# Key Issues in Financing Hospitality Properties

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A Practice Note discussing key issues mortgage lenders must consider when making a commercial mortgage loan secured by a hotel or other hospitality property. This Note addresses due diligence issues, loan document provisions, and closing requirements applicable to hospitality loans.

The underwriting and due diligence process for commercial mortgage loans is typically straightforward when the collateral is a stabilized property leased to office, retail, industrial, or multifamily tenants. The tenants occupy their premises under the terms of written leases. In exchange, they pay the owner rent for the use of the premises for a specified term. The lender's primary underwriting involves assessing the real estate value based on the income stream from the in-place leases and the property's operating expenses, which generally don't vary significantly from year to year. The lender takes a security interest in:

- The real estate and improvements.
- The leases.
- The rents.

A hospitality property presents a more complex underwriting scenario and therefore more risk for the mortgage lender. Hotel owners both own property and operate (or engage an agent to operate) the hotel business on the property. Because hotel businesses market individual rooms to users for short-term use, rather than having contracted long-term rents, the business is relatively volatile and cyclical. The lender must underwrite and due diligence both the real estate and the value of the hotel business, which is impacted by any franchise or management agreement with a hotel operator engaged by the borrower. The lender must also identify and obtain a security interest in all personal property used in the hotel's business. If there is a valuable franchise or management agreement in place, the lender must ensure:

- The agreement is not terminated without the lender's approval.
- The lender has the right to succeed to the borrower's interests after:
  - a default under the agreement; or
  - a foreclosure.

This Note addresses issues specific to financing hospitality properties, including discussion of:

- Types of ownership and operating structures.
- Due diligence considerations.
- Loan structuring, collateral, and document negotiation.
- Closing requirements.

For information on hospitality law generally, see Practice Note, Hospitality Law: Overview (4-583-6149).

## HOTEL OPERATING STRUCTURES

One of the first steps in the due diligence process of a hospitality loan is understanding the operating structure. Hotel owners often enter long-term relationships with third-party hotel operating or franchising companies that provide branding power and expertise in exchange for fees. Two common hotel operating arrangements are:

- Franchised hotels (see Franchised Hotels).
- Operator managed hotels (see Operator Managed Hotels).

A third model is the independent boutique, where a property or small collection of properties is owned and operated by an individual or joint venture. The owner may self-manage or hire a third party to manage the hotel. Lenders are traditionally less likely to finance boutique hotels because of their perceived lack of marketing and name recognition (see Practice Note, Hospitality Law: Overview: Independent Boutique (4-583-6149)).

### FRANCHISED HOTELS

A hotel franchising arrangement is a long-term contractual relationship under which the hotel owner operates its hotel based on a template provided by a third-party franchisor. The hotel owner, with permission from the third-party franchisor, uses the franchisor's overall business plan to achieve a concept that has proven successful in holding a market niche over time. The hotel owner benefits from the goodwill built up by the third-party franchisor.

Typical features of a franchise agreement include:

- Limits on the owner's ability to vary the business plan to meet market conditions without franchisor consent.
- Requiring the owner to open the hotel's operations and financial condition to detailed scrutiny by the franchisor.
- Restrictions on other typical rights of real estate ownership, such as the owner's transfer rights.
- Allowing the owner to retain day-to-day possession and operational control of the asset (which it may or may not delegate to a property management company), subject to compliance with the brand standards, budget, and other franchisor guidelines.

For additional information on hotel franchise arrangements, see Practice Note, Hospitality Law: Overview: Branded Franchise Arrangement (4-583-6149) and Branded Hotel Franchise Arrangement Chart (7-575-8989).

### OPERATOR MANAGED HOTELS

A hotel management agreement (HMA) is a long-term contractual relationship between a hotel owner and a hotel operating company (operator or manager) to operate the hotel business on the owner's behalf. The arrangement is normally couched as a principal-agency contract that gives the operator no legal estate or interest in the real estate (but see Operating Leases). However, the owner often cedes practically all forms of control, and even exclusive use and occupancy, of the property to the operator.

Specifically, the operator, and not the owner, may control (among other things):

- Day-to-day operations.
- Hiring and firing of employees (usually subject to owner consent for key executives).
- Capital and operating budgets (usually subject to owner approval rights).
- All intellectual property.

