

# Five things that players in the hotel industry can do until the recovery

Much ink has been spilled lately about how bad conditions have become in the hotel industry. No one seems ready to say that the bottom has been reached, perhaps remembering the grave-robbing scene in Young Frankenstein where Marty Feldman tries to console Gene Wilder by saying "it could be worse...it could be raining," right before a downpour drenched the both of them. While waiting for the rain to end, however, players in the hotel industry could:

**1. Improve The Standard Documents:** There is nothing quite like an economic downturn for pointing out areas for improvement in the documents which govern the critical relationships surrounding a hotel. Since your hotel lawyer is not as busy as he or she used to be doing your transactions, it is likely that he or she would welcome the opportunity to assist you in the creation of state of the art form documents. Many top-notch firms are increasingly willing to entertain creative billing arrangements and are already hard at work improving their own form files in anticipation of the inevitable recovery. By engaging the firm to do work at what might otherwise seem the least appropriate time, you gain the benefit of work that in many cases is already being done by the firm for other clients or for itself. If you plan to stay in business, there really is no better time to do housekeeping.

**2. Form A Service Alliance:** A hotel is an operating business inside a large and complicated piece of real estate. More than one professional discipline must frequently be brought to bear to sort through any issues. Hospitality lawyers, feasibility analysts, appraisers, asset man-

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ers, brokers, development consultants, management companies and construction project managers with long-standing strategic relationships are increasingly marketing their services as part of a formal alliance of service brands. Such an alliance demonstrates to a prospective client the capacity to deliver integrated solutions, involving relevant providers where appropriate. From the perspective of an embattled lender or equity investor new to the world of hotels, this could look very much like a life preserver.

## ISSUES & PERSPECTIVES

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**3. Buy The Debt:** If you own a hotel and closed a loan within the last few years, your hotel is likely worth less than your outstanding loan balance and you may soon not only have "technical" debt service coverage or loan to value covenant defaults on your hands, but also may be unable to pay actual debt service in full. Some comfort may perhaps reside in the loan's being non-recourse. At least you don't have to feed a failing situation. That said, in better times, you were very happy to own this hotel. Rather than simply toss the lender the keys and walk away, you could obtain one or more proposals for third party refinancing of the hotel. Such proposals are difficult, but not impossible, to obtain. The most important purpose served by

revenue from management fees is the icing on the cake if you are also playing a management role. Before undertaking any of the actions dis-

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cussed in this paragraph, you will need to conduct a careful review of the non-recourse "carve-outs" in the loan documents and speak to your tax advisor regarding any potential adverse income tax consequences.

**4. Wait Until Tomorrow:** If you are a lender confronted with a borrower making a proposal of the kind discussed in the paragraph above, you have another alternative: say "no" and wait for conditions to improve. Many lenders seem to be adopting the wait and see approach through deliberation, simple paralysis or the not unreasonable conclusion that things are bound to get better with time. Unless you are convinced that the hotel's distress could be mitigated by a change of management or the borrower is a crook, your best bet is usually to leave the existing borrower/manager in place. Of course, you may not feel that you know enough to make the distinction or determine whether the borrower has a hand in the till, in which case, see item 2 above. So long as the borrower is turning over all of the net cash flow, the waste and misapplication non-recourse "carve-outs" in your loan documents will likely be enough of an incentive for the borrower to continue active management of the hotel on your behalf, despite any threats to the contrary. Additionally, while the borrower may not have

personal liability for the repayment of your loan, it may have been required to offer meaningful recourse to an entity with assets under the

franchise agreement in order to get the hotel flag. If so, the borrower is not likely to risk tossing you the keys to the hotel if it could face exposure for franchise termination fees. Even if you know or suspect the borrower isn't going to walk away, don't get greedy. Be careful what you do under any cash management agreements if your borrower cannot meet debt service. If you

scoop cash to pay yourself and put the borrower in the position of not being able to meet payroll for hotel employees or brand requirements under a franchise agreement with the hotel flag, be aware that you may have voted to close the hotel. Payroll exposure for the borrower at a significant hotel could be large enough to require even the most responsible borrowers to cease operation. The borrower/manager has to meet payroll for hotel employees, with potential criminal liability for failure, whether or not you let the borrower have the necessary cash. If you think the hotel should stay open and that the borrower remains your best bet, don't raid the payroll to pay debt service and don't expect the borrower to work for free. A reasonable management fee under those circumstances is a legitimate operating expense.

**5. Get A Brand Of Relief:** Believe it or not, most of the major hotel brands have demonstrated a willingness to work with franchisees having cash flow problems. So long as the brand is comfortable that the franchisee's distress arises from general market conditions, rather than from any particular failing on the franchisee's part, the brand will usually be willing to entertain proposals to defer fees, modify PIP requirements, or take other steps to give the franchisee some near term relief. Smart brands have allied with their owners as never before to help them weather the storm. Those brands deserve credit for recognizing that the long term interests of their shareholders are best served by such actions.

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## About this month's author

*Kenneth MacKenzie, a director at Goulston & Storrs, is a member of the firm's Hospitality & Recreation and Real Estate Groups. MacKenzie represents institutional investors, private equity funds, investment managers, pension funds, university endowments, REITs, major lending institutions and developers in the acquisition, financing and disposition of all classes of real estate assets both nationally and internationally.*

*MacKenzie specializes in transactions involving hospitality assets and has significant experience in large-scale joint-ventured deals, often involving non-profit institutions such as universities or hospitals. He frequently assists clients in structuring their responses to RFPs for complex mixed-use projects.*

*MacKenzie received his A.B. from Dartmouth College and his J.D. from Boston University School of Law, where he graduated magna cum laude. MacKenzie is admitted to practice law in the state of Massachusetts.*