations, limited liability companies or whatever entity is involved. They will certainly say that the provision was a part of the bargained-for-consideration among sophisticated players and that it does not block access to the bankruptcy courts. It just requires the business judgment of independent directors with fiduciary obligations.

The business judgment rule will presumably protect these independent directors, IF THEY PROPERLY INVOKE THE RULE. The business judgment rule only protects directors who actually exercise their judgment by identifying an issue, getting appropriate advice, giving due consideration to the information, and properly documenting their decisions. This means

that outside directors will likely need independent counsel, independent appraisers and careful guidance to properly exercise their "business judgment" and gain protection of the rule.

Who wins?

At the time of this writing, there is no bankruptcy authority on this critical issue. We suspect that the bankruptcy courts may have divergent opinions initially, and that eventually, a consensus may develop at least in certain circuits, on a jurisdiction-by-jurisdiction basis. This makes predicting results difficult until the results begin to form a pattern.

Pro-debtor bankruptcy judges probably will not enforce the independent director requirement and may hold them void as a matter of public policy. Pro-creditor bankruptcy judges will enforce the independent director requirements on the ground that they were negotiated between sophisticated parties in a commercial setting.

Until some controlling authority develops, at least where borrowers feel that they have some equity, they are likely to try filing bankruptcy without independent director approval, or try establishing independent directors liability for breach of fiduciary duty for failing to act in the best interest of the corporation (i.e., by preferring the lender constituency).

The other "speed bump" that we will look at is whether a hotel can ever qualify for the expedited relief from stay provisions for "single asset" bankruptcy cases. See *page 35 of this book*).

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Can a hotel ever be a "single asset" for bankruptcy purposes
. . . and what is an "SARE"
"Speed bumps" in the road to bankruptcy for hotels and resorts

Hotel Law Blog: 16 November 2008

http://hotellaw.jmbm.com/2008/11/hotel_speed_bumps_2.html

Making hotel mortgage loans and dealing with troubled hotel loans is always more complex than with other real estate assets. Some of these issues have been nicely summarized in prior articles on the Hotel Law Blog.

As the previous article noted, the new wave of bankruptcies will test loan structures and provisions developed since the mid 1990s and never tested before, as with the requirement for unanimous board approval for bankruptcy filing (See *the article on page 32 of this book*).

Now, in this article, we look at an issue that hotels, resorts, marinas, sports facilities and other hospitality-related assets will likely present to many lenders seeking to use the expedited relief from bankruptcy stay provisions available to creditors in certain "single asset" bankruptcy cases.

— *Jim*

Can a hotel ever be a "single asset" for bankruptcy purposes? And who cares?
by Jim Butler and Bob Kaplan

Since the mid 1990s, lenders on hotels, resorts and other hospitality properties have generally required their borrowers to transfer the asset being financed into a "special purpose" entity which will own only the asset being mortgaged. Intuitively, a corporation with only one asset would seem to be a "single asset" entity, but does that work under the Bankruptcy Code, and why is it important to lenders and borrowers?

This determination has important consequences. If a bankruptcy involves a "single asset" (or "single asset real estate" as it is often called), the proceedings will tilt greatly in favor of the secured creditor. In a single asset real estate bankruptcy (sometimes called an "SARE" bankruptcy), the creditor will be entitled to relief from the bankruptcy stay as a matter of law, unless the debtor does one of two things within 90 days of filing.

The debtor must either:

1. file a plan of reorganization which has a reasonable possibility of being confirmed in a reasonable time, or

2. start making interest only payments at the non-default contract rate of interest

These are often difficult to accomplish unless the asset is really viable and cash flowing.

And if the bankruptcy court finds that the hotel does not involve a single asset real estate bankruptcy, the creditor will likely be delayed in more protracted proceedings and greater costs.

But, why isn't every single hotel a "single asset"? How could a borrower with a single hotel possibly avoid this single asset rule that gives creditors an expedited relief from the bankruptcy stay?

When is a hotel NOT a "single asset"?

The expedited relief from stay provisions are set forth in section 362(d)(3) of the Bankruptcy Code for cases which involve "single asset real estate" or SARE as defined in section 101(51B) of the Code. The idea is that creditors should not be unduly delayed from foreclosing where there is a single real estate asset and therefore minimal chances of a successful bankruptcy reorganization.

The courts generally hold that there are certain requirements for a debtor to qualify as a SARE debtor, as follows:

1. The real property must constitute a single property or project (other than residential property with fewer than four residential units)

2. The real property must generate substantially all of the income of the debtor

3. The debtor is not a family farmer and is not engaged in any substantial business other than operation of the real property and activities incidental thereto

A fourth requirement, a limitation of secured debt to $4 million, was eliminated by the Bankruptcy Code amendments in 1994.

The classic cases for single asset real estate involve a single office building or apartment house passively held for income. Properties involving an operating business, like hotels, are more problematic. Thus, the 9th Circuit Bankruptcy Appellate Panel (or BAP) found that at least a full-service hotel did not qualify as SARE. In the case before it, the Court said that the "hotel is sufficiently active in nature to constitute a business other than the mere operation of property." The gift shop, restaurant and bar, among other things included in the operation of a 63-room full service, constituted other "substantial business" than the operation of real property. (CBJ Dev., Inc., 202 B.R. 472-473).

And another case where the hotel was operated without a gift shop or restaurant also held that the hotel business itself was more than "the business of operating the real property" and the property was therefore not single asset real estate.

In fact, some courts have declared a wide range of hospitality properties to be non-SARE, including properties involving one of the following

- a marina
- a golf and ski club

- a property with golf pro shop and golf-related services

One commentator argued, perhaps only half tongue-in-cheek, that every hotel should have a gift shop, if only to avoid single asset real estate status in bankruptcy.

But creditors may take hope from a case decided in Tennessee where a 126-room Comfort Inn was held to be a single asset.

What does this all mean in terms of debtor or creditor strategy?

As noted above, debtors may open gift shops if only to defeat single asset status. Otherwise, they face relatively short proceedings unless they either present a plan of reorganization within the first 90 days after the bankruptcy filing (or a court-approved extension), or start making interest only payments on the loan.

Where it is clear that a case is a single asset case (like an office building or an apartment house), the strategy is for the lender to wait 90 the days. If the debtor has not done one of the required things (i.e. filed a plan of reorganization or started making interest payments) during that timeframe, then the lender files a motion for relief from stay.

But, when there is doubt about the single asset status – as there will normally be with hotels, resorts, marinas, and sports facilities – the lender should generally move quickly to file a motion for the bankruptcy court to determine if it is a single asset case. If you have a loan on a hotel, then you probably need to make this motion unless there is governing law in the jurisdiction involved.

The lender wants a determination of the single asset status early, because if it turns out to be a single asset case, the statute gives the lender relief from the bankruptcy stay the LATER of 90 days after the petition's filing, or 30 days after court determines it is a single asset.

Another strategy that we recommend in appropriate situations is adding a provision to any workout or forbearance agreement. In substance, the lender wants to include a representation or warranty by the debtor that the debtor qualifies for single asset real estate status to be governed under the appropriate provision of the Bankruptcy Code, and acknowledging that the lender is entering into the forbearance agreement in reliance on this representation and undertaking. We don't know if this works yet, but it is worth a try, and a lot of covenants may be enforceable if made in a workout that would not have been valid when the loan was originated.

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JMBM's SAVE™ Program
Defaulted hotel mortgage loans: turnarounds, restructurings and bankruptcies
Making a bigger pie for everyone

Hotel Law Blog: 25 November 2008

http://hotellaw.jmbm.com/2008/11/jmbm_have_programtm.html

With a keen recognition of the problems presented by underwater hotel assets, the hospitality lawyers in JMBM's Global Hospitality Group® have developed the SAVE™ Program for Lenders, Borrowers and investors with troubled hotel loans or hotel loans in restructuring as a result of the 2008 Financial Crisis.

SAVE™ stands for **Strategies & Approaches for Value Enhancement**.

How can you make the pie bigger with the SAVE™ Program?

We look to sources beyond the Lender-Borrower duo to increase asset value in the workout game – to competition, guests, brand, manager, union, and all other stakeholders. That is what increases the size of the pie for the Owner and Lender – adding all stakeholders to the equation. Participation in the SAVE™ Program will help the Lender and the Borrower:

- Make a bigger pie – increase asset value from other stakeholders
- Save legal fees associated with contentious litigation and disputes
- Create a win-win for Borrower and Lender
- Avoid typical collateral deterioration from bankruptcy, brand fights and unhappy guests
- Expand the universe of potential buyers and sell the asset at a greater price

Interested? Read on to see how the SAVE™ Program works.

— *Jim*

Defaulted hotel mortgage loans
Making a bigger pie for everyone
by Jim Butler

Lender, does this sound like one of your loans?

You made a $100 million loan on a luxury hotel with a major brand just a few years ago when the hotel was appraised at $150 million. Today, this hotel would sell for a mere $65 million. You are under water.

You have watched this loan carefully, but the Borrower has now defaulted on loan payments. Cash flow from the property is no longer covering debt service and may soon be inadequate to cover all operating expenses. All the key loan covenants on loan-to-value and

debt-service-coverage are in default. As you prepare to file the Notice of Default, you keep looking at all the information on the Hotel Law Blog, like "Lender and borrower alternatives for troubled hotel mortgage loans" (*Hotel Law Blog: 30 October 2008, p. 18*) and "Butler's Matrix" (*Hotel Law Blog: 30 October 2008, p. 28*).

How are you going to maximize the value of this hotel asset and get it off your books? Short of prolonged litigation or bankruptcy, what are your options?

Other than the Borrower, are there any other stakeholders who could contribute to this shortfall?

Here is what you know:

- Declaring the loan default could trigger a loss of the hotel's flag, and the flag seems to drive rate and occupancy. (But you wonder if the income from the brand justifies its big costs for high service levels and endless capital improvement programs.)
- The brand's long-term, no-cut management agreement discourages more than 80% of the potential buyers for the hotel, and may halve its potential sale price.
- The hotel may owe large sums to the brand and vendors.
- The union contract might be adding 35% or more to the cost of operating your hotel.
- There may be serious buyers for the hotel, but only without the union contract or the management agreement.
- The Borrower will soon hire lawyers (perhaps from law firms that are known for a "scorched earth" litigation approach, destroying value for the Lender).

But your hands are tied (or are they?), because you are "just" a Lender

Your lawyers say that you can't tell the Borrower what to do, and you cannot deal with the brand anyway, because you are "only" the Lender. Any attempt to exercise control over the Borrower could subject you to lender liability, subordinate your debt, and would probably be fruitless (why would the desperate Borrower listen to you?). What can you do?

This is where the Strategies & Approaches for Value Enhancement (SAVE™) Program for Hospitality Assets comes in

The SAVE™ Program increases the size of the pie (the hospitality's asset value) with all the available tools – operating efficiencies, RevPAR enhancements, effective capital improvements, rebranding and repositioning alternatives, new management, sale and recapitalization – and one more: bringing more stakeholders to the table.

Hotel Lenders can require Borrowers to participate in SAVE™

Whenever the Borrower needs a forbearance, a Lender can require – as a condition to the forbearance – that the Borrower hire an approved legal and advisory team for the sole

purpose of developing with the Borrower and Lender a "workout plan" designed to maximize asset value. Engaging JMBM's creative and analytical pragmatists to perform a SAVE™ analysis can increase a hotel's asset value by 20-30%! We have seen increases of up to 100%.

SAVE™ is a win-win for all

Even if the Borrower is already in bankruptcy or there is pending litigation, participation in the SAVE™ Program may create a win-win solution for all involved.

For a $100 million project, a 20%-30% increase in value is $20-30 million! What if the Borrower's cooperation could facilitate that?

Would the Lender be willing to release some or all personal guarantees or additional collateral? If there are none, would the Lender be willing to consider a workout, or paying "walk away" money to the Borrower who might otherwise get nothing?

The "have not" alternative is likely "scorched earth." Borrowers on the verge of default will certainly hire their own lawyers – maybe from one of the firms known for the scorched-earth bankruptcy and lender liability approach to big loans – to assert its rights, such as they are, and prevent the Lender from protecting its rights. For Lenders that understand all too well what this scenario looks like, the SAVE™ Program is an attractive alternative.

Lenders take note: JMBM will limit representation to the SAVE™ Program for referring Lenders. Ask for details. Where a Lender refers a Borrower to JMBM's Global Hospitality Group® SAVE™ Program, the Firm will not accept engagement to pursue lender liability or other litigation claims by that Borrower against the Lender. The Borrower will need to obtain other bankruptcy or litigation counsel if it wishes to pursue such claims. Our role will be strictly limited to the SAVE™ Program. We are focused only on creating and allocating a bigger pie by adding significant value in troubled hotel loans, benefiting both Lender and Borrower.

What does it all mean?

Lenders can get Borrowers to the negotiating table. Lenders can hire straight-talking lawyers who focus on pragmatic approaches to enhancing hotel value. Developing a plan that benefits both Lender and Borrower can be achieved.

If there is a way to enhance your hotel's value, creating a win-win, we will find it. If there is not, we will tell you. Our goal is always to find alternatives to increase hotel asset value. We usually succeed.

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Global Hospitality Advisor®
Part 1 – Restructuring distressed condo hotels
The background and structure of the typical condo hotel

Hotel Law Blog: 20 December 2008

http://hotellaw.jmbm.com/2008/12/restructuring_distressed_condo_hotel_1.html

Restructuring distressed condo hotel projects and loans secured by them is moving to the top of the list for many lenders, owners and investors. Condo hotel deals are so complex and varied that there is no single "silver bullet" to take care of all problems. Combining JMBM's legal and business experience in advising on more than 100 condo hotel and hotel condo deals with the knowledge of veteran condo hotel expert Peter Connolly, we offer a 3-part series that will explain:

Part 1: the background and structure of the typical condo hotel;

Part 2: the critical differences between condo hotel restructurings and traditional hotels;

Part 3: a unique approach to working out some troubled condo hotel projects.