HMAs also impose substantial costs and expenses on hotel owners. The owner is responsible for all costs of owning and operating the hotel. The owner must also pay the operator some combination of fees, such as:

- Base fee.
- Incentive fee.
- Marketing fee.
- Centralized system fee.
- Consulting fee.

For additional information on hotel management arrangements, see Practice Note, Hospitality Law: Overview: Branded Hotel Management Arrangement (4-583-6149) and Branded Hotel Management Arrangement Chart (1-575-8992).

#### Operating Leases

HMAs are occasionally structured to give the operator a legal estate or interest in the real estate. This interest is most often a leasehold interest with the operator as the tenant under an operating lease. Hotel operating leases are generally only used in situations where the operator's ownership (or a portion of it) invests through a REIT and "bad income" concerns cause the operator to adopt the leasehold structure in which a qualified REIT subsidiary of the operator owns the hotel and a taxable REIT subsidiary leases it (see Practice Note, REITs: Overview (8-504-7098)).

Where this structure exists, the lessee is normally the counterparty to the HMA and the lender normally requires, among other things:

- The lessee to be a co-borrower and assign or pledge its leasehold estate and all of its other property (which normally includes much or all of the hotel's operational assets) as loan collateral.
- Both borrowers to make appropriate representations about the operating lease and covenant not to amend, surrender, or terminate the lease and to pay and perform their respective obligations (with appropriate default and recourse triggers).
- Lease default notice and cure rights and other self-help rights in favor of the lender.
- Subordination of the operating lease and all related liens, payment rights, and other rights to the mortgage liens, loan repayment obligations, and other loan provisions.

## DUE DILIGENCE

There are certain unique aspects of a hotel financing that must be reviewed by the lender and its counsel in due diligence. These include an analysis of:

- Any franchise agreement or HMA (see Franchise and Management Agreements).
- Licenses and permits (see Licenses and Permits).
- Employment issues (see Employment Issues).

### FRANCHISE AND MANAGEMENT AGREEMENTS

The lender must identify any provisions in the HMA or franchise agreement that are adverse to the lender's interests both when the loan is performing and if the loan defaults and the lender succeeds to ownership. The franchise or HMA must be reviewed to determine:

- Its business terms and impact on the financial performance of the property and to confirm the lender's underwriting.
- If the borrower defaults under the loan, the lender's ability to:
  - exercise its remedies; and
  - keep or terminate the franchise or HMA.

A standard due diligence and closing requirement that lenders rely on to confirm the terms and status of the HMA or franchise agreement is an operator estoppel certificate (see Operator Estoppels).

The following terms in a franchise or management agreement are important for lender's counsel to review:

- **Fees.** The fees paid by the borrower under the agreement should be market rate. This is of particular importance where an operator under an HMA has control of the cash flow and pays itself fees. Also, any incentive fees paid to the operator under an HMA should be based on net profits, not gross revenues. Incentive fees based on gross revenues can result in a misalignment of incentives and negatively impact net profit.

