

## A cautionary tale in hotel lending

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When representing hotel lenders, the expression “forewarned is forearmed” seems especially appropriate. While there may be an abundance of lenders chasing hotel deals in Massachusetts these days, it is

important for lawyers advising hotel lenders to keep in mind that hotel loans present risks not typically encountered with other asset classes of real estate.

Hotels are “hybrid assets” that consist of both real estate and one or more operating businesses. For that reason, a smart hotel lender needs to have the right team of professionals in place, including an experienced hotel lawyer. Since the Great Recession, I have seen many distressed hotel loans that were simply not documented properly at closing. In many of such situations, the lenders involved were represented by large, well-respected law firms that simply lacked hospitality lending expertise. If you don’t typically deal with the issues described in this article, consider engaging “special hospitality counsel” or referring the project elsewhere. Your client may appreciate, and ultimately reward, your doing so.

One of the largest challenges for hotel lawyers is properly collateralizing all of the assets of the hotel, including all necessary tangible and intangible personal property. Taking a mortgage on the hotel land and building only goes so far. The lender also needs the ability to take possession and/or control (directly or through a third-party management com-

pany) of the entire hotel and all associated businesses after an event of default. With regard to personal property, a well-drafted security agreement that expressly covers all of the personal property at the hotel (including without limitation furniture, fixtures, equipment, vehicles, inventory, accounts, contracts, trademarks and other intellectual property, capital leases, general intangibles and books and records) is critical, as is the proper perfection of the security interest created thereby. There are differing views about whether hotel room revenue constitutes “rent” that may be collateralized by an assignment of leases and rents. Uniform commercial code (UCC) insurance is available from national title companies, and many lenders obtain legal opinions from borrower’s counsel on UCC perfection. However, there is simply no substitute for a lender’s counsel with a deep understanding of the UCC.

A security agreement and the associated UCC filings are really just the beginning. Many hotels are subject to a franchise license agreement (FLA) that grants the borrower the right to operate the hotel under the franchisor’s system or “flag.” The continued availability of the flag during the term of the loan is often a critical component to the lender’s underwriting. As a legal matter, most FLAs may not be collateralized. However, it is critical that a hotel lender have certain rights under the FLA, including notice and cure rights, and the right to obtain an FLA for its own benefit (either directly or through a third party manager) in the event the lender takes title to the hotel. Such rights are usually conveyed pursuant to a “comfort letter,” which is an agreement by and among the borrower, lender and franchisor.

Starting in the 1970s, there has been

a nationwide trend for hotel owners to outsource hotel operations to third-party hotel management companies, pursuant to hotel management agreements (HMAs). Although some HMAs allow for termination on short notice without large termination fees, others may continue for decades and may not have express termination rights, even in the event of a foreclosure or sale of the hotel. Thus, it is important that a hotel lender receives a commercially reasonable subordination, non-disturbance, and attornment agreements (SNDAs) from the management company. Although deals rarely fall apart over the SNDA, they are complicated agreements that should be carefully negotiated. For example, the manager may push hard for an SNDA that grants the manager what it believes to be the benefit of its bargain, i.e., the ability to, absent a default by the manager, operate the hotel without interruption for the entire term of the HMA, notwithstanding any borrower default under the loan documents or transfer of title. The hotel lender, on the other hand, may want the right to change management or alter the terms of the HMA following any borrower default.

Dealing with the above described issues can be quite a balancing act for the hotel lender. For example, consider that many lenders use a deposit account control agreement or “lock box” agreement when making hotel loans, since the only way to perfect a security interest in a deposit account under UCC § 9-314 as original collateral is through control (as defined under UCC § 9-104(a)). However, the hotel manager may insist on having access to sufficient cash to ensure that the manager can make payroll, even following an event of default under the loan documents. Surely the manager’s position

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seems reasonable given that the manager would have liability under the Massachusetts Wage and Hour Act if it misses payroll. But is the lender's security interest in the deposit account perfected if the manager has the unfettered right to make withdrawals?

The above constitute only a small number of the issues associated with hotel lending. For hotels with liquor licenses, pledges of liquor licenses in Massachusetts must be approved by the Alcoholic Beverage Control Commission before a security interest may be perfected by the lender. For hotels with equipment leases,

the hotel lender should evaluate what would happen if they foreclosed on the hotel without taking ownership of leased personal property like beds, televisions or phones systems. Financial covenants may require hospitality specific terminology, some of which is defined in the Uniform System of Accounts (the hospitality industry's version of generally accept accounting principles). Certain types of hotels may be subject to the Worker Adjustment and Retraining Notification Act and/or collective bargaining agreements, either of which can materially affect the lender. If the hotel has significant govern-

ment business, the lender may have rights under the Federal Assignment of Claims Act. Know when to call in reinforcements. In the words of one of my favorite hotel clients: "If you're not a barber, don't cut hair." ♦

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