The condo hotel structure is a long-term viable part of the hotel mixed-use landscape

First, let me clearly state that JMBM's hospitality lawyers believe that condo hotels have earned an enduring place in hotel mixed-use development. They are viable. They make sense. They will continue to be very useful. Damning failed condo hotels in the current downturn is like bashing single family residences in the housing bust.

There is nothing fundamentally wrong with this type of property – when it is structured properly and built in accordance with sound economics of supply and demand. Yes, there are a lot of poorly conceived and executed condo hotels that deserve their fate, but many sound projects are suffering now, too.

A landscape littered with distressed condo hotel opportunity (and danger)

Although there is nothing wrong with the condo hotel concept, the landscape is littered with stalled condo hotel sales construction projects frozen in the financial deep freeze. Construction lenders, like Lehman, have reneged on binding loan commitments, and end-user financing has virtually disappeared. Many great projects are now in deep distress. Most condominium buyers are hiding under the bed at home, saving their money and hoping they don't lose their jobs. Most lenders are ignoring even great projects because they are hoarding capital to cover their capital depletion from derivative losses, no-documentation home loans and investments with the likes of Bernie Madoff.

As the optimist said, "Somewhere in here there has to be a pony!" The question is: Can you find it?

— *Jim*

Restructuring distressed condo hotels
Part 1: The background and structure of the typical condo hotel

by Jim Butler and Peter Connolly

A significant number of condo hotels came on line as the credit crisis was brewing and now, many of them are facing problems. In many instances, the "hotel" part of the condo hotel is performing reasonably well, but the underlying condo ownership structure is dragging it down.

In the context of the current credit crisis, many believe the "new" condo hotel structure is a failed concept. However, much of what is written about condo hotel workouts does not distinguish between (a) condo hotels that are failing as a result of hotel performance issues and (b) condo hotel failures that are directly attributable to the condominium structure rather than to basic hotel economics.

Economic problems due to hotel non-performance

Condo hotels that have economic problems resulting from either expenses that are too high or revenues that are too low are no different than any other hotel when it comes to workouts. But while the same principles apply, the process itself is much more complicated because you are dealing with many individual unit owners – not just one hotel owner – and all those owners will need to be cajoled into accepting restructuring pain. Professionals familiar with the complexities involved in hotel workouts can competently (and painstakingly) untangle these kinds of failed condo hotels.

Economic problems due to the condo ownership structure

On the other hand, dealing with condo hotels that are struggling financially as a result of the condominium ownership structure – regardless of hotel performance – requires professionals with an entirely new skill set.

Important background on condo hotels

In the early 1970s, a number of condo hotel projects were developed, principally in resort areas. At a time when condominium financing generally was in its infancy, the concept of using hard contract pre-sales for equity "credit" with construction lenders was one happily embraced by the development community. Using the condominium financing structure allowed the developer to take advantage of the condominium pre-sale "credit," thus reducing the hard equity required for construction and increasing construction loan leverage.

Typically, the developer sold individual room units to consumers. The consumer purchased a unit and when he or she was not using the room, the hotel operator (generally not the developer) would put the room in a rental program to be rented to hotel guests. From this, the room owner would receive either a specific percentage of room revenue or a percentage of the profit generated by the room after the payment of operating expenses.

Why most early condo hotels failed

1. **Agreements between hotel operations and condo ownership didn't mesh.** The agreements that attempted to merge hotel operations with condominium ownership simply did not work very well in the early days. Many projects were unable to be maintained appropriately because the agreements did not provide the hotel operation with a source of funding for working capital, capital expenses, etc.

2. **The SEC determined that condo hotel sales were subject to securities registration.** In 1973 the SEC issued a Release concluding that if a condo hotel unit was sold based upon its income potential, or if the unit owner was required to place the unit in the hotel rental program, or if the income and/or expenses of the hotel operation were being pooled among the unit owners, then the condo hotel offering was an offering of securities requiring registration. Since virtually all hotel condos being developed at the time had those precise requirements, the structure quickly disappeared.

The second wave of condo hotels

In 2001, having had considerable success with it as a second home investment vehicle in Canada, Intrawest asked the SEC for a "No Action" letter stating that condo hotels could be sold in a way that did not offend the 1973 Release. The SEC agreed in 2002, and by 2004 the condo hotel structure was back in vogue.

To achieve compliance under the "No Action" letter, the new breed of condo hotel offering provided very little information to prospective unit purchasers about the rental arrangement and none about the likely financial results of room ownership. Since nature abhors a vacuum, real estate investors, sensing that the condo hotel was a solid real estate play for income property at a lower price point than buying residential condominiums, and with a rental arrangement (albeit unknown) already in place, made up their own financial results.

They were, of course, wrong.

Most unit owners paid too much

By late 2005, it was clear that many unit purchasers were not enjoying the financial success that they anticipated and, as their stories were reported in the marketplace, condo hotels began to lose popularity among consumers. Largely unfamiliar with the economics of an operating hotel, unit owners were unhappy with the disparity between what they paid to the developer and the market value of their unit.

Financing for unit purchasers is no longer available

By late 2006, at the same time that the consumer purchasing market was becoming smarter, the emerging credit crunch essentially eliminated the availability of end user financing for condo hotel units. The condo hotel as an asset had always been characterized as a riskier loan than a second home financing, often carrying a 100 to 150 basis point

premium to vacation home and timeshare mortgages. This rating had very little to do with the underlying credit of the borrowers, but was more a function of the unknown resale market for condo hotel units, coupled with the FDIC's unfortunate experiences with the first round of hotel condos back in the 1970s. In any case, these loans were subprime by definition and are now not available at any price.

200 projects stuck in the pipeline

While there are no official statistics, in early 2007, Smith Travel Research estimated that there were slightly over 200 condo hotel projects in the U.S. which were either in late pre-development stages or under construction. There were also many existing hotels which were in various stages of conversion to condo hotels at the same time, the owners of those hotels planning to use the condo hotel structure as an exit strategy.

Setting the stage: how typical condo hotels are structured

In the new, typical condo hotel structure, the condominium common property consists of the room floor corridors. The unit owners own the guest rooms. The developer or its successors own the public spaces (restaurants, spas, meeting spaces, elevators, etc.) and the back of the house areas. The condominium documents generally require the unit owners to fund their own debt service, taxes and FF&E, as well as a portion of the undistributed operating expenses, public space FF&E and common area expenses of the hotel. The unit rental agreements, which are generally additional agreements with requirements beyond those in the condominium documents, invariably have provisions restricting unit owner usage and requiring unit owners to provide working capital and make capital expenditures needed to meet specific hotel or, if applicable, brand operating standards. Most unit rental agreements are for terms of one to three years (securities concerns and the lack of meaningful alternative rental opportunities for the unit owners led to the short terms).

What does it all mean?

We have just described the structure that must be "unwound" and re-structured so that a workout can be accomplished. Sound complicated? It is. In part 2 of this series on restructuring distressed condo hotels, we will look at how condo hotels workouts are different than hotel workouts. In part 3, we will offer a unique approach to working out some troubled condo hotel projects.

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Global Hospitality Advisor®
Part 2 – Restructuring distressed condo hotels
Critical differences between restructuring condo hotels and traditional hotels

Hotel Law Blog: 21 December 2008

http://hotellaw.jmbm.com/2008/12/restructuring_distressed_condo_hotels_2.html

Welcome to Part 2 of our 3-part series on restructuring distressed condo hotels, which includes:

Part 1: the background and structure of the typical condo hotel;

Part 2: the critical differences between condo hotel restructurings and traditional hotels;

Part 3: a unique approach to working out some troubled condo hotel projects.

Part 1 concluded with an important explanation of how a typical condo hotel is structured. If you have not read Part 1, posted on 22 December 2008, you will want to review it before you read this Part 2, which covers the background and structure of the typical condo hotel. Part 2 includes 5 rules for getting all stakeholders aligned in the workout – one of the critical moves necessary for a successful workout.

It is important to note that there is nothing systemically wrong with the condominium hotel financing structure. It has its place in the permanent "tool box" used by developers and their advisors to structure hotel projects. However, in the current credit crisis, the structure provides impediments to permanent financing or exit that need remediation.

— *Jim*

Restructuring distressed condo hotels
Part 2 – Critical differences between restructuring condo hotels and traditional hotels
by Jim Butler and Peter Connolly

Why even good condo hotel projects are failing

In the current market, there are a number of solid assets which were structured as condo hotels during their pre-development phases, and generated enough unit pre-sales activity to get built. These hotels are now open or opening, and the developers are closing the sales of their pre-sold units to pay down their construction debt. However, because both the market for unit sales has dissipated and end user financing has disappeared, these projects now cannot sell out to new purchasers. And many of the existing pre-sold contracts are not closing, as the purchasers either cannot find financing or are electing to lose their deposit rather than close on assets of questionable value.

Developers in "take-out limbo" and unit owners in shock

The developers of these projects are left in "take-out limbo." No conventional financing lender will place a mortgage on the residual hotel (the unsold units and public spaces) because no one knows what it means to foreclose on part of a hotel, and no financial buyer will acquire the leftover parts in order to own pieces of a condo hotel from which there is no easily identifiable future exit. A developer that cannot sell out its units will not be able to pay off the construction loan. At the same time, unit owners that do close on their units are beginning to learn, in many cases, that the economics of the hotel business are different than the economics they expected when they purchased their unit.

Not your traditional hotel workout – the developer cannot be the workout entity

The basic strategy for working out condo hotels must be to "uncondo" them. Again, it is important to note that these hotels may be performing as well as originally projected by their developers. The problem they now face is that the existing condominium structure is preventing either a sell-out or a take-out. Absent some way to infuse new capital into these projects they will ultimately become economically untenable.

As with all workouts, there will be some marking of equity to market in the rationalization of the ownership structure, and the recognition that the original unit prices were not market value. The original developer risks securities class action litigation if it attempts to buy back the units it sold from the same buyers at a discount to the price it sold them for. So, in most cases, the workout entity for this type of workout cannot be the original developer.

A third party purchaser is required: risk and opportunity

A third party purchaser will be required to drive the workout plan. Because there are no financing and sales exits available for the third party if it fails to "uncondo" the property, the value of the remaining units must be adjusted by what appraisers would call a "marketability discount," and reduced to justify the risks taken by the purchaser. In order

for the third party to make a risk justified return, the discount to fair market value (not the unit purchase prices) will need to be very substantial.

5 Rules for getting all stakeholders aligned in the workout

The fundamental principles of hotel workouts must be observed, but with special consideration to the condo hotel structure. The workout plan must offer some hope to all stakeholders.

1. **The stakeholders need to be identified and each needs to accept the economic dilemma as its own.** In this case, the stakeholders are the developer, lender and the unit owners. The developer, for reasons noted above, needs to be taken out of the equation, leaving the lender and the unit owners;

2. **Everyone needs to "share in the pain" required to effect a solution.** In the hotel condo situation, the developer gives up its position on the way out, the lender may need to write down the balance due on the loan to reflect what the purchaser is able to pay for the remaining units, and the unit owners will need to come to grips with the disparity between purchase price and fair market value;

3. **The stakeholders need to understand and accept that the workout is the only way out.** In the hotel condo circumstances, neither the lender nor the unit owners have any other exit possibilities;

4. **The party with the workout plan drives the bus.** In the hotel condo situation, the third party purchaser is the entity bringing value and hope to the lender and the unit owners, and cannot allow itself to be placed in a position in which it is negotiating a series of separate deals with a multitude of condo owners. The purchaser makes a deal with the lender and then makes a "take it or leave it" offer to the unit owners;

5. **The plan needs to offer hope to the stakeholders.** In this instance, that hope may be literally a "hope certificate" in the form of a pay or waive portion of the loan or a subordinated equity interest reflecting the market write-down.

What does it all mean?

Condo hotel workouts are different from traditional hotel workouts due to the complex condo hotel structure and the many condo unit owners that need to align themselves with the workout plan. In most cases, the workout entity for a condo hotel cannot be the original developer.

Sound difficult? It is.

Next, in Part 3 of "Restructuring distressed condo hotels," we will offer a unique approach to working out some troubled condo hotel projects and look at what it takes to "uncondo" a condo hotel.

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Global Hospitality Advisor®
Part 3 – Restructuring distressed condo hotels
A unique approach to working out some troubled condo hotel projects

Hotel Law Blog: 22 December 2008

http://hotellaw.jmbm.com/2008/12/restructuring_distressed_condo_hotels_3.html

This is the final segment of our 3-part series on restructuring distressed condo hotels, which includes:

Part 1: the background and structure of the typical condo hotel;

Part 2: the critical differences between condo hotel restructurings and traditional hotels;

Part 3: a unique approach to working out some troubled condo hotel projects.

Part 1 of the series concluded with an important explanation of how a typical condo hotel is structured and Part 2 covered some critical differences between condo hotel restructurings and those with traditional hotels. You will want to read those parts before moving on to this Part 3, which gives our unique approach to working out some troubled condo hotel projects

Again, it is important to note that there is nothing systemically wrong with the condominium hotel financing structure. Unfortunately, in the current credit crisis, the structure impedes developers and owners from obtaining permanent financing or executing a viable exit strategy.