- **Term.** The term of the agreement should extend beyond the loan term. If there are extension options, the extension conditions should be reviewed to determine if they are reasonable and likely to be satisfied.
- **Financing rights.** The agreement may contain restrictions on the owner's mortgage financing, such as the loan amount or identity of the lender. For example, it may require the lender to be institutional or not be a competitor of the operator. Franchise agreements also typically prohibit the granting of a security interest in or other collateral assignment or pledge of the franchisee's interests or rights in the agreement. These issues are typically mitigated from the lender's perspective in agreements with the operator (see SNDAs) or franchisor (see Comfort Letters).
- **Transfer restrictions.** Any restrictions on the owner's right to terminate or retain the HMA or franchise agreement on a sale of the property must be analyzed. HMAs are long-term contracts and are only occasionally terminable on a sale of the hotel (and then only on payment of a large termination premium). The hotel owner who wants to sell the hotel free and clear of the HMA may have limited ability to do so, and there may be a limited pool of potential purchasers willing to purchase the property subject to the HMA. Conversely, a franchise agreement is typically not assignable to a purchaser and requires a new owner to apply for a new franchise. The lender must address these issues before closing the loan to ensure the property retains the value the lender ascribes to it under the existing operating agreements and the loan can be repaid at maturity or the lender can sell the property in a foreclosure. The lender typically enters into a subordination, non-disturbance, and attornment agreement (SNDA) with the manager under an HMA (see SNDAs) or a comfort letter (sometimes called a tri-party agreement) with a franchisor (see Comfort Letters) that addresses the lender's rights in a default scenario.
- **Preferential rights.** Owners sometimes negotiate for a right to sell the hotel unencumbered by the HMA and have a termination right in that circumstance. Some HMAs give the operator a preferential right of first refusal (ROFR) to purchase the hotel as an alternative. If the operator has a ROFR, the lender needs the operator to acknowledge that no preferential rights will be triggered by any foreclosure or deed in lieu, nor by the next following transfer (see SNDAs). Similarly, many franchise agreements contain a ROFR or termination right in favor of the franchisor if the owner proposes to sell the hotel (or a controlling entity-level interest in the owner) to a competitor of the franchisor. The lender needs the franchisor to acknowledge that no preferential rights will be triggered by any foreclosure or deed in lieu, nor by the next following transfer (see Comfort Letters).
- **Termination rights.** Any termination rights of the operator, the franchisor, or the borrower under the agreement should be identified and addressed in an SNDA or comfort letter (see SNDAs and Comfort Letters). Termination rights should be available to both parties in an HMA for a material default by the other party after customary cure rights. The lender should also confirm the borrower has the right to terminate the operator under an HMA based on performance tests if the operator fails to properly manage the hotel. These performance standards are usually both:
  - qualitative, which may take the form of a covenant to act reasonably and prudently with a view to maximizing long term profitability and value; and
  - quantitative, which most commonly allows the owner to terminate the HMA if the hotel fails to achieve a specific percentage of both budget and average competitive set RevPAR.

  Owners with significant negotiating leverage sometimes obtain the right to terminate the HMA without cause, either at will or on a sale of the hotel, often following a specified holding period (usually seven to ten years). This is normally subject to payment of liquidated damages based on the fees payable over the remaining term absent the termination.
- **Non-competition.** A key element of a lender's due diligence is confirming that the operator or franchisor cannot materially interfere with the success of the hotel by having interests in competing hotels. This limit on competition is typically embodied in a non-compete or radius clause, which sets a radius (or other geographical zone) around the hotel within which the operator or franchisor may not:
  - manage competitive hotels;
  - grant other competitive franchises; or
  - otherwise carry out competing business.
- **Reserve/PIP requirements.** The lender should confirm the borrower's obligations under the HMA or franchise agreement to:
  - maintain reserves for capital improvements or furniture, fixtures, and equipment (FF&E); or
  - complete future property improvement plans (PIPs).

  The lender should account for these obligations in its underwriting and ensure they are properly funded in loan reserves (see FF&E and PIP Reserves).
- **Governing law.** Operators want operator-friendly Maryland law to govern HMAs. Owners and lenders want New York or Florida law to control. Notably, Maryland has bucked a trend in some other states to allow HMA termination by owners without cause in spite of the HMA's provisions to the contrary (but subject to the operator's ability to seek damages at law for termination) based on agency law principles (see Md. Code Ann., Com. Law § 23-102(a); *IHG Management (Maryland) LLC v. West 44th Street Hotel LLC*, 2018 WL 1730843 (N.Y. Sup. Ct. 2018), *aff'd* 81 N.Y.S.3d 401 (1st Dep't 2018)).

### LICENSES AND PERMITS

Hospitality properties often provide amenities for their guests that may require specialized licenses or permits, such as:

- Restaurants.
- Bars.
- Casinos.
- Spas.
- Pools.
- Banquet facilities.

The lender must confirm:

- That all required licenses and permits are in effect.
- Which party holds each license and permit. For example, liquor and gaming licenses are often issued in the operator's name rather than the owner's name. In that case, the borrower often leases the bar or casino to the operator to comply with legal requirements.
- Whether (and how) each license and permit can be assigned to the lender as collateral and on foreclosure.

These questions are jurisdiction-specific and it may be necessary to consult with local counsel.

#### EMPLOYMENT ISSUES

Because a hotel is an operating business, there are employees on the property and employment issues the lender must consider. Employees are often employed by the operator or manager and, in practice, are almost always controlled by the operator. Employee compensation is always an expense borne by the owner. Where the operator is the employer, the owner normally has approval rights over the general manager, department heads, and sometimes other key employees.

The owner is typically responsible for and indemnifies the manager from any liabilities that may be incurred in connection with the employees, except to the extent caused by the manager's gross negligence or willful misconduct.

