BEYOND THE BASICS: HOW TO DEAL WITH TROUBLED LOANS ON SPECIAL PURPOSE REAL ESTATE ASSETS WITH OPERATING BUSINESSES

Hotels, Casinos, Entertainment Parks, Senior Living Facilities, Franchised Gasoline Stations, Convenience Stores & Restaurants

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THE PIPELINE BEGINS TO FILL

After unprecedented years of economic expansion, our teetering economy was shoved rudely toward recession by the September 11, 2001, terrorist attacks. In the immediate aftermath, more than 100,000 people were laid off by the airlines and travel was down by more than a third. The travel, tourism, and lodging industries were hardest hit. One respected national firm predicted the worst performance for the hotel industry in 33 years. Most hotel stocks lost between 20 percent and 70 percent of their value in the first week of trading after the attack. Many hotels and restaurants watched their business fall by 40 percent or 50 percent. Conventions, meetings, and vacations were canceled or postponed.

Another major national hotel consulting firm agreed that recent declines in the revenue per available room, a common measure of hotel profitability, showed the biggest drop in the 80 years the firm has been tracking the industry. It also analyzed the financial statements of more than 3,300 hotel financial statements in its database and in late 2001, the firm predicted that the number of hotels unable to generate sufficient cash to meet debt service would rise from 16.4 percent in 2000, to 20.9 percent in 2001, and to an astounding 36.5 percent in 2002.

Prior to the events of that fateful September, many lenders' pipelines were starting to see a flow of troubled real estate loans—particularly those loans secured by hotels, casinos, entertainment parks, senior living facilities, franchised gasoline stations, convenience stores, restaurants, and other special purpose real estate associated with operating businesses. Now the pipelines are starting to fill with such loans gone sour.

This article will provide a brief reminder to lenders about the basics of working with troubled loans, and then it will quickly go beyond those fundamentals to discuss some of the unique issues and problems encountered in dealing with troubled loans on special purpose real estate assets with operating businesses.

QUICK REVIEW: BASIC DO's-AND-DON'Ts OF WORKING WITH TROUBLED LOANS

The 1980s and 1990s saw an explosion of troubled real estate loans and specialized lender teams to handle them. The ensuing years saw veteran workout teams clean up the mess and ultimately disband, as troubled loans all but disappeared. While each lender tended to have its own name and acronym for the troubled loan department, most lenders recognized the need for a special assets group or "SAG" to handle the problems presented by troubled loans. Savvy lenders also realized that workouts take time, and that line officers who spend time on workouts can't spend that time generating new deals.

These lenders focused on prevention, monitoring, and early detection. At the first signs of trouble, they brought the SAG into the picture or transferred responsibility to the SAG. They recognized that information is powerful and constantly updated critical information about the loan, the collateral, and the borrower. They analyzed their options in light of clearly defined goals and policies. They developed a game plan for each asset and they stuck to it. And having been burned by lender liability claims, they used pre-workout agreements and team members knowledgeable about lender liability matters. They also knew that complete documentation of any deal was essential. We have summarized these fundamentals in the "Basic Do's-and-Don'ts" set forth in *Appendix 1*.

WHAT MAKES SOME SPECIAL PURPOSE ASSETS DIFFERENT?

Special purpose real estate assets associated with operating businesses present unique problems. The pipelines of lenders and special servicers are filling with troubled loans secured by such hotels, casinos, entertainment parks, senior living facilities, franchised gasoline stations, convenience stores, restaurants, and the like. Each of these assets involves 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 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 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?

Or, to use another common example of loans secured by gasoline stations with franchised restaurants and convenience stores, it may be easy enough to renegotiate gasoline supply agreements, but what is the value of a Burger King or Del Taco restaurant that loses its franchise, jeopardizes its ground lease, and faces default under its franchise agreement and other contracts?

USING A HOTEL EXAMPLE

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 the hotel loans. 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.

When you drive by a hotel and see a big red Marriott sign on top, the chances are great that 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. But it is fairly unlikely that Marriott owns the property or a significant interest in it. 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 arrangement.