— *Jim*

Converting to a traditional ownership structure the property can be financed

The basics of the workout plan revolve around terminating the condominium. All condominiums are essentially corporations and can be terminated based on (a) state and local laws on termination and (b) the termination provisions of the condominium documents. In most cases, a supermajority of the units must vote in favor of terminating the condominium corporation. The condo hotel workout plan is centered on convincing a sufficient number of unit owners that terminating the condominium is the only hope they have to preserve any asset value in their units, so that when combined with the units purchased by the workout purchaser, the supermajority number of units will vote for termination. Once the hotel has been converted to a unified and more traditional ownership structure, it can be financed or brought to market on a conventional basis.

Stop selling and closing on units: convincing the lender this is best

The first step in this process is to stop selling units. If there are units under contract that have not closed, the lender and the developer need to agree not to close those contracts. While there are virtually no sales being made in the current market, whatever sales activity is occurring should cease immediately. It may seem intuitive that the sales process needs to end, but it should be recognized that the construction lender's first instincts will be to insist on closing existing contracts as a way of getting paid down and will push to sell more. That lender will have to be convinced that it will be more likely to receive full payment on the loan by permitting the termination of the condominium and the conversion to a traditional ownership structure. Again, as is the case with the unit owners, it will be difficult if not impossible for the developer who was the borrower to effectively manage that process with the lender.

Equity write downs: convincing unit owners this is best

The heavy lifting in this workout process clearly will be dealing with the unit owners. A group of frustrated people will need to be told that they made substantial errors in their hotel investment analyses and that the only chance they have for an exit is an immediate equity write-down – in exchange for hope of a recovery later. This process will be difficult, time-consuming and painful, as the unit owners will have to work their way through the stages of denial and anger on the way to acceptance.

In all cases, the workout plan should include some of the amenities that presumably caused these individuals to buy units in the first place. For example, extending the same owner use price that was available under the unit rental agreements for a few extra years, or providing ownership recognition to these people are not overly expensive gestures that may make the bitter pill of financial disappointment a bit easier to swallow.

What should the new structure look like? It depends on units sold.

There are several options for the replacement structure that should be considered for the condo hotel workout, largely dependent upon the number of units which have been sold as a

percentage of the total units in the hotel. If only a small number of units have actually been sold and the transactions closed, it may be advisable, depending upon the mood of the unit owners, simply to buy them back.

If the majority of the units have been sold, then it may be preferable to restructure the entity as a partnership with the unit owners becoming limited partners. There are certainly a variety of structures in between those extremes that may be deployed, depending upon the individual project circumstances. At this point in the process, the tools used in traditional workouts, such as carried interests, preferred returns on new money, and the like, can be used to minimize the de facto write-downs to make the offering one that will get the unit owners over the goal line. A lender or potential purchaser embarking upon this type of workout should consult their hotel lawyers and advisors about both local legal requirements and the correct approach for their particular situation.

"Key" money – bringing in a brand

Since new money will be needed to accomplish these workouts, sources of funds need to be identified. In addition to the normal equity sources, consideration should be given to bringing a brand into the workout mix, and requiring either "key" money or equity as the price of brand expansion. One of the better attributes, at least for workout purposes, of the most recent condo hotel development boom is the fact that many of these projects are not branded, as the major lodging companies avoided them. In the current economic climate, the brands recognize that the easiest path to increased distribution is rebranding rather than new construction, so key money should be available. The timing of the introduction of a brand into the workout process will need to be carefully evaluated, however, as most of the major brands will not want to be associated with the "uncondo-ing" activities.

Does a condo hotel workout sound complicated? It is, or anyone would be able to do this work and we wouldn't call them "workouts!"

What does it all mean?

Due to the condo hotel structure and additional stakeholders (the individual condo unit owners), a condo hotel workout does not follow the workout scenario of traditional hotels.

But a carefully crafted plan to fix a broken condo hotel can unlock considerable value in the kind of hotel asset that you might like to include in your portfolio. The work is time consuming and complicated, but the opportunity is unprecedented.

JMBM's Global Hospitality Group has experience in advising on more than 100 condo hotel and hotel condo deals. Call on us – we can help.

Contact Jim Butler at 310.201.3526 or jbutler@jmbm.com.

Contact Peter Connolly, Hostmark Hospitality Group, at 847.517.8782 or pconnolly@hostmark.com.

If there is a way to maximize the value of your hotel, we will find it. If there is not, we will tell you. Our goal is always to find alternatives to increase hotel asset value. We usually succeed.

JMBM's Global Hospitality Group®

Access this article, and our rich library of resources, on www.HotelLawBlog.com.

Ask the Hotel Lawyer™
Condo Hotel bankruptcies, workouts and turnarounds
100 Questions to ask before you foreclose or invest in condo hotel projects

Hotel Law Blog: 22 December 2008

http://hotellaw.jmbm.com/2008/12/condo_hotel_bankruptcies_workouts_1.html

Distressed condo hotel bankruptcies, workouts and turnarounds fill the headlines, the nightmares of lenders, and the dreams of opportunistic investors.

What lies at the bottom? Hidden treasure or a snare for the unwary?

The landscape is littered with condo hotel bankruptcies, foreclosures, workouts and investment opportunities. But as lenders hasten to clean up their balance sheets, and as opportunistic investors prepare to profit from buying at condo hotel foreclose or bankruptcy sales, or buying deep discount condo hotel debt or underlying assets, they should pause one moment. Unless they ask the right questions before they "jump" into the unknown, they may find themselves in a financially disastrous situation – at any price.

Our team of hotel lawyers has experience in more than 100 condo hotel and hotel condo projects since 2000. Drawing on this experience, Catherine Holmes and Guy Maisnik, senior members of the Global Hospitality Group®, have put together a list of 100+ questions to ask BEFORE foreclosing on or buying condo hotel assets.

— *Jim*

100 Questions You Should Ask When Looking for Distressed Condo Hotel Opportunities

by Catherine Holmes and Guy Maisnik

It is no secret that the "illness" started with the toxic home mortgage mess has now infected most residential and commercial real estate and financial institutions in a global epidemic. Hotel development has been particularly hard hit in most markets. Particularly at the high end of the spectrum, many of these stalled or failing projects involved residential condominiums and other mixed uses. Condo hotels have had the triple whammy of the housing bubble hitting residential sales, the financial crisis freezing credit, and the hotel industry falling off a cliff in September 2008.

As lenders look to foreclose and investors evaluate the financial rubble of distressed hotel mixed-use developments and conversions, they find a large number of condo hotel projects that are "stuck." But the question is: What lies at the bottom of the failed condo hotels? Hidden treasure or a snare for the unwary? Here are some questions to ask that can reveal the difference between opportunity and financially lethal traps.

Magnitude of distressed condo motel market

The global financial panic of 2008 has affected every segment of the real estate market, but has hit the condo hotel market particularly hard. In 2007, according to Lodging Econometrics, 17 % of all hotel rooms in development in the U.S. were part of a residential mixed-use project, many of which included condo hotels.

And at the same time, Smith Travel Research reported that:

- 31 states had condo hotel projects in the pipeline
- 70% of all project rooms were in only 5 states
- 81.5% of all project rooms were in 10 states
- Las Vegas was at the very top of the list (with almost 30,000 units)
- Florida was second (with almost 25,000 units)
- California was a distant third (with only 8,500 units)
- Illinois, Arizona, Colorado, Massachusetts, New Jersey, South Carolina and Colorado made a "showing" at between 2,000-3,000 units

Not surprisingly, given the housing bubble's affect on all residential real estate, recent data shows that there are a large number of unsold hotel condos on the market, and it is likely that many condo hotel units built or under construction will remain unsold for a long time. Of course, there are exceptions in unique markets with special product, but . . . they will be the exception for the near term.

Other problems specific to the condo hotel market have exacerbated the problems facing condo hotel projects. Most importantly, it is estimated by some hospitality industry experts

that up to 80% of the buyers of condo hotel units were "flippers" in overheated markets such as Las Vegas and Florida. These buyers are the first to default on their obligations. Even buyers looking for a longer term ownership of condo hotel units have walked away from forfeitable deposits because of the collapse in residential real estate values and the difficulty in finding financing.

Condo hotel developers, like developers of most other hospitality projects, have also seen their own sources of construction financing disappear. Some existing lenders to condo hotel projects, notably Lehman Brothers, are out of business, and others have just stopped lending. As a result, condo hotel developers are finding it extremely difficult to find the financing necessary to complete their projects.

What perspective do you need?

Here's the real problem:

- Many of the condo hotel projects that were started over the last five years will never work, either due to their location, wrong programming or other factors. An investor will need to focus on the ones that have the right fundamentals so that they can work.

- When you find a project with good fundamental value, you have to understand how the condo structure works to evaluate how to fix it.

Condo hotel projects are not a homogenous product

Condo hotels are NOT homogenous. In fact, they have incredible variations. According to data from Smith Travel Research, almost 90% of condo hotels in the pipeline were independent. They were not branded!

Many of those condo hotels were conversions of economy or mid-market lodging products with no professional management. These tended to be the projects that were converted without regard to fundamental economics, product consistency, quality, or other factors critical to the financial and market success of a condo hotel. These properties were early favorites of the flippers in Southern Florida and have given condo hotels a bad name (like bad timeshare product in the 1970s or 1980s prior to Marriott entering the vacation ownership market). This product is fraught with problems and has to be examined extremely carefully. Often the legal and business models of these projects are so fatally flawed that they cannot be fixed.

Other condo hotel projects were caught in a game of musical chairs when the music stopped. They may already be branded, or were about to brand. Their structures and facilities may be fantastic, or not yet developed. Or they may be tar pools waiting to ensnare you.

So what are the questions you need to ask to tell the difference between good projects and bad ones? How do you find the gold and avoid the traps?

Asking the right questions is the key to success in finding value in failed condo hotel projects

Opportunistic investors are picking through the rubble of the real estate market crash, seeking the gold that others have left behind. Failed condo hotel projects present one of the single best buys today for opportunistic investors, whether the investor is buying assets or debt. In fact, the debt on a condo hotel project is particularly attractive as lenders and other capital providers holding debt interests in failed condo hotel projects may be more willing to sell that debt at a deeper discount because of the potential pitfalls and risks involved in ultimately owning the condo hotel project.

New investment capital can be greatly rewarded for taking such risks. However, many investors in failed condo hotel projects will be confounded by the legal and business complexities that these projects will present. The key to success will be asking the right questions and working with business advisors with deep experience in condo hotels, and having such advisors help structure the right plan.

Why are condo hotels different from other hotel properties?

Unlike a traditional hotel that is typically owned by a single entity, a condo hotel will have multiple owners and/or interest holders, consisting of: (1) the "front desk owner," who is often but not always the developer of the condo hotel and who may or may not own some hotel rooms in the condo hotel, (2) owners or prospective purchasers of the condo hotel units, (3) the condo hotel unit owners association that may own the common area of the hotel, and (4) owners or tenants of restaurant, spa and retail venues in the condo hotel. Therefore, in addition to evaluating all of the factors that apply to a traditional hotel, prospective investors in a condo hotel must also consider the rights and obligations of the developer, the condo hotel unit owners and prospective purchasers, the condo hotel unit owners association, the owners or tenants of the commercial venues located in the condo hotel and the operator of the hotel.

Foundational issues

Evaluating a condo hotel project begins with an understanding of the fundamentals of the project, including the following:

- Why did this project fail? Is it a great project caught in the "deep freeze" of hotel and condo financing? Is it "just" a matter of residential sales failure from the housing bubble or from lack of end buyer financing? When will it recover, if ever? Is there a better or different use of the residential units as apartments, hotel rooms, bulk storage, or whatever? [Bulk storage was a tragic joke, but a solution we have seen to troubled property purchased at pennies on the dollar.]

- What is the status with the brand? Does it add to or subtract from the project? What is its enthusiasm level for the project? Will it support the project financially or is it ready to walk away?

- What are the fundamentals of both the hotel and condominium components of the project? Is this a great hotel project with bad condominium fundamentals? Is

it a great condominium project with bad hotel fundamentals? Have you done a **comprehensive situation analysis?**

- What does it take to "fix" the obvious problems – other than to wait enough time for the economy to change? How much is "enough" time? Do you have "enough" time"? What is the alternate exit plan? Is there a way to make the property cash flow on a current basis from price concessions or lender/borrower support . . . or other sources, like the local city or major employer, who "need" this project to succeed?

- Is the condo hotel in operation yet? If so, how many rooms are in its rental program? What is the current occupancy rate of the hotel? How much of the revenues and profits are shared with the condo hotel unit owners? What is the rental program? How can it be restructured?

- Are all of the condo hotel units sold out? If not, how many are sold? Why are they not selling? How many are under binding contracts to be sold? Will the buyers under "binding contract" likely close on their contracts or walk away? If they walk away, do they forfeit some or all of their deposit?

- Would it be possible to terminate or negotiate a termination of the purchase agreements with any condo unit purchasers who have not closed? If a termination of purchase agreements is possible, are the purchasers' deposit funds in escrow, or have they been used by the developer? Can those funds be attached or recovered? Will the lender or new owner be obligated to repay these purchase deposits if used by the developer to fund construction of the project?

- Who owns what components of the condo hotel? Who is responsible for payment of operating and maintenance expenses of each component? Is the allocation of who gets what and who pays for what a sustainable and viable allocation? If not, is there an alternative that might be?

- Are there are other components of the condo hotel that need to be analyzed, such as fractional units, pure residential units, office, entertainment venues? What rights and obligations apply to those components? Are they viable on their own? Are they paying their fair share? Does there need to be a reallocation?

- How many condo hotel unit owners have mortgages on their units? How many of them are in default under those mortgages? How many lenders are there? Do the lenders (or does the lender) present special issues that need to be analyzed?