If the borrower employs a large staff at the hotel, the lender needs to evaluate:

- The borrower's liabilities (current and potential, funded and unfunded) for employee benefits, including:
  - pension plans;
  - vacation pay;
  - sick pay; and
  - medical benefits.
- If it should require reserves for these employee benefit expenses.

The marketability of a hotel in a foreclosure sale may be improved or worsened by the number of employees and the type and terms of their employment. These matters and the level of flexibility to change them if desired are important to evaluate as part of the lender's due diligence process.

If a collective bargaining agreement is in place, it usually survives foreclosure, meaning that the purchaser assumes all accrued pension obligations. This can be a substantial liability.

The Worker Adjustment/Retraining Notification (WARN) Act (and state law equivalents) require that if the number of employees exceeds a threshold, they must get advance notice of hotel closure or significant levels of redundancies (see Practice Note, Worker Adjustment and Retraining Notification (WARN) Act: Overview (4-501-6503)). This can among other things delay a foreclosure sale.

### LOAN STRUCTURE AND DOCUMENTS

When documenting a hospitality loan there are specific provisions that should be incorporated in the loan documents to protect the lender and address this unique property type.

#### COLLATERAL

Because of the nature of hospitality properties as operating businesses, they include several types of valuable personal property. These include:

- The HMA or franchise agreement.
- The borrower's rights in intellectual property, such as:
  - tradenames;
  - trademarks;
  - service marks;
  - logos; and
  - copyrights.
- FF&E.
- Inventory items.
- Tangible personal property.
- Amenities, such as golf, tennis, ski, swimming, or spa facilities.
- Licenses and permits.
- Room bookings.
- Employment contracts.
- Timeshare contracts and club memberships.

A lender must ensure all the personal property is included in its collateral description and it has a properly perfected security interest in the collateral (see Practice Note, UCC Creation, Perfection, and Priority of Security Interests (6-381-0551)). The mortgage granting clause is usually expanded to include a description of each category of collateral. Schedules should also be attached to the loan agreement as necessary to clearly identify the collateral.

Some borrowers lease certain items of FF&E rather than own it. In that case, the leases must be assigned to the lender as part of its collateral and the lessor must agree to give the lender specific rights relating to:

- Notice and cure for borrower defaults.
- Assumptions.
- Termination rights.

The borrower's rights in intellectual property of a branded franchised or managed hotel is governed by the terms of the HMA or franchise agreement. In those cases, the borrower does not own any rights in the brand's intellectual property but typically has limited rights to use the brand's names and logos subject to the terms of the applicable agreement. The lender should obtain a security interest in all rights the borrower holds.

#### LENDER RIGHTS

Any HMA or franchise agreement should be included in the loan agreement's definition of a "Major Contract," giving the lender the approval rights and other protections usually associated with the term. Block room reservation arrangements may also merit major contract status.

Where possible the lender should have a right to require the borrower to terminate the HMA or franchise agreement if a substantial default by or the bankruptcy of the franchisor or operator occurs.

### BORROWER REPRESENTATIONS

Several hotel-specific borrower representations should be included in the loan documents. These include representations regarding:

- **The HMA/franchise agreement.** The borrower should represent that it has delivered a complete copy of the agreement to the lender, the agreement is in full force and effect, and regarding the status of:
  - amendments;
  - defaults;
  - PIP requirements; and
  - quality assurance scores.
- **Employees.** The borrower should represent whether the hotel's employees are employed by the borrower, the hotel operator, or an operating tenant. The borrower should also represent regarding the existence and status of any (and that the lender has been given complete copies of any):
  - collective bargaining or other labor agreements;
  - employment contracts;
  - profit sharing or stock option or other incentive arrangements; and
  - pension plans, fringe benefit plans and the like.
- **Licenses and permits.** The borrower should represent that all licenses and permits (including liquor licenses) necessary to operate the hotel are in force and whether these licenses are held by the borrower, a manager, or an operating tenant. The borrower should also represent that the lender has been given complete copies of all licenses and permits.