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-operator 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.[1]

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 leases that provide access to hotel guests for 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, marinas, 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, and 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.

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.

Special purpose real estate assets associated with operating businesses present unique problems. The pipelines of lenders and special servicers are filling with troubled loans. Each of these assets involves 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.

THE PRACTICAL IMPACT: SPECIAL PURPOSE ASSETS MEAN SPECIAL PROBLEMS

All the basics of troubled loans summarized in *Appendix 1* still apply to the special purpose assets we are focusing on. One need only add the overlay that the operating business creates. Without repeating the basic principles, we can continue using the example of a troubled hotel loan and focus on what is different, beginning with the first principle—prevention.

Prevention

Initial underwriting includes focus on brand, operator, terms of management and franchise agreements and borrower's track record. It also requires a market analysis and use of consultants and counsel experienced in hospitality matters, because the hospitality industry has its own unique standards, norms, customs, and players. Lenders should use professionals familiar with the industry who can apply a checklist approach to hospitality financing, like the Hospitality Investment Task List or HIT List® developed by the authors' firm and published by the Educational Institute.[2]

With hotel loans, there are at least four categories of issues that lenders don't usually encounter with traditional real estate loans such as those on their office buildings or apartment houses. These

Basic Do's-and-Don'ts of Working with Troubled Loans

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. 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 signs of trouble appear, the troubled asset group should be consulted at an early stage, even if the project stays in the hands of the loan servicing department.

3. Use a Special Assets Group for Troubled Assets. Whatever the name and acronym,[1] 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 special 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. Information Update. The SAG, 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, and evidences of advances, notices, a complete written history of the loan should be prepared. When the history is compiled, care should be given to protect as much as possible from discovery if you choose litigation so that any candid descriptions of problems and proposed solutions to such problems will not be a part of the evidence at trial. 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.

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 "drive-by" or 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 SAG 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

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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 work-out or restructure of the loan, seek a receiver, initiate foreclosure or initiate involuntary bankruptcy proceedings.

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 blue print 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 for 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 to 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 that 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 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 agreement should: 1). provide that only amendments in writing have any effect; 2). should state that the pre-workout agreement is the entire agreement of the parties on the subject matter; 3). specify the governing law; and 4). 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 attorney's fees to be incurred by the lender in the workout would 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.

1. Specialized groups working on troubled loan assets have often had interesting names and acronyms, such as the Managed Asset Division or "MAD," the Specialized Asset Division or "SAD," and the Specialized Assets Group or "SAG."

special issues should all be addressed in the prevention stage and considered as a loan gets into trouble. They include:

1. Subordination and SNDA. Subordination agreements and SNDAs will be addressed in depth later, but many prudent lenders will require the subordination of management and franchise agreements so that in the event of a default, the lender or its successor will have the option to either reaffirm and continue the arrangement under an automatically approved assignment, or the right to terminate the arrangement if it wishes to do so. In many cases, a management agreement can add or subtract up to 25 percent of the value of a hotel.

2. "Rents vs. accounts." Hotel revenues are not the same as "rents" from other kinds of commercial real estate. As a result, a lender's security interests in the revenues of a hotel are perfected differently (requiring both a deed of trust along with a security agreement and a UCC-1 adequately describing the collateral revenue source). Hotel revenues are also subject to different treatment in bankruptcy than rents from traditional real estate, but we will talk about these issues shortly under the so-called "rents vs. accounts" topic on page 54.

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 assure access to such vital information, and may provide that a default occurs if there is deterioration in certain operations or procedures reflected in such reports.

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 overzealous 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.

Early Warning Signs

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/or other changes in the annual, budget, or marketing plans may all be early warning signs. Many prudent lenders have consultants watch their asset portfolios for significant trends and changes that indicate problems. The SAG team should become involved early in the process. But special assets generally also require availability and advice from industry-savvy consultants and counsel.