- Can the hotel be sold, financed and otherwise transferred without approval of the condo unit owners?

Once you know the answers to these fundamental questions, you may have enough information to make a preliminary decision on whether a project is worth a second look. In that event, you will want to move on to the next set of questions, below.

Construction and sales status

Options available to an investor vary greatly depending upon whether the project construction is complete or not.

Therefore the prospective investor needs to ask:

- What percentage of the project construction is complete? What remains to be done? How much will it cost to complete construction? What are the potential successor liabilities for the failure to complete construction? Do the existing condo unit owners have remedies that have priority?

- How long will it take to complete construction? Are there purchase contracts for condo hotel units that will expire before the units can be completed?

- Is the project phased in such a way that the investor could complete part, but not the entire project now, and possibly complete the rest later? What amenities need to be completed in order to meet the obligations to the condo hotel unit buyers under the disclosure documents they received?

- Does the lender or investor intend to continue selling condo hotel units? What approvals are necessary from state regulators under state condominium registration laws where the project is being sold? Is there a temporary exemption for lenders who foreclose on a project in the applicable state? What states are involved? Where (what states) is the project is being sold? What registrations are in effect? What further action needs to be taken to retain these registrations in effect? What steps need to be taken to "cure" any defects? Can they be cured? What is the cost?

Condo hotel owners association issues

The owners association has an important role in most condo hotels. In many cases, the association owns all of the common elements of the condo hotel, and condo hotel unit owners pay monthly assessments to the association to operate and maintain the common elements.

Therefore, an investor in a condo hotel needs to ask:

- Who manages the association? Is it a professional management company, or is it an elected board? If a management company, what are the terms of the contract with that company? Is that company doing a good job? Are there any issues about being able to retain the management company's services, or to terminate them? What is the cost of termination or replacement?

- Is the association's budget sufficient to pay for the operation and maintenance of the common elements of the condo hotel? Does the budget need to be increased to cover a shortfall in operating or maintenance expenses, or can the budget be reduced, at least temporarily?

- Have all condo hotel unit owners paid their assessments? If not, has the association taken actions necessary to foreclose on the units? Are failures to pay

the result of owner grievances about project facilities that can be taken care of for a reasonable price, or do they reflect a broad-based economic depression in the region?

- For condo hotel units that have been taken over or are being foreclosed on by the lenders to the condo hotel unit owners, is the lender or subsequent purchaser required to pay any assessments owed by the defaulting unit owners? If not, how much of a shortfall in assessments will have to be covered by the remaining condo hotel unit owners? How do the defaults and assessments affect the viability of the project or liability of the foreclosing lender?

- What impact would there be on the condo hotel from multiple foreclosures of units – signs, advertisements, publicity? How would this impact the ability to operate the condo hotel? What about the effect on the ambiance and desirability of the core hotel?

- Does the developer have a subsidy agreement with the association, where the developer has agreed to pay for expenses of operation until a specified number of units have been sold? Has the developer paid all amounts required under the agreement? If not, would the investor be liable for these amounts? How critical are these amounts to viability of hotel facilities such as pool, spa, gym, entertainment facilities, parking or upkeep of general appearance?

- What approval rights does the association have in the restructuring of the condo hotel program and the condo hotel project?

What liabilities and potential claims exist?

What is the status of potential "successor liability" of lenders and investors to condo hotel unit owners? This may be a deal killer.

It is critically important that a lender or investor ask:

- What claims might condo hotel unit owners bring against the developer that could tag onto the lender or investor on theories of successor liability – the liability that automatically attaches to someone who steps into another's shoes? How about construction defect claims that may run for 10 years or more in states like California or Florida? Securities law violation claims that would allow unit owners to rescind and receive a return of their full purchase price of units? Misrepresentation claims, such as for claims that the developer "low-balled" budget estimates, and the actual budgets to operate the project are much higher than represented to unit purchasers? Is there a way for the investor to avoid successor liability for these claims, such as through a foreclosure or bankruptcy proceeding? What are some of the techniques experienced condo hotel lawyers have employed to mitigate successor liability?

- Are there condo hotel unit owners who are part of a rental program? What are the terms of the rental program agreement? What is the revenue split between the unit owners and the owner or manager of the condo hotel? Can the program be modified to meet commercially viable standards? How?

- Are there many condo hotel unit owners who are renting out units outside of the rental program? If so, why? Who are they using and why? Are these outside rentals impacting the operation, economic viability or consistency of the condo hotel? Can changes be made in the rental program so that more unit owners will want to participate?

- Are the condo hotel unit owners generally satisfied with their units and the condo hotel as a whole? Are they satisfied with the management of the rental program, and the amount of revenues they are receiving from it? Can anything be done to improve the unit owners' overall experience?

- Perhaps more importantly, do the circumstances surrounding the failed condo hotel project present an opportunity of repurchasing condo hotel units at a deep discount? If greater control of the project is required to accomplish the investor's plans, how can unit owners be incentivized to sell their units to the investor?

Condo hotel franchise/management issues

If the developer of the condo hotel has a hotel franchise agreement or hotel management agreement, the investor has to evaluate the rights and obligations under those agreements, and how best to handle the relationship with the franchisor or manager.

Therefore, the investor should ask:

- Is the hotel brand provided by the franchisor or manager adding significant value to the condo hotel? If not, or if the value is outweighed by the expense of the management and other fees charged by the franchisor or manager, can the franchise or management agreement be terminated? How much additional value could be added to the condo hotel just by terminating the franchise or management agreement? (In our experience, the additional value can be 25% or more.).

- Can the terms of the franchise or management agreement be renegotiated? Some condo hotel franchise or management agreements were extremely one-sided in favor of the franchisor or manager, primarily because the developer needed the hotel brand to get financing, but the developer did not care what happened after the project was built, because the developer did not intend to remain an owner of the project. Is the franchisor or manager willing to renegotiate the terms of their agreement in order to retain their position in the condo hotel, or maybe even want out of a bad condo hotel structure?

- Would the failed condo hotel project emerge in a more valuable position if it were taken through a bankruptcy?

Zoning and entitlements issues

If the investor is thinking about changing the characteristics of the condo hotel, such as by making some of the units residential, that can raise zoning issues.

The investor needs to ask:

- Does local zoning limit the condo hotel unit owners' personal use of their units to a certain number of days per year? If so, what kind of local government approval does the investor need to get to remove the restriction?

- What is the regulatory scheme of the condo project, and what other governmental approvals are needed to restructure the condo project?

Insurance issues

Most condo hotel documents require each individual condo hotel unit owner to insure their own unit, but the association provides insurance for the common areas of the project. If the project is operating as a hotel, the developer should also have general liability insurance covering all hotel operations related liabilities, in addition to property and casualty insurance for the project.

The investor needs to ask:

- Is the condo hotel adequately insured for casualty losses and liability claims, both as to common areas and individual units? Who is the right condo hotel insurance advisor to review existing policies and do they run in favor of the new investor to the condo hotel project?

- Is there any insurance in place that can help protect the developer and investor from potential construction defect claims?

These are some of the important questions that an investor in a failed condo project must ask before determining if the distressed project is an opportunity in the making or a risk to be avoided.

What does it all mean?

Condo hotels are complex businesses with complex legal structures. Asking informed questions will help investors and lenders to understand the issues. To help evaluate these issues, the lender or investor will need to have a condo hotel team with a deep understanding and significant experience in structuring, marketing and operating condo hotels.

JMBM's Global Hospitality Group can provide the experience necessary for investors to pick up the pieces of failed condo hotels and find the hidden value that could turn these properties from rubble to riches.

Contact Catherine Holmes at 310.201.3553 or cholmes@jmbm.com.
Contact Guy Maisnik at 310.201.3588 or gmaisnik@jmbm.com.
Contact Jim Butler at 310.201.3526 or jbutler@jmbm.com.

If there is a way to maximize the value of your hotel, we will find it. If there is not, we will tell you. Our goal is always to find alternatives to increase hotel asset value. We usually succeed.

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Access this article, and our rich library of resources, on www.HotelLawBlog.com.

Lenders, are you planning to sell a note?
Why not increase your realization with an Enhanced Note Sale™?

Hotel Law Blog: 5 January 2009

http://hotellaw.jmbm.com/2009/01/hotel_bankruptcy_distessed_hotels.html

If there is a way to enhance your Hotel's value, creating a win-win for the Hotel Lender and Borrower, JMBM's Global Hospitality Group® will find it. If there is not, we will tell you. Our goal is always to find alternatives to increase hotel asset value. We usually succeed.

One way of increasing hotel value is through the SAVE™ program, (See *Hotel Law Blog, 25 November 2008, published on page 38 of this book*.)

Another technique for increasing hotel asset value is the Enhanced Note Sale™.

The ***Enhanced Note Sale***™ is the sale of a secured Promissory Note (secured by a troubled hotel) which is "enhanced" by a cooperative Borrower giving a deed-in-lieu of foreclosure to the Lender or a Buyer of the Note.

Sound interesting? Here's how it works.

— *Jim*

Enhanced Note Sale™
A Powerful Tool for hotel lenders, borrowers, and prospective buyers
by Jim Butler

The ***Enhanced Note Sale***™ is the sale of a secured Promissory Note (secured by a troubled hotel) which is "enhanced" by a cooperative Borrower giving a deed-in-lieu of foreclosure to the Lender or a Buyer of the Note.

The Note and security are left in place through a two-tiered subsidiary structure used by the Lender or Buyer, with title insurance endorsements to prevent merger of title when the affiliated parties acquire both the Note and related Mortgage or Trust Deed (by purchase from the Lender) and title to the property itself (by deed-in-lieu from the Borrower).

The Note and security interest in the hotel are preserved to enable the Buyer of the Note to foreclose out junior liens and preserve a senior secured lien position in case the new owner of the hotel (the subsidiary entity) needs to deal with bankruptcy clean up or repositioning

What are the advantages to an *Enhanced Note Sale*™ transaction?

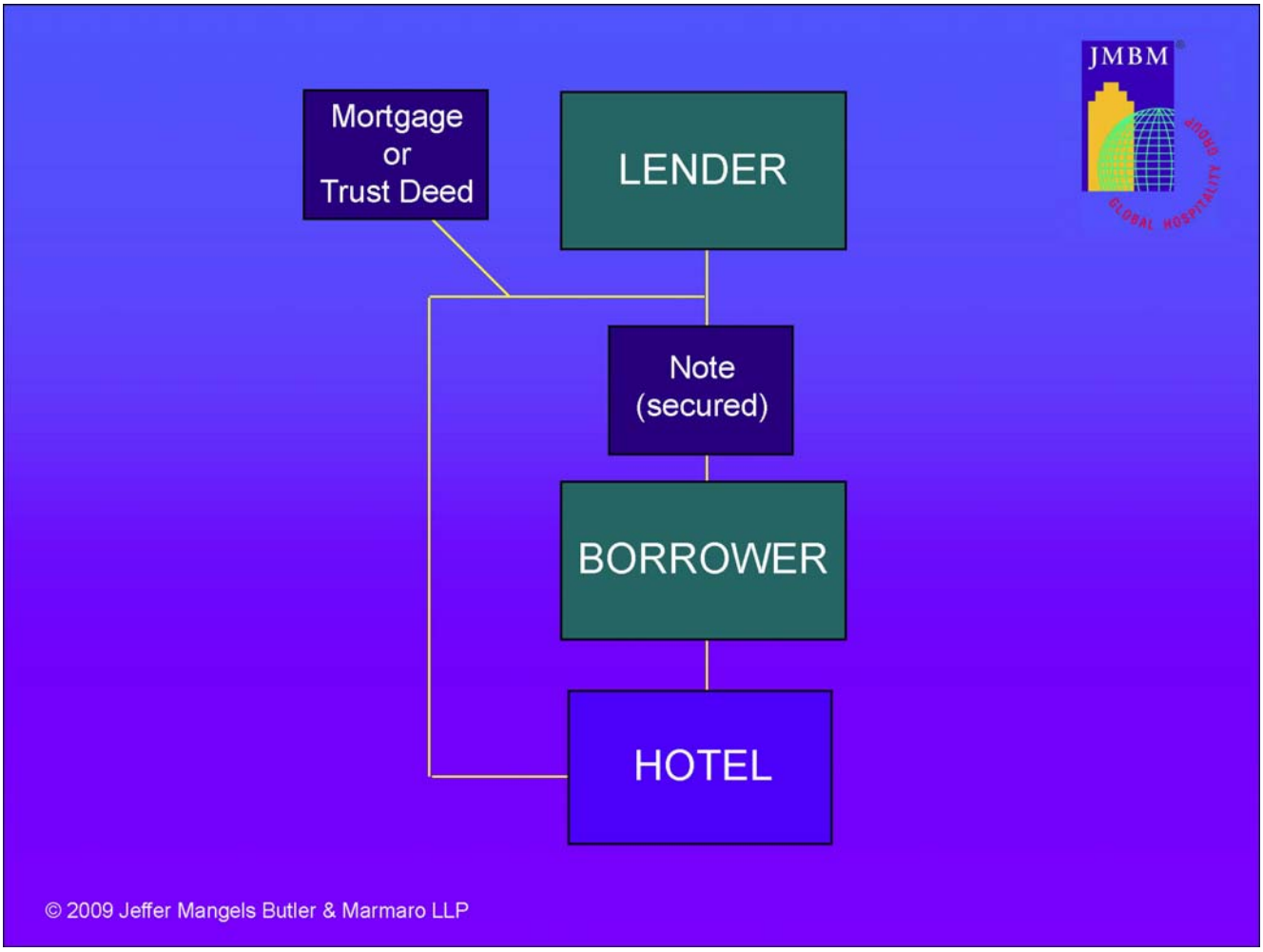
By selling the Promissory Note as part of an ***Enhanced Note Sale***™ transaction, the parties can enjoy the following benefits:

- Lender eliminates the distressed loan from its troubled assets without taking title
- Lender maximizes sale proceeds for the Note by eliminating the risk of Borrower's bankruptcy, loan defenses and typical lender liability claims
- Borrower avoids a foreclosure
- Buyer's subsidiary obtains title to the property quickly so that it can manage and control the asset
- Buyer retains the ability to wipe out junior lien holders through foreclosure of the Mortgage or Trust Deed acquired from the Lender

How does the *Enhanced Note Sale*™ work?