### BORROWER COVENANTS

Affirmative and negative covenants relating to the borrower's operation of the hotel are critical to protect the lender's security. Customary covenants that should be incorporated in hospitality loan documents include:

- **Hotel operation.** The borrower should covenant generally to cause the hotel to be operated, repaired, and maintained to provide amenities, facilities, and services substantially equivalent to those at hotels of similar average room rate and targeted market segment operating in the same or comparable geographic area, with inventory sufficient to do so at full occupancy.
- **HMA/franchise agreement.** Loan covenants specifically relating to the HMA or franchise agreement generally track those applicable to property management agreements. For example, the borrower should affirmatively covenant (both for itself and on behalf of any property manager):
  - to cause the hotel to be operated under, perform and observe the covenants in, and to otherwise comply with the agreement and keep its rights under the agreement unimpaired;
  - to notify the lender of any default under the agreement;
  - to give the lender copies of all notices, business plans, capital expenditure plans and budgets, financial statements, and the like under the agreement;
  - to enforce the counterparty's obligations;
  - to exercise any extension options at the lender's direction;
  - not to surrender, terminate, cancel, extend, or otherwise modify the agreement;
  - not to enter into any new agreement regarding the subject matter of the agreement;
  - not to consent to the assignment of the manager's or franchisor's obligations; and
  - not to waive or release any of its rights and remedies under the agreement.
- The borrower should also covenant to replace any terminated or expired HMA or franchise agreement with a new one, in form and substance acceptable to the lender, with a reputable and appropriately experienced replacement franchisor or operator. Any replacement should be conditional on the lender's receipt of a satisfactory collateral assignment of the new agreement and a new consent and subordination agreement from the operator or appropriate comfort letter or tri-party agreement from the franchisor.
- **Licenses and permits.** Hotel loan agreements typically require the borrower to maintain (or cause the license holder to maintain) all licenses in effect or to be continuously renewed, with copies delivered to the lender. The loan agreement should also provide that if an event of default occurs, the borrower must take all actions necessary to transfer the licenses to the lender if local law permits or else to enter into permissible interim management, leasing, or other arrangements to enable the lender to continue operations. A power of attorney in favor of the lender is often granted to help ensure the desired outcome. If the liquor licenses are held by a borrower affiliate, that affiliate should enter into a liquor license cooperation agreement providing for the same outcome.

### RECOURSE

Most mortgage loans secured by stabilized properties are nonrecourse to the borrower, except for specified nonrecourse carveouts known as "bad boy" acts (see Practice Note, Negotiating Nonrecourse Carveout Guaranties in Commercial Real Estate Loans (2-521-0515)). There are additional nonrecourse carveouts for a hospitality loan that a lender should consider.

Any hotel loan agreement should provide a nonrecourse carveout for losses resulting from the borrower's default under the HMA or franchise agreement. An exception is appropriate where the default occurred because the lender improperly failed to release funds reserved to pay PIP costs (or, absent these reserves, if the default occurred because of cash flow shortfalls or because the lender refused to waive a loan covenant that conflicts with the HMA or franchise agreement provision at issue).

Loss recourse may also be appropriate where:

- The property fails to have a valid liquor license.
- The borrower fails to cooperate with reasonable lender requests to transfer liquor licenses following a foreclosure or deed in lieu.

The same result should apply if a borrower affiliate breaches the key provisions of any liquor license cooperation agreement.

Loss recourse is also sometimes imposed for:

- Any unpermitted amendment of an HMA or franchise agreement.
- Any expense (including new PIP costs) related to replacing an HMA or franchise agreement.

### TRANSFERS

Any transfer rights of the borrower in the loan documents should be conditioned on non-contravention of the HMA or franchise agreement and liquor licenses, all of which must remain in full force and effect after giving effect to the transfer, unless a replacement satisfactory to the lender becomes effective.

### SEASONALITY RESERVE

Because the hotel business fluctuates over the course of a year, the lender often imposes a seasonality reserve. A seasonality reserve aims to cover debt service and operating expense shortfalls in the hotel's low season by appropriating a fixed monthly amount of excess cash flow in high season, held in a reserve for that purpose. If the HMA provides for a seasonality reserve, the lender normally does not require its own seasonality reserve unless the HMA's reserve is considered inadequate.

Seasonality reserves may be initially funded in a lump sum at loan closing and later replenished from excess cash flow in monthly installments during high season. The aggregate amount in the reserve at the transition point from high to low season should equal the aggregate amount of the monthly current cash flow shortfalls to fund debt service that are expected to occur over the course of the low season, plus a cushion (often 15% of the aggregate expected shortfall). The borrower may persuade the lender to reduce the cushion percentage or to accept a whole-dollar cap on the seasonality reserve.