The "before" situation

The diagram below illustrates the typical lending relationship prior to an ***Enhanced Note Sale***™.



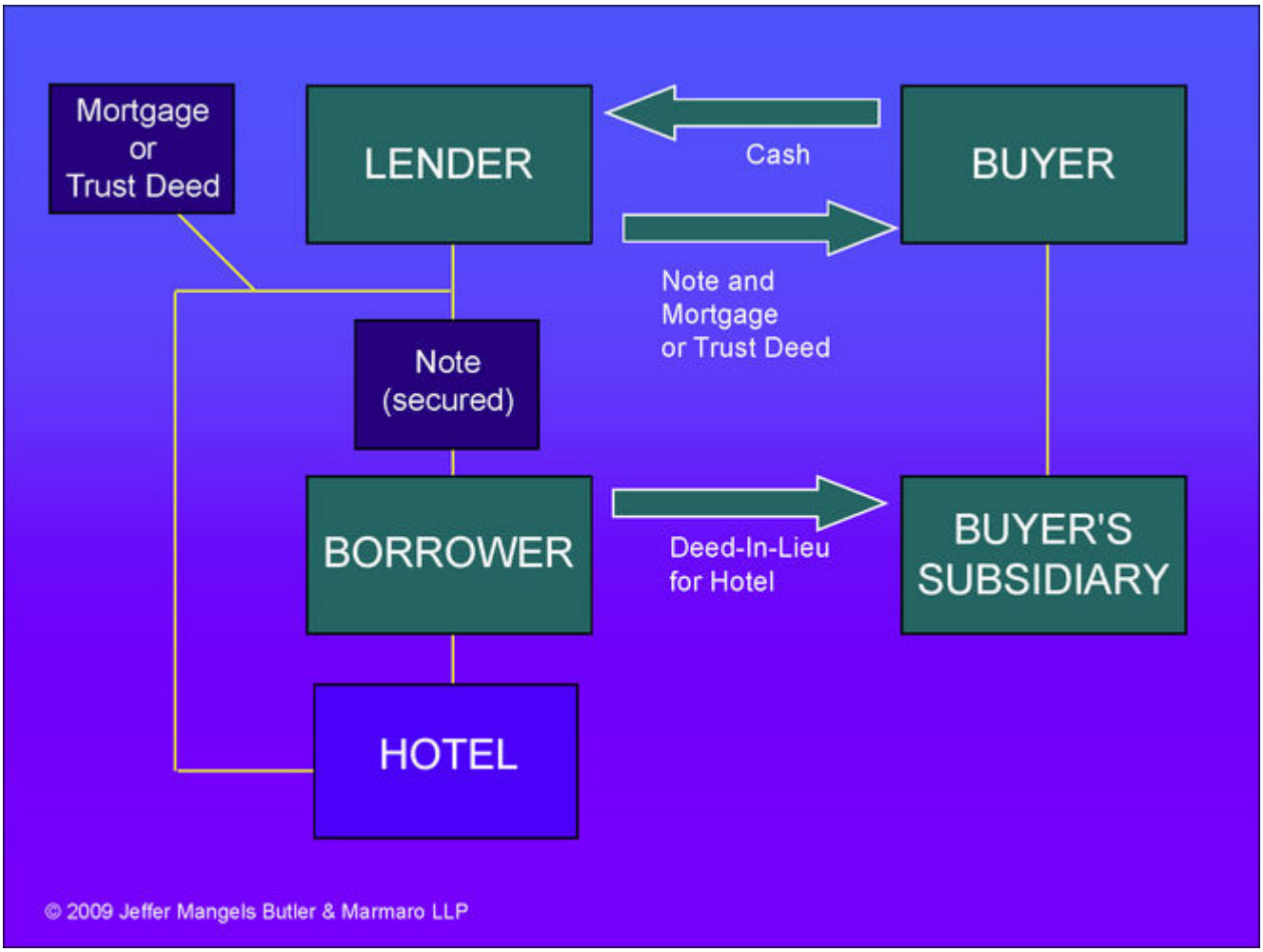
Initially, there is a Lender, a Borrower, and a Hotel (or other real estate collateral). The Lender has lent money to the Borrower, taking back a Note and a security interest in the Hotel (evidenced by a Mortgage or Trust Deed).

Then comes the *Enhanced Note Sale*™

The diagram below illustrates the essentials of the ***Enhanced Note Sale***™ transaction.

The key is a ***Master Agreement*** that coordinates and ties together all the parts of the transaction.

This transaction is a multi-party agreement with Lender, Borrower, Buyer, and Buyer's subsidiary as parties – unlike a traditional deed-in-lieu transaction (with only Lender and Borrower as parties).



This process is often started by the Lender, Borrower or an investor with a view to:

- Start negotiating the ***Master Agreement*** in anticipation of marketing the Note, or finding a buyer for the property at a later time (who will then enter into the ***Enhanced Note Sale***™ transaction contemplated in the diagram above), or

- Proceed directly with the ***Enhanced Note Sale***™ transaction with a Buyer who has already been identified and is ready to purchase the Hotel.

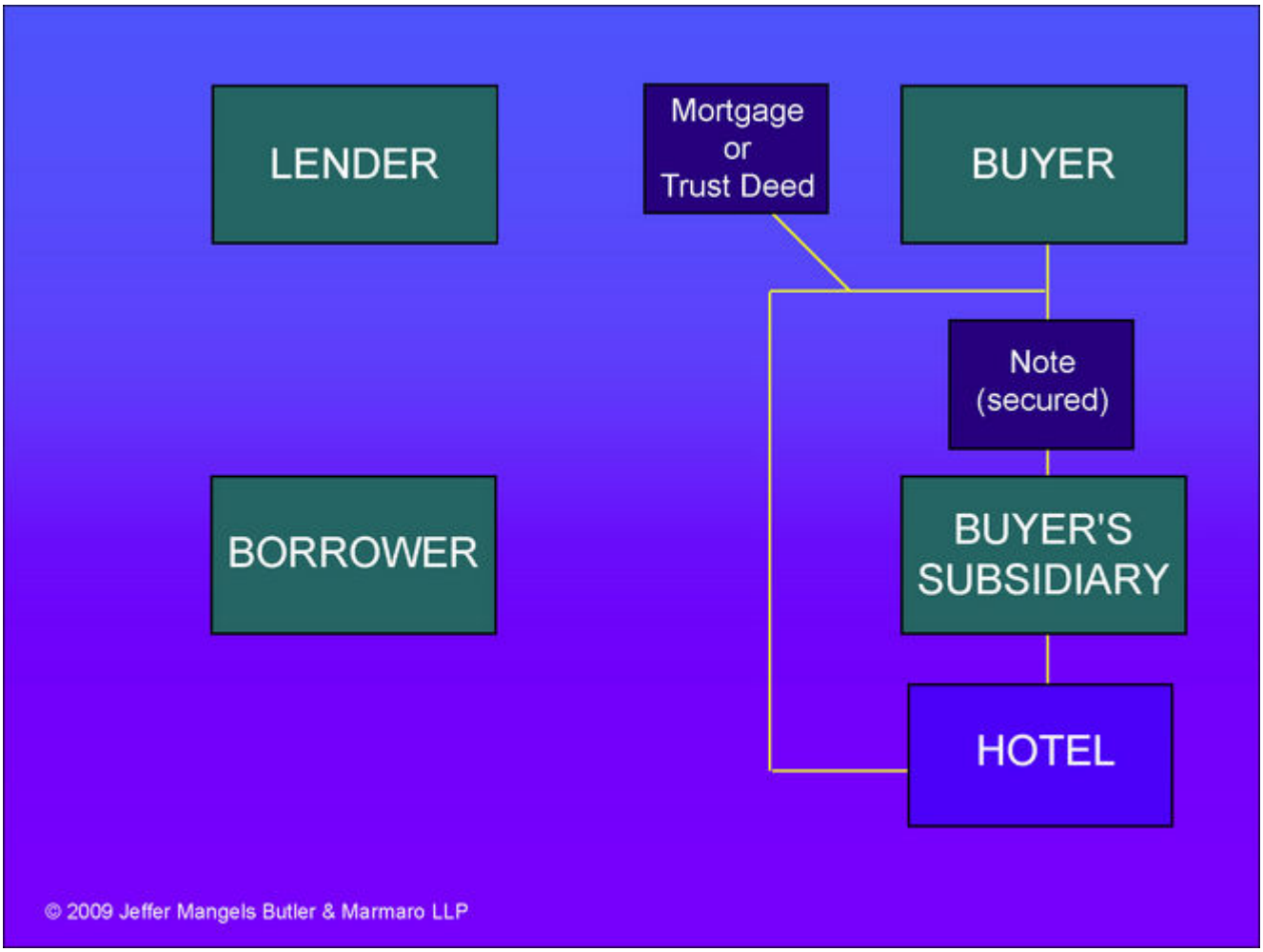
The parties to the ***Master Agreement*** include Lender, Borrower and Buyer. The ***Master Agreement*** is a critical document that must have a number of important provisions. Lender may use this opportunity to include certain releases and protections in favor of Lender. The ***Master Agreement*** should also set forth certain critical covenants, representations, warranties and indemnities that will flow from Borrower to Lender and also run independently from Borrower to Buyer.

Pursuant to the ***Master Agreement***, Lender will sell the Note and Mortgage or Trust Deed to Buyer, and Borrower will concurrently convey to Buyer's wholly-owned subsidiary the title to the property by deed-in-lieu of foreclosure. Because a subsidiary takes title to the property (rather than the party that buys and owns the Note and Mortgage or Trust Deed),

the estates are not merged, and the Buyer can later foreclose on the real property, if necessary, to extinguish junior liens and other junior interests.

The "after" situation – when the *Enhanced Note Sale*™ is concluded.

The diagram below shows parties' positions after conclusion of the ***Enhanced Note Sale***™ transaction.



The Lender and the Borrower are no longer involved with the real property or the loan.

Buyer now owns the Note and Mortgage or Trust Deed as a result of the purchase from Lender. The obligations on the Note have been assumed by Buyer's wholly-owned subsidiary (as the successor owner of the Hotel). Buyer's wholly owned subsidiary has obtained title to the Hotel by a deed-in-lieu from the original Borrower. Thus Buyer has obtained immediate control of the real property asset through deed-in-lieu from the original Borrower.

This transaction structure should eliminate a substantial part of the discount that a Buyer would otherwise require, to buy a defaulted note as a result of Borrower's representations and warranties and the cooperation of all parties in the transaction. The delays, expense

and uncertainty of Borrower bankruptcy, or Borrower-related litigation and claims are eliminated.

Meanwhile, the Lender avoids the delay, cost, regulatory and other problems involved in foreclosure, a deed-in-lieu and bankruptcy. With JMBM's ***Enhanced Note Sale***™, the Lender is also able to avoid making representations and warranties that it might have otherwise, because these representations come directly from the Borrower. And the Lender should not need to assume the risk of environmental and other liabilities that are incurred when taking title to real property.

Lender can also sell the Note and Mortgage or Trust Deed without the usual heavy "discount" for a distressed note, because the ***Enhanced Note Sale***™ structure avoids the risk of Borrower filing claims and proffering defenses to enforcement of the Promissory Note and taking title to the property. Meanwhile, Borrower avoids a foreclosure, antagonistic litigation with Lender, and maximizes the pay down to Lender (minimizing Borrower's own continuing liability and possibly resulting in guaranty or other relief).

What does it all mean?

The ***Enhanced Note Sale***™ transaction will expand the universe of interested buyers willing to buy distressed Hotel debt, because the Buyer knows that at the conclusion of the transaction it will own the Hotel, the Note and the Mortgage or Trust Deed.

Cooperation brings advantages for all parties in an ***Enhanced Note Sale***™ transaction.

JMBM's Global Hospitality Group® is committed to helping create value with troubled Hotels. We provide straight talk and pragmatic approaches to enhance hospitality asset value with our SAVE™ and the ***Enhanced Note Sale***™. If there is a way to enhance your Hotel's value, creating a win-win for the Hotel Lender and Borrower, JMBM will find it. Please call on us if we can help.

Contact Jim Butler at 310.201.3526 or jbutler@jmbm.com.

If there is a way to maximize the value of your hotel, we will find it. If there is not, we will tell you. Our goal is always to find alternatives to increase hotel asset value. We usually succeed.

JMBM's Global Hospitality Group®

Access this article, and our rich library of resources, on www.HotelLawBlog.com.

Global Hospitality Advisor®
Closing that hotel may be the worst money-saving idea you ever had!
Lenders, here's why mothballing a hotel can be a very bad idea.

Hotel Law Blog: 3 August 2009

http://hotellaw.jmbm.com/2009/08/closing_that_hotel_01.html

Sometimes there seem to be no alternatives. The borrower is broke or no longer in title. The lender may be capital-constrained, or as a matter of policy will not advance further capital to a hotel losing money on a current operating basis.

The moment of truth is upon you. The lender seems to be the only funding source to advance money to meet the payroll, pay the utilities, or pay critical vendors who have put the hotel on a C.O.D. basis. A stubborn union won't relent of ruinous work rules, or an operator won't reduce staffing and facilities to reflect depressed occupancies. What can the lender do other than close or "mothball" the hotel?

Initially, it may seem like a fire sale liquidation of a failed hotel is a poor alternative to suspending operations until the hotel market returns to some sense of normalcy. But unless the lender will make further advances to support current operating deficits, the hotel must be closed.

Ultimately, you may have no other decision, but here is the wakeup call before you decide to close the hotel: ***hotel values can "crash" – literally over night – once a hotel is closed***.

For a case study of hotel in Hawaii faced with closure, read on.

— *Jim*

Closing down hotel operations to staunch the negative cash flow
by Jim Butler

As more hotels fail to earn enough gross revenue to cover payroll, utilities and other operating expenses, underwater borrowers are giving the keys back to lenders. They are leaving it up to the lenders to decide if they want to advance operating shortfalls to keep the hotels open. Increasingly, frustrated lenders are thinking of suspending hotel operations to stop the negative cash flow. This alternative to a liquidation sale is deceptively attractive. It can look like the better of two evils before you dig down to do the hard present value analysis.

Record hotel failures and record hotel closings

The hotel lawyers of JMBM's Global Hospitality Group® believe that this recession will bring several thousand hotel failures. In contrast to past economic cycles where most hotels continued to operate through receiverships, foreclosures and bankruptcies, it looks like things may be different this time.

We foresee a record number of hotel "closings" – situations where the hotels cease ongoing operations as hotels. Someone "turns off the lights." The hotels "go dark." They are closed down and "mothballed" because neither the defaulting borrower nor the lender will pay the shortfall in cash necessary to meet payroll, utilities and other operating costs to keep the hotel open.

Rule #1 for lenders: If you are thinking about closing a hotel, you need to run a present value and holding cost analysis.

As discussed below in greater detail, there are two warnings we give lenders confronted by this challenge:

- The decision to close an operating hotel may be the worst decision you can make (and someone is likely to be second guessing your decision with the benefit of hindsight)!

- You are probably better off with a fast "fire sale" disposition of an open hotel today than mothballing the hotel. Because in most cases, the day a hotel closes, it will be worth less than half the value it had the day before.

Why is closing a hotel so much worse than mothballing an office building, multi-family residential or any other kind of real estate? What pitfalls and liabilities accrue to the inexperienced troubled asset managers turning off the hotel lights?

Weigh your alternatives carefully. If you cannot afford to keep the hotel open, you may be better off with a liquidation sale. Here is a recent case study that illustrates why.

A recent case study

Just a few days ago, a lender pulled back from brink . . . and just in time!

In a distressed scenario becoming increasingly common, a lender recently found itself with a hotel in Hawaii where the borrower defaulted and a receiver was appointed. The hotel was not producing enough income to meet payroll, utilities and other operating costs, and was unlikely to do so in the foreseeable future. The lender's initial decision was to stop advancing cash to meet necessary working capital and mothball the hotel.

But then, the lender got some good advice and did a comprehensive situation analysis. They asked for both a cash flow and a present value analysis of two alternatives. Alternative #1 was the ugly option of keeping the hotel open by making new advances to fund the shortfall to meet operating costs for 3 years. Alternative #2 was the expedient option of closing down the hotel to "stop the bleeding." It was a good thing the lender did the analysis!

The analysis showed that the best alternative was clearly keeping the hotel open. Why? Because the hotel was worth more (if it stayed open) at every point over a projected 3-year hold, AND because it cost less to supplement the negative cash flow to maintain operations than it did to close the hotel.

A closed hotel generates no revenue, but still has expenses for security, insurance, property taxes, property maintenance and the like. Let's look at this in some more detail.

What does every hotel veteran know about closed hotels that you need to know, too?

If you weren't working with troubled hotels in the early 1990s, you may wonder how you could possibly be better off making a fire sale disposition rather than mothballing the hotel.

Here are 8 bad things that happen when a hotel closes:

1. The day a hotel closes, most professional hotel brokers, appraisers and investors will tell you that the hotel will be worth less than half the value it had the day before.

2. When you close a hotel, the franchise and management arrangements will terminate. It may be difficult or impossible to secure as good a brand again. It will at least be very time consuming and expensive for someone to secure a major flag. There is likely to be litigation over breach of management and franchise agreements which can cloud over the property's ability to reopen without some right of first refusal to the original operator and brand.

3. Closed hotels are vulnerable to vandalism, vexatious litigation and high-profile public relation disasters.

4. The cost of holding a closed hotel (which generates no revenue) often exceeds the cost of supplementing the negative cash flow from a losing hotel operation. A closed hotel still needs security, insurance, temperature control and systems maintenance. Property taxes continue to run.

5. Property and liability insurance may be impossible to obtain on a vacant property, or may be prohibitively expensive. Security can also be very expensive depending on the nature of the property. Most municipalities will not permit landscaping to be deferred. Communities will picket, protest and sue boarded up eyesores. Utilities must normally remain on for fire and life safety reasons, and if boilers, chillers, plumbing and other systems aren't flushed or maintained, they may soon need complete replacement. Lenders may have to choose between running air conditioning in tropics or heat in winter environments to avoid the necessity of replacing frozen pipes and rusted equipment and to prevent mold and ruined wall paper, carpets and soft goods.

6. The cost of starting up or reopening a hotel is substantial. The larger the hotel, the greater the time and cost of reopening – refurbishing, relicensing, re-contracting for brand and management, rehiring and training employees, repositioning and marketing the hotel, ordering supplies and inventories, replacing liquor licenses and amenity agreements, and refilling the empty pipeline for future business.

7. Closing a hotel may forfeit entitlements, trigger governmental backlash and have a devastating impact on related components in the project.

8. Investors will also want a price concession cushion for the risks in trying to overcome the negative image of a closed hotel. They know it takes a lot of time and money, and may not succeed.

An open hotel is more attractive to investors and is easier to assess. There are so many unknown risks with a closed hotel, that buyers may tend to overestimate the costs and risks.

There certainly may be cases where a careful present value analysis demonstrates that it makes economic sense to close an operating hotel rather than operate it at a loss for an unknown period. But we think that a third alternative is likely to be even more attractive than closing a hotel through a protracted downturn and slow recovery. In most cases, a sale of an open hotel at a realistic market price will be preferable to mothballing the hotel.

What does it all mean?

Conclusions and situations will vary. But we believe, as a general matter, prudent lenders will run a proper cash flow analysis, sharpen their pencils, and find some interesting results.

If you need help analyzing your options, we invite you to call us.

Contact Jim Butler at 310.201.3526 or jbutler@jmbm.com.

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A Blog Reader's Response

Some practical alternatives to hotel closings – turning around operating results.

Hotel Law Blog: 9 August 2009

http://hotellaw.jmbm.com/2009/08/other_articles_on_state_of_the.html

We received a lot of feedback on our blog article of 3 August 2009 about the precipitous drop in value that accompanies a hotel closing, or as some say, when the hotel is "put in mothballs" or "goes dark".

In that article, we talked about 8 bad things that happen when you close a hotel, and suggested that a hotel should never be closed without first running a careful analysis of cash flows and holding costs. That is not to say a hotel should never be closed, but a hotel closing deserves close scrutiny, and full exploration of the alternatives.

Jack Westergom, one of our long-time industry friends responded to the blog with some thoughtful insights, or "real-time thoughts from the field." Jack Westergom is Chairman and Managing Director of Manhattan Hospitality Advisors. We have worked with him for many years and have seen clients get some great results by tapping into his 30 years' of hotel experience, so we thought we would share his comments with our readers.

Westergom's report from the battlefield expounds on another alternative to closing hotels or liquidating them in distressed sales. He tells us that his team improves the operating results and makes it feasible to hold the assets longer. He tells us that he has set up budgets with owners and lenders for an agreed-upon minimum amount of working capital to fund shortfalls while making an all-out focused effort to make hotels self-sustaining where others continue to falter.

Here is Westergom's message from the field, with 12 salient observations.

— *Jim*

Intense, pro-active asset management

Dear Jim,

Loved your blog on hotel closings and figured I would forward some real-time thoughts from the hospitality battlefield on what is truly happening in the marketplace. Hotels and resorts in every market and at every price point are fighting for survival as declining demand, over-supply and the current financial crisis has impaired many hotels' ability to fund their operating costs and meet debt service coverage.

The business plans and strategies that supported record financial results in 2007 don't work anymore. As asset managers, we are responsible for "managing the hotel management company." It is quite apparent to us that only new and bold actions will enable hotels and resorts to survive in these perilous financial times. While many operators have already taken some steps to minimize the gap between operating expenses and revenues, much more needs to be done. The primary focus has been on cost containment and very little attention has been given on altering strategies to drive revenue. Here is a recap on what is happening:

1. Communication between owners, asset managers and operators must be improved in order to facilitate the relationship between the two. Today, all but the worst of operators generate cash-flow forecasts as a regular operating exercise for owners and lenders. Some run them monthly, which might have been adequate in years past, but is highly inadequate with today's declining revenue stream. We have asked operators to focus on cash-flow on a weekly basis, in order to compensate for the difficulties in forecasting in today's environment.

2. The best operators already reduced expenses last fall and many have reduced them again in the first quarter of this year. Now, expense reduction today is no longer the issue. Today, revenue enhancement is the main issue facing hotels.

3. Most operators have failed to understand that the "doing business as usual" business plan no longer works and alternative strategies and creative game plans are necessary. The one concept that many operators have failed to deal with effectively is the need for increased revenue generation. This is an area where we, as asset managers, collaboratively guide the operator to get creative and change their way of thinking.

4. The past six great years of good times in the hospitality business has bred a new generation of marketing people who focus on "order taking," as opposed to "order making."

5. Operators have become too reliant on generic brand marketing to fill their hotels – a strategy that may be adequate in the best of times, but

is grossly inadequate in the worst of times. In recent years, strong brands could generate the majority of a property's business, generating up to 75-80% of their business. Today, a brand might be capable of generating 35-40% of a hotel's business as corporate and group travel has declined markedly. With the brands delivering less than 40% of a hotel's business, neither the operators nor their marketing personnel know how to make up the difference.

6. Brands have long forgotten and abandoned the "backyard strategies" required to drive "local marketing initiatives" that fill hotel rooms in good times and in bad. These property specific strategies include marketing partner alliances, local website strategies, neighborhood marketing strategies for food and beverage and competitive hotel intelligence.

7. There is a misconception amongst many lenders today who believe that additional expense reduction is the only appropriate strategy to create income. We strongly disagree as we have reviewed many distressed properties this year that have cut expenses so deeply that service is below minimum brand and consumer standards. In many instances, the asset and its ability to generate revenue and asset value have suffered.

8. It appears that most lenders' basic strategy with today's distressed assets is to immediately put a receiver in place to hold the asset. We believe that this may not necessarily be the most prudent action in order to maintain and increase asset value.

9. Most operators' sole goal is to meet brand standards, not to protect and preserve asset value, and, therefore, they do not have their interests aligned with the owners.

10. Most operators do not understand that CMBS loans differ from traditional loans and require capital expenditure approval by lenders.

11. Most operators do not know that the ground rules for operating hotels change when a receiver is put in place or a hotel is foreclosed upon.

12. In this financial downturn, most brands have done little to create programs (as they did last downturn) that attempt to focus on the owner and the owner's ability to satisfy debt service requirements.

Very truly yours,

Jack Westergom
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What does it all mean?

In order to make intelligent decisions, you should know all your options and understand their consequences. Closing a hotel is generally one of the least attractive options, compared with a fast sale or better asset management. Sometimes, keeping a hotel open takes cooperation and contributions from different stakeholders – perhaps unions, municipalities, operators, lenders, owners and others.

To discuss what this means to you, in our particular situation, please call us.

Contact Jim Butler at 310.201.3526 or jbutler@jmbm.com.

If there is a way to maximize the value of your hotel, we will find it. If there is not, we will tell you. Our goal is always to find alternatives to increase hotel asset value. We usually succeed.

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Ask the Hotel Lawyer™
Should you sell your distressed hotel property now or sell later?
How long does it take to market a hotel today?

Hotel Law Blog: 1 September 2009

http://hotellaw.jmbm.com/2009/09/how_long_to_market_hotels.html

It's the worst business environment in 70 years and you are a hotel owner or lender with a distressed property. You have a decision to make: Do you sell the hotel now at a deep discount, or do you hold on for things to get better? How long does it take to market a property in this environment?

Owners and lenders of thousands of hotels in the United States and abroad are confronted with this decision. To get some perspective on this issue, we bring you the perspective of experts in the field: Mark Elliott, Managing Partner of Hodges Ward Elliott, Stephen Rushmore, founder and CEO of HVS, and Alan Reay, the founder and CEO of Atlas Hospitality.

Here are thoughts from the pros.

— *Jim*

The Hotel Owner's and Lender's Dilemma: When to sell? Now or later? What price can you get if you sell now? Market value or liquidation value?

by Jim Butler

When making the "sell now or sell later" decision, many hotel owners are concerned about the value they will realize on the sale, and how long it will take to realize a "market value."

Last week, Steve Rushmore, founder and CEO of HVS, presented a webinar on distressed properties. He said that there are at least two big differences between a seller realizing "market value" on a hotel property instead of "liquidation value." According to Rushmore:

1. Today, it takes 1 to 2 years to provide adequate marketing time to realize a market value price in today's market.

2. Liquidation value will be 20-50% below market value.

Mark Elliott of Hodges Ward Elliott, one of the premier hotel brokers in the country, agrees with Steve Rushmore that there is at least a 20% additional discount from 2007 values for "forced sale" transactions.