When monthly shortfalls occur in low season, funds in the reserve are typically released in accordance with a priority waterfall, such as:

- First, to fund monthly debt service then coming due.
- Next, to fund reserve payments then coming due.
- Last, to fund operating expenses then coming due.

The borrower remains responsible to fund from equity all amounts due to the extent that the seasonality reserve is insufficient to do so. The lender may require that the borrower's failure to make a monthly seasonality reserve replenishment payment triggers an excess cash trap.

### FF&E AND PIP RESERVES

A hotel's ability to remain competitive depends on maintaining its appearance and making periodic upgrades. HMAs usually require the owner to maintain or fund an FF&E reserve ranging from two to five percent of gross monthly revenues. Franchise agreements typically require the owner to implement periodic PIPs during the term of the agreement.

The lender should structure loan reserves to ensure funds are available for these capital improvement and replacement requirements. Lenders sometimes waive FF&E reserves if the hotel manager holds sufficient reserves.

If the loan is financing the conversion of the hotel from one flag to another, higher-grade flag, the capital improvements mandated by the incoming franchisor's PIP may be so extensive that the loan takes on characteristics of a construction loan, with a large holdback being disbursed over time under a lender-approved schedule and budget to fund the upgrades.

Borrowers want reasonable reserve disbursement procedures so they can timely comply with the HMA or franchise agreement.

### REPORTING

In addition to the lender's customary financial reporting requirements, there are specialized hotel reports that should be incorporated into the loan documents. These include:

- Smith Travel Accommodation Reports (STAR).
- Franchise inspection reports.
- Notices of noncompliance with brand standards.
- Occupancy reports.

The borrower's annual budget should include projections of:

- Daily room rates.
- Occupancy rates.
- Monthly FF&E expenditures.

Reports should be required monthly because of the transient nature of the hospitality business. Financial statements should be prepared based on the Uniform System of Accounts for the Lodging Industry, an accounting system for the hospitality industry.

### CASH MANAGEMENT

An HMA typically gives the operator initial control of the revenues, which it uses to pay itself fees and fund reserves that it requires. As a result, the lender has the ability to perfect a security interest only in the cash remaining after the operator has used much of it for those purposes.

The lender needs the operator to agree to release the balance of the cash directly to the lender's controlled account. The lender normally permits (and requires) the borrower to set up an operating account, a payroll account, and reserve accounts. The lender may require that the operating account be a secure lockbox account, either:

- From the date of the loan closing.
- Commencing on a negative financial event or loan default.

The lender should ensure that all accounts are held at a bank that is acceptable to the lender and that all accounts are collaterally assigned to the lender, with properly perfected security interests and sufficient lender controls.

While the loan is in good standing, the borrower (or operator) is normally authorized to pay budgeted operating expenses from the operating or reserve accounts, subject to a payment priority waterfall (which may be the one established in the HMA, if it is acceptable to the lender).

Hotel loans with springing cash sweep and cash management arrangements typically include among the triggers:

- The borrower's failure to fund any required seasonality reserve replenishment payment.
- Any default notice given to the borrower under the HMA or franchise agreement.

The related cash sweep/cash management periods then normally end on a cure of the relevant default.

A typical operating account waterfall prioritizes payments in this order:

- Employee payments.
- Tax and insurance reserve deposits.
- License and permit fees and taxes.
- Budgeted operating expenses.
- Any unsubordinated component of the operator's fees.
- Loan debt service.
- Any subordinated component of the operator's fee (including the incentive fee).
- Payments on account of contracts with borrower or operator affiliates.
- Any remainder to the borrower.

Hotel loan cash management waterfalls should provide for prompt release to the borrower of any sales and use taxes that have been paid over to the lender, as these amounts are not considered property of the borrower but property of the taxing authority. The waterfalls also provide for the replenishment of any seasonality reserve that may be below its cap (see Seasonality Reserve).

For additional information on cash management for hospitality loans, see Practice Note, Cash Management for Commercial Real Estate Loans: Box, Cash Management for Hospitality Properties (8-595-5927).

### EVENTS OF DEFAULT

Several hotel-specific events of default are typically set out in the loan documents, generally tracking breaches of the hotel-specific representations and covenants. For example, a hotel loan agreement should provide that an event of default exists if:

- The HMA or franchise agreement is modified without lender consent.
- A borrower default under the HMA or franchise agreement triggers a right on the part of the counterparty to terminate the agreement (or to exercise certain other rights or remedies).
- The liquor licenses are not in full force and effect.

## CLOSING DELIVERIES

With a hospitality property, a key factor in the hotel's operation and value is the hotel brand and management. This is why the franchise agreement and HMA are of critical importance to the lender in its underwriting and due diligence. The lender also wants to ensure that these agreements remain in place throughout the term of the loan, or at the lender's option, after a foreclosure.

To protect against the potential loss of the hotel brand or management, lenders typically require the following closing deliveries:

- A comfort letter if the property operates under a franchise or license agreement (see Comfort Letters).
- An SNDA if the property operates under an HMA (see SNDAs).

### COMFORT LETTERS

A comfort letter is an agreement between a lender and a franchisor that lets the lender:

- Exercise self-help if necessary to preserve the franchised rights.
- Continue to operate under the hotel's brand name during receivership or post-foreclosure or other acquisition of the property by the lender.

Key rights that a lender seeks to negotiate in a comfort letter include:

- The franchisor's consent to the borrower's collateral assignment of the franchise agreement to the lender.
- The franchisor agrees to give the lender notice of borrower defaults under the franchise agreement and an extended opportunity (but not the obligation) to cure the default before the default becomes a basis on which the franchisor may terminate the franchise agreement.
- The franchisor agrees not to assert against the lender any borrower defaults under the franchise agreement which by their nature are personal to the borrower and not curable by the lender.
- The franchisor agrees not to modify or terminate the franchise agreement without lender consent.
- The franchisor agrees to waive or reduce termination fees in connection with a termination of the franchise agreement by the lender.
- The franchisor allows the lender to change the manager.
- If the lender takes title, the lender may elect to succeed to the borrower's interest in the franchise agreement or to be granted a new agreement, in each case without paying any fee to do so.
- The franchisor agrees to waive or reduce application fees in connection with an application for a replacement franchise agreement by a third-party purchaser after foreclosure.

For additional guidance in negotiating comfort letters, see Practice Note, Negotiating Comfort Letters in Hotel Loans (W-010-7368).

### SNDAS

An SNDA is a complex agreement negotiated among the hotel owner, the hotel manager, and the lender. An SNDA:

- Subordinates the HMA to the mortgage, including the payment of certain fees under the HMA.
- Allows the lender to exercise rights in connection with the HMA after an owner default under the loan documents or the HMA.

A key negotiating point in an SNDA is the lender's right to terminate the hotel manager if a borrower default occurs under the loan documents. In that case, the lender wants the option either to:

- Continue the HMA and keep the services of the manager in place. This keeps hotel branding, reservations systems, and management in place.
- Terminate the HMA and replace the manager without liability for termination fees. The lender may also want later purchasers to have the right to terminate the management agreement, but some managers do not agree to this and want any new owner after foreclosure to recognize the manager. Large national operators sometimes also require that the lender be responsible for:
  - all termination fees contemplated by the HMA; and
  - working capital needs going forward.

The lender typically negotiates to include several other rights in the SNDA, such as:

- The manager specifically agrees that the loan and the lender both comply with the HMA's requirements (or that the manager waives compliance).
- The manager agrees to give the lender notice of borrower defaults under the HMA and an extended opportunity to cure the default before the default becomes a basis on which the manager may terminate the HMA.
- The manager agrees not to amend the HMA without the lender's consent.
- If the HMA gives the manager a preferential ROFR to purchase the hotel, the manager acknowledges that the ROFR is not triggered by any foreclosure or deed in lieu, or by the next following transfer.
- The lender has budget approval rights.
- Cash management rights (see Cash Management).

### OPERATOR ESTOPPELS

Given the importance of the HMA or franchise agreement to the hotel's value and the lender's underwriting, a standard closing delivery and due diligence item is an estoppel certificate from the hotel operator or franchisor. It is also customary to require an estoppel as a condition to any loan extension or future loan advance. The estoppel typically confirms that:

- The owner has paid all fees and other sums due or otherwise payable by the owner in connection with the hotel.
- The owner is not in default under the agreement.
- The operator or franchisor has not delivered any termination notice to the owner.
- The operator or franchisor has no offsets, counterclaims, or defenses to enforcement of the agreement.
- The operator or franchisor has not assigned its rights under the agreement.

In many cases these statements are included in the comfort letter or SNDA rather than in a separate estoppel certificate.