Elliott also thinks that there will be a rush of sales over the next few quarters as more desperate owners and lenders come to the realization that values are not going to improve for a long time, and decide that they would rather cash out now at any cost. He believes lots of desperate sellers will likely start dumping properties and keep values low for a long time. His advice: Sell now and avoid the traffic jam!

How long do you have to market the property in order to accomplish market value?

At an intellectual level, I understand what Steve Rushmore is saying. He believes it is going to take a long time before someone can realize a higher price than they can today – maybe up to 2 years . . . or even longer.

But as a practical matter, the concept of a 1 or 2 year marketing period is absurd. This is not a period for marketing. It is a refusal to deal with the abysmal economy that is our reality today. A 1 or 2 year marketing period is just a stall – waiting for the world to change. Can you actually imagine giving a broker a 2-year listing agreement on your property?

I decided I would test my reaction out on Alan Reay, the founder and CEO of Atlas Hospitality, the leading hotel broker in California. Reay's Atlas Hospitality Group has sold more hotels in California than any other brokerage firm.

Reay takes a more pragmatic approach to the marketing period.

Alan Reay says lenders are asking him for the price they can realize on a property sale within 60 to 90 days. He believes that this is the only feasible approach today. Reay said, "The price we give lenders today is based on 60 to 90 days closing, otherwise, they need to lower the price 10 to 15%, at least."

According to Reay, "The days of 6 to 12 month marketing timeframe (what you see in all appraisals) are long gone. Anyone who talks about a 1 to 2 year marketing period is out of his mind. If you have not sold within 90 days of putting your hotel on the market, you're toast!"

Why is delay a problem?

When I asked Alan Reay what this means, he had two specific considerations:

1. We have a 10 year supply of hotels on the market at the present absorption rate – and that assumes no other hotels are put on the market. It is "highly unlikely" that more hotels will not be put on the market.

2. Unless you are prepared for a fairly long term hold – say 3 to 5 years – "a hard present value analysis is likely to show that you are better off selling today at a realistic market price. The alternative may be feeding a negative cash flow beast and waiting for a long time for value recovery."

Reay says, "If you don't like the market price today, you are really not going to like it 12 to 18 months from now."

Basically, he sees that sellers have been looking for "yesterday's prices" and by the time they reconcile themselves to the price they were offered 6 months ago, that is no longer achievable.

What do the hotel lawyers at JMBM's Global Hospitality Group® advise?

Do the math yourself! Run a present value analysis of likely cash flows on 3 alternate scenarios. Decide whether you have the stamina and capital for a long haul if you intend to hold. Or decide that you are a gambler.

Be realistic. And if you are going to be a seller, then sell quickly.

Many experts see values continuing to decline until at least 2011 or, more likely 2012. Some think values recover peak levels by 2014 and others think recovery to 2007 levels is TWO real estate cycles from now (given that a typical hotel cycle lasts 7 to 8 years, this could possibly be 10 to 16 years, i.e. 2019 to 2025).

We would be happy to help you evaluate your options and develop the best plan from here.

Contact Jim Butler at 310.201.3526 or jbutler@jmbm.com.

Contact Mark Elliott at 404.238.0927 or melliott@hwehotels.com.

Contact Alan Reay at 949.622.3409 or alan@atlashospitality.com.

Contact Stephen Rushmore at 516.248.8828 or srushmore@hvsinternational.com

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Terminating hotel management agreements when things don't work
Not easy, but not impossible

Hotel Law Blog: 27 May 2009

http://hotellaw.jmbm.com/2009/05/terminating_hotel_management_agree.html

What is one of the nicest acknowledgements of professional accomplishment a hotel lawyer might receive? In my book, being recognized by the New York Times as an expert in a core aspect of my legal and advisory practice is pretty close. Yesterday, I was quoted in a Times article by Jonathan D. Glater about the increased friction between hotel owners and operators now erupting into litigation in the case of the Four Seasons Aviara and the Fairmont Turnberry.

In another New York Times article, written last month by Martha C. White, I warned that we are facing the prospect of hotel bankruptcies and foreclosures reaching levels not seen since the last big downturn of the 1990s.

And indeed, it is in difficult times like these when hotels fail to meet debt service – or even operating expenses – that hotel owners and lenders become very frustrated with operators that prefer their own interests to those of the hotel. And that is why Jonathan Glater's article was looking at two high profile emerging battles where owners are standing up to operators and saying, "I'm mad as hell, and I'm not going to take it anymore."

What is our advice to owners and lenders in this situation? Read on!

— *Jim*

Fixing Hotel Management Agreements That Don't Work
Hotel management agreement hell – our perspective
by Jim Butler

Sometimes desperate owners prematurely jump to the conclusion that a hotel management agreement should be terminated. Without the correct analysis, this is like the old joke about "fire, ready, aim." Do your analysis first. But more about that in a moment.

Struggling to carry an underwater hotel with a bad operator and an onerous agreement is "management agreement hell." We know.

We launched the JMBM Global Hospitality Group®, focusing on hotel owners and lenders, more than 20 years ago. At that time, it seemed like anyone who knew anything about hotel management agreements was on the operator side, so we started helping lenders and owners terminate or renegotiate long-term, no-cut hotel management agreements that purported to run for 50 or 100 years.

Since then, we have negotiated, re-negotiated, litigated or arbitrated and advised on many HUNDREDS of hotel management agreements – more than 3,800. We understand how the contract relates to the operations of the hotel business associated with the real estate. We know the players, the norms and customs, and the practices of the industry. And our experience over many hundreds of management agreements helps us define and guide our client on what is "market" and an achievable result.

We have seen it all: Operators who insist on keeping 5 restaurants open 24 hours a day even though they are empty and losing a fortune. Overstaffed executive and line staff that inflate payrolls and sometimes are used to make your hotel a training ground or retirement center. Branded operators delivering only 5% of the hotel's business through its reservation and marketing systems. Operating standards that may maintain a brand image but don't contribute to profitability. Pricing rooms and services to maintain "rate leadership" in a market for the brand's perceived position, instead of getting a fair share of the available business for the hotel.

Does this sound familiar?

Operators that are ineffective or fail to respond to critical needs

Most owners become very frustrated when they feel that their operator is not responding to a critical situation. The aggravation level escalates when the operator isn't proactive to drive business, cut costs and better manage capital expenditure issues. Sometimes the operators seem to tell you anything they think you want to hear – month after month – but do nothing, despite repeated promises. Whatever the reasons, bad financial results can severely wound owners and lenders who believe they are entitled to expect results from operators who proclaim their expertise and take their money "off the top" – as a percentage of gross revenues, or through markups, purchasing fees, reservation fees, frequent traveler charges, and the like. Hotel owners are dismayed when their operator is unable or ineffectual at getting results.

The operators run your hotel, hire and fire your employees, set the pricing and standards, and tell you when they want you to write checks to upgrade the carpet and pool furniture, make payroll or pay their fees.

It is my 20 years of experience in representing owners that informed my perspective as quoted in the *New York Times* article about how hotel management agreements structure the relationship of owner and operator:

> "It gives the operators all the benefits of ownership with none of the burdens," said James R. Butler Jr., a lawyer at Jeffer Mangels Butler & Mitchell in Los Angeles. "It pushes to the owner all of the cost – the capital costs of buying, maintaining and operating the property – and lets the managing companies take most of their money off the top."
>
> *New York Times*, "Luxe Hotels in a Battle for Control", Jonathan Glater. May 25, 2009

Why not just terminate a bad operator? What can you do?

Most branded hotel management agreements run for decades and it is not easy to terminate them. Management agreements cannot be terminated "at will" or just because the hotel is underperforming. And they usually have very tricky procedures requiring notice of a perceived "breach of contract" with one or more opportunities for the operator to "cure" the default. But if you terminate and do not have proper justification, you will be responsible for damages for breach of contract, which could amount to the present value of the income stream the operator would have received for the remainder of the contract term. This could be very expensive.

Of course there are other reasons not to terminate a hotel management agreement without due consideration. For example, although it may be convenient to blame the operator, a hotel's difficulties may not be the operator's fault at all. Maybe the present brand is the best brand and management for a property. The costs (and loss of momentum) of rebranding can be substantial. To do so if not necessary to do so would be very counterproductive. Besides, most brands will make a termination effort very expensive and time consuming unless they see it your way (and they probably won't without a lot of professional guidance).

When your hotel fails to perform, what should you do?
The SAVE™ program – analysis, planning and implementation

When things are not going well at your hotel, the first thing you need to do is find out WHY they aren't going right. And that is exactly what we designed the SAVE™ program to do. SAVE stands for "Strategies and Approaches for Value Enhancement" for a hotel.

The SAVE™ program is a cooperative and pro-active approach that brings analytical diagnostics to the troubled hotel or hotel loan situation and evaluates options to improve revenues, control costs, manage CapEx and deal with legal options. With lender encouragement, the goal is to help the owner/borrower to quickly develop a detailed plan and approach, gain lender approval for the plan, and then execute the plan with regular reporting and communications between the borrower and lender.

Along with the operational analysis, we give careful consideration to the operator's performance. What can be done cooperatively with the operator to improve results? Many operators are more responsive to owner requests in this environment. Is this the right operator or just difficult times for everyone? Has the operator breached either its express or implied covenants under the hotel management agreement? Can the management agreement be terminated for any other reason, such as the fiduciary duty of the agency relationship created by almost all hotel management agreements? Is there some win-win for all parties other than termination?

For more on the SAVE™ program approach see Hotel Law Blog, 25 November 2008, on page 38 of this book.

Contact Jim Butler at 310.201.3526 or jbutler@jmbm.com.

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Global Hospitality Advisor®
Foreclosing on hotels and other mixed collateral in California can be tricky
How to avoid the pitfalls

Hotel Law Blog: 7 February 2010

http://hotellaw.jmbm.com/2010/02/hotel_lawyer_california_forecl.html

California now leads the nation in defaulted mortgages for hotels and commercial real estate. As lenders start to review their options, they must formulate asset plans that will avoid violating California's tricky one action and anti-deficiency rules, or they may be in for some nasty surprises.

To help lenders avoid unnecessary pitfalls, we asked Guy Maisnik, one of the senior members of our real estate department and Global Hospitality Group® to help us review essential principles that every lender should know. Guy is a member of our deep bench who has been through every real estate downturn since the 1980s, and helps lenders and investors maximize the value on billion dollar portfolios or one-off assets.

Guy's career includes advising lenders on restructuring and exercising remedies. He has worked with numerous banks, special servicers, opportunity funds and pension funds including GE Capital, Midland Loan Services, Helios AMC, HSH Nordbank, AG, HSBC, Wells Fargo Bank, Bank of America, Morgan Stanley, Sumitomo Mitsui Bank, Colony Advisors, Lone Star, Archon Capital, CalPERS and Washington PERS. His work has involved analyzing and assisting in the successful bidding and purchase of loan/asset portfolios – from small portfolios to those exceeding a billion dollars – exercising remedies on the acquired loans, addressing complex workout and guaranties realization issues, addressing tranche disputes, restructuring capital requirements, structuring sales of the acquired loans/assets and addressing tax consequences of note holders to facilitate workout and disposition strategies.

He knows what he's talking about. Read on.

— *Jim*

California Foreclosure Traps for Unwary Lenders
California's one action and anti-deficiency rules
by Guy Maisnik

California is the state where a judge released a guarantor from its debt obligations because the judge did not like a perfectly well-drafted guaranty waiver (so the State has a new form of waiver). A court in the State also found a bank's violation of California's one action rule released the security interest in the real property, making the debt uncollectible (a later case sustained the first part of this decision releasing the real property security, and reversed the second part, holding the debt **was** collectible). Welcome to the sunshine state!

Even those of us who practice regularly in this area find that the principles of California commercial finance law can be contradictory and inconsistent. If you have troubled assets

in California, you need to understand some of California's one action and anti-deficiency rules to avoid falling into some dangerous – and unnecessary – traps.

Part 1: California's One Action Rule

California enacted CCP §726, commonly called the "One Action Rule" (or sometimes the "One Form of Action Rule"), to prevent multiple actions when a creditor sues a borrower on a debt secured by real property after the borrower has gone into default. The One Action Rule provides that "... there can be but one form of action for the recovery of any debt, or for the enforcement of any right secured by a mortgage on real property ..." Thus, if a debt is secured by real property, the creditor must exhaust all real property collateral before seeking an action against the debtor. This means the creditor must bring a judicial or non-judicial foreclosure action first against the real property collateral. If there is a deficiency between the amount realized on a foreclosure sale and the outstanding debt, then action may be taken to pursue a deficiency judgment against the debtor, subject to the fair value limitations set forth in §726 and to the limitations of §§580b and 580d. *Security Pacific National Bank v. Wozab* ("*Wozab*".)

What is an "action"?

CCP §22 defines "action" as "an ordinary proceeding in a court of justice by which one party prosecutes another for the declaration, enforcement or protection of a right... " This seems to be a simple enough definition. However, California courts have redefined "action" in an expansive and inconsistent manner. For example, the court in *Bank of America v. Daily*, 152 Cal. App. 3d 767 (1984), ruled that a bank's setoff of the debtor's deposits constituted an "action." Yet, in *Wozab*, the California Supreme Court ruled that such a setoff was not an "action."

Other judicial decisions continue to construe "action" so as to require the exhaustion of all real property security before seeking action directly against the debtor.

Fortunately, there are some limits to the bounds of judicial activism. For example, in *Hatch v. Security-First Nat'l Bank*, the court ruled that a trustee's sale under a mortgage or deed of trust is not an "action" for purposes of the One Action Rule.

And what about seeking appointment of a receiver? Is that an "action"? CCP §564(d) states that an action by a secured lender to appoint a receiver is not an "action" under §726. Further, §564(b)(11) states that the appointment of a receiver may be continued even after entry of a judgment for specific performance in that action, if appropriate to protect, operate, or maintain real property encumbered by the deed of trust or mortgage or to collect the rents therefrom while a pending non-judicial foreclosure under power of sale in the deed of trust or mortgage, is being completed.

How does this impact hotel properties?

As anyone knows who is familiar with Rule #1 of Hotels: **hotels are more than just real estate**. In fact, in any full service hotel, the operating business easily comprises more than half the value of the property. So the question is: does §564(d)(11) apply to the collection of operating revenues from a hotel if appropriate to "protect, operate or maintain" the hotel pending non-judicial foreclosure? Arguably, revenues from hotel rooms can be construed as "rents." But what about food service, gift shop proceeds, green fees and proceeds from other

amenities? Again, while unclear, the application of §564(d) to hotels ought to fall within §564(d)(12), which includes any case "brought by an assignee under an assignment of leases, rents, issues, or profits pursuant to subdivision (g) of Section 2938 of the Civil Code."

Can a creditor apply collected rents and revenue to the debt without violating CCP §726?

Today, the answer should be "yes" following decertification of *Great American First Savings Bank v. Bayside Developers*, 284 Cal. Rptr. 194 (1991), decertified 92 C.D.O.S. 2217 (Cal. 1992) (finding a receiver's selling of condominium units and application of sales proceeds to the debt violated §726), and the Bayside decision in *Resolution Trust Corporation v. Bayside Developers*, implicitly approving the application of sales proceeds to the debt before the trustee's sale.

However, the law remains on soft ground and counsel should proceed cautiously.

What happens if the creditor violates the One Action Rule?

Earlier case law (*Bank of America v. Daily*) held that the creditor's violation applied to extinguish both the real property collateral and the debtor's obligation. This was an extraordinarily punitive result, particularly since the main purpose behind the One Action Rule was primarily procedural, preventing multiple actions, and compelling exhaustion of all security before a deficiency judgment is entered and ensuring that debtors are credited with the fair market value of the secured property before they are subjected to personal liability. However, the Supreme Court in *Wozab*, modified the earlier decision, holding that the violation of the One Action Rule did not extinguish underlying debt but did terminate the real property collateral interest.

How does California law address mixed collateral?

A hotel creditor typically has multiple forms of collateral such as real property, fixtures, furnishings and equipment and cash collateral. How does the One Action Rule work under these circumstances? Is the creditor required to foreclose on the real property first, even before taking cash collateral or other personal property?

California Commercial Code §9604(a)(2)(A) provides a broad exception to the One Action Rule for personal property and fixtures included in a "unified sale" conducted under real property rules. Otherwise, the drafters of California's "mixed collateral" statute clearly intended to insulate personal property collateral from compliance with real property provisions. There is no security-first requirement under California law with respect to personal property collateral. Further, CCP §730.5 expressly states that except as otherwise provided by CCC §9604, the anti-deficiency rules do not apply to any security interest in personal property or fixtures governed by the Commercial Code.

What if the creditor applies cash collateral to the debt?

Do payments from a collateralized cash account to a lender (either directly or from a receiver) who holds real property collateral violate the One Action Rule? In re *Sunnymead*, the court found that the creditor's acceptance of payments from the debtor did not constitute an "action" under the "security-first rule." The court's Bankruptcy Appellate

Panel (BAP) stated that the payments were "cash collateral" and that the lender had not sought "to collect against noncollateral general assets."

Part 2: Judicial v. Non-judicial Foreclosure

There are two ways for a creditor to foreclose on real property in California: judicial and non-judicial.

In judicial foreclosure, a creditor sues the debtor in court for foreclosure, and obtains a judgment for foreclosure against real property collateral and, presumably, obtains a personal judgment against the debtor for any deficiency amount. This process is usually time-consuming and expensive. Moreover, even after the judicial foreclosure sale, the debtor will retain the right to redeem the real property for a period of one year, frustrating any commercially reasonable sale for that period of redemption. CCP §729.010.

The redemption period makes judicial foreclosure a clumsy remedy for lenders since the lender does not have the right to possess the collateral after the judicial foreclosure until the redemption period has expired. In fact, in such cases the lender is forced to seek a receiver post-foreclosure under CC §564(b)(4) to possess the property and collect revenues during such period.

As a result, the preferred remedy for most lenders is typically non-judicial foreclosure. Non-judicial foreclosure is relatively fast and inexpensive, if uncontested. A non-judicial foreclosure is a public sale by the trustee identified in the deed of trust under the private power of sale clause. The process is strictly governed by statute, taking approximately 120 days, unless the borrower contests the action in court, or seeks delays and adjournments of sales.

Typically, the lender will acquire the property at the trustee's sale by credit bidding all or some portion of its secured debt. (There is an art to the credit bid, with potentially serious legal and business implications to the amount of the bid, but that is an issue for another article.) The lender's title is evidenced by a trustee's deed upon sale.

A trustee's sale is final, and the lender becomes the owner of the property free and clear of all junior liens. The counterbalancing consequence to a lender of a non-judicial sale is foregoing the right to seek a deficiency if proceeds from the trustee's sale fails to cover the outstanding debt, as discussed below.

How does this impact hotel properties?

Regardless of proceeding with a judicial or non-judicial foreclosure, hotel lenders are cautioned to pay careful attention to whether a non-disturbance is in place with the hotel operator, requiring the lender to honor a hotel management agreement upon the lender's taking of title. Depending upon the impact of the hotel management agreement to the value (positive or negative) of the hotel, lenders are well-advised to seek legal counsel to address issues concerning the hotel management agreement well before commencing and completing a foreclosure sale on the hotel.

Anti-deficiency rules

The main purpose of the anti-deficiency rules is to place the risk of overvaluation and inadequate security on lenders who stand to profit directly from the loans they make. The One Action Rule together with the fair value and anti-deficiency rules are designed to protect borrowers from being taken advantage of by lenders and require lenders to rely on property values. Thus, if the proceeds from the sale of real property are insufficient to cover the debt, the lender's right to a deficiency judgment may be limited or barred under one or more of these statutes. This statutory scheme works against a creditor who wants the liberty to choose between enforcing a security interest through foreclosure or to avoid the anti-deficiency statutes and sue on the underlying debt.

No deficiency after a non-judicial sale – CCP §580d

"No judgment shall be rendered for any deficiency upon a note secured by a deed of trust...in which the real property...has been sold by the...trustee under power of sale contained in the...deed of trust."

The law is designed to prevent a creditor from underbidding at a non-judicial foreclosure sale, thereby maximizing a deficiency to be recovered in later action. §580d only refers to a "note" secured by mortgage or deed of trust. Thus, arguably, a deficiency judgment may be obtained after a non-judicial foreclosure sale where the obligation is evidenced by other than a note. However, California courts have applied §580d even when a note was not involved.

Thus, the trade-off for a lender who chooses to foreclose non-judicially on the property is surrendering any right to recover any deficiency from the debtor after a non-judicial foreclosure sale.

Unlike a judicial foreclosure, which allows a lender to pursue a deficiency judgment against the debtor, a non-judicial foreclosure limits the lender's recovery against the debtor to the value of the property.

A non-judicial sale does not, however, preclude the lender from foreclosing on other collateral, whether real or personal property, provided the lender has not credit bid (or received in the case of a third party purchase) the full amount of the debt at the foreclosure sale.

Deficiency protection for purchase-money borrowers

CCP §580b states: "No deficiency judgment shall lie...after a sale of real property...under a deed of trust...given to the vendor to secure payment of the balance of the purchase price of that real property...." Thus, CCP §580b precludes a deficiency judgment after judicial or non-judicial foreclosure of a "purchase-money" deed of trust.

A few exceptions

A foreclosed-out junior purchase-money lienholder who subordinated its lien to a construction loan may enjoy an exception to §580b. Bad-faith waste committed by a debtor may also be an exception. The 9th Circuit has found that waste due to a debtor's economic hardship was not committed in bad faith, even though the debtor diverted hotel funds to

other uses. However, in another case where a debtor diverted funds instead of paying property taxes, the debtor was found liable for bad faith waste, and the court assessed compensatory and punitive damages against the debtor.

Can borrowers validly waive the One Action Rule and Anti-deficiency rule protections?

The One Action Rule and the anti-deficiency protections are supported by strong public policy, and, as a result, cannot be waived in advance by a borrower. CC §2953. Thus, contemporaneous waivers (contemporaneous with making the loan) of the California anti-deficiency statutes (CCP §§726, and CC §§580a, 580b, and 580d) are generally prohibited both by statute on and public policy grounds. Some cases have discussed subsequent waivers of certain anti-deficiency statutes. Although, it may be possible for these protections to be waived subsequent to the initial loan (typically in connection with a workout after an event of default or in connection with a loan modification). The validity of such waivers has not been fully explored by the California courts. Many issues remain unanswered. It is important to note that waivers of the protections of CC §580b have so far not been permitted.

Can guarantors validly waive One Action Rule and Anti-Deficiency Rule protections?

The public policy protections that benefit borrowers do not extend to guarantors. CC §2856. Earlier case law has not been consistent as to what would constitute an effective guarantor waiver. Some courts allowed general guarantor waivers; others required very specific waivers. The California legislature clarified matters after the judicial decision in Cathay Bank v. Lee, 14 Cal. App. 4th 1533 (1993) by enacting (in 1994 and 1996) a specific statute which sets forth what would qualify as an effective waiver. See CC §2856(c) and (d). Most guaranties quote this statute verbatim in the waiver sections of the guaranty.

Still, lenders should remain cautious, as California courts can and do find ways to protect guarantors. For example, in Bank of Southern California v Dombrow, the court avoided awarding a deficiency judgment after the lender foreclosed on the real property security, stating the guarantor was entitled to a judicial hearing to determine the fair market value of the property as of the date of foreclosure, regardless of the amount bid at the foreclosure sale; the court also indicated that any judgment against the guarantor should not exceed the difference between the total amount of the debt and the greater of the foreclosure sale price or the fair market value of the property determined by the court.

Errant judicial decisions notwithstanding, and with few exceptions, a lender should be able to proceed against the guarantor independent of any action against the borrower, and the guarantor should not be able to hide behind the collateral and require a lender to pursue the collateral first. Still, with the complexities and unique structures presented in modern day transactions secured by real estate (e.g., structured finance and CMBS loans), there is little doubt the opportunity will continue to exist in California for further judicial interpretation and legislative refinement of California's infamous and complex real property secured transaction laws.

Don't learn the hard way

California foreclosures can be tricky for lenders, particularly when foreclosing on hotels and mixed collateral.

Foreclosures in California are subject to special statutory and judicially created rules. Lenders are well-advised to develop their strategies with these rules and the potential pitfalls in mind.

California's laws: *If you want the details, California's one action and anti-deficiency rules are set forth in California Code of Civil Procedure ("CCP") section 726, Civil Code ("CC") sections 580a, 580b, 580d, and California Commercial Code ("CCC") section 9-604.*

Feel free to contact the author for more information about the cases referenced throughout this article.

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sale of the loan to a third party; the mezzanine lender in the Vail Plaza Chapter 11 case; and the holders of various loans, repayment of which were secured by hotels located throughout the United States. He has also served as counsel to Berkadia Commercial Mortgage (formerly Capmark Financial, Inc. and GMAC), J.E. Robert Company, Inc., LNR Partners, Inc., ORIX Capital Markets, LLC, and Midland Loan Services, Inc. in their capacity as special servicers on troubled hotel loans in CMBS pools.

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The Lenders Handbook for Troubled Hotels

Essentials and Advanced Techniques - A Practical Guide

In *The Lenders Handbook for Troubled Hotels: Essentials and Advanced Techniques - A Practical Guide*, veteran hotel lawyer Jim Butler gives lenders, owners and investors the information they need to make practical decisions in the high stakes world of troubled hotel loans. Butler also provides an insightful perspective that allows all players to see how they can maximize value while making tough decisions.

Based on timely blog posts in the Hotel Law Blog, *The Lenders Handbook for Troubled Hotels: Essentials and Advanced Techniques - A Practical Guide* is a must-read for lenders, owners and investors that care about their companies and the future of the hospitality industry.

Jim Butler has been quoted as an expert on hospitality issues in The New York Times, The Wall Street Journal, Los Angeles Times, Forbes, BusinessWeek, Hotel Business, and other publications. He leads the JMBM Global Hospitality Group®, which has over 20 years experience with $71 billion of hotel transactions involving more than 3,800 properties all over the world. Its team of troubled loan veterans have dealt with more than 1,000 receiverships, bankruptcies and workouts over the years and includes handling some of the biggest real estate, timeshare and hotel assets for banks and the U.S. Government (both the FDIC and the RTC in the last great meltdown).

About Jim Butler
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Jim Butler is the author of the Hotel Law Blog (www.HotelLawBlog.com), founding partner of Jeffer Mangels Butler & Mitchell LLP (JMBM), Chairman of JMBM's Global Hospitality Group®, and Founder and Conference Chairman of Meet the Money®. Jim and his team have represented hotel lenders, owners and investors for more than 20 years. They have helped their clients find business and legal solutions for more than $71 billion of hotel transactions, involving more than 3,800 properties all over the world. JMBM's troubled assets team has handled more than 1,000 receiverships and many complex insolvency issues.