Information Update

The concept of updating all information for special 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 and Selection of Alternatives

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 SAG team, experienced hospitality lawyers, and hotel consultants. It examines the business, legal and hotel-specific factors affecting the asset—the complexities captured by the following update of what many 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."[3]

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* business.

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. The market and the property will each affect the other and 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?

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.

The SNDA—The lender's rights are often vitally affected by the terms of a subordination agreement or a common variation called the SNDA[4] 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.

This may be of great value in some circumstances. However, as many surprised lenders learned in the last downturn of the early 1990s, approximately 80 percent 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 original agreement. Alternatively, they are obligated to execute a new agreement 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 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.

"Rents vs. Accounts"—This issue here normally comes up when a hotel goes into bankruptcy. The Bankruptcy Code looks to state law for the characterization of the property and how a security interest is created and perfected. For example, you generally create and perfect an interest in real property with a mortgage or deed of trust and an assignment of rents which you record in the appropriate office, but you create and perfect an interest in personal property with a security agreement and a UCC-1 that is filed appropriately. And as lenders to operating businesses know, the filing of a bankruptcy petition cuts off even a perfected security interest in future earnings of a bankrupt business (though leaving it in place as to pre-petition receivables and inventory), but a perfected security interest in real property survives the bankruptcy petition filing. Thus it is critical to know whether your collateral is viewed as a real property interest or a personal property interest. This characterization will affect both how you create and perfect your security interest—or whether you have a perfected interest—and it will also determine whether your security interest terminates upon the filing of bankruptcy as to post-petition revenues.

As an example, say one has an office building and a hotel. Both structures and the underlying land are real property. And the security interest in the real estate is perfected by the recording of the mortgage or deed of trust and assignment of rents. But what is the revenue that is derived by the owner from each of these pieces of real estate? Rents?

It has not always been so, at least according to the courts, and even now it is not always so. Normally the revenue derived from an office building or an apartment house under leases will be treated as "rents." But one doesn't sign a lease on checking into a hotel, and, in addition to providing a room, the hotel may provide a number of services including food and beverage, telephone, parking, laundry, in-room movies, banquet facilities, golf or tennis, spa treatments, maid service, and so on. Are payments the hotel collects for the use of the room and these services really "rents" or something else?

At least one court in a case called *Drake Hotel Associates*[5] said the payments were "rents." Realizing that it was one of the few courts to take that position, the judge said that he did not care about the overwhelming number of cases to the contrary. He felt that the common-sense meaning of "rents" should characterize revenues derived from use of a hotel and its facilities. Unfortunately, there were many more cases representing the other view generally characterized by the *Northview* case[6] that held revenues from hotel rooms and these other activities were not "rents." Instead, they were some form of intangible personal property in the nature of "accounts" or receivables.

What does that mean to a lender? If the loan is secured with a typical mortgage and assignment of rents, this would create a valid security interest in the real estate under either line of cases. But the lender also wants to control the income or cash flow from the property. That is what the cash collateral battles are all about while seeking relief from a bankruptcy stay or working on a plan for disposition of the hotel. And that is where the difference is.

Under the *Northview* approach, unless one had a security agreement with an appropriate description of the revenues from the hotel and a properly filed UCC-1, the security interest in the revenues would not be validly created and perfected. The typical assignment of rents in a mortgage would not be adequate. So when the hotel goes into bankruptcy, the security interest is not perfected in either the pre-petition or post-petition income from the hotel.

And if even if the lender did use a good security agreement and UCC-1, under the *Northview* approach, the security interest is cut off by the filing of the bankruptcy petition in post-petition revenues. Only under the *Drake Associates* approach does the security interest survive the filing of the bankruptcy petition as to post-petition revenues.

Although this appears to be a fairly grim scenario for lenders, things were improved a little when the Bankruptcy Code was amended in 1994. There was a specific provision added to treat room revenues like rents. The provision was amended to include "fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties . . . except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise."[7]

Unfortunately, in a full-service hotel or resort, revenues from other sources—banquet, food and beverage, telephones, and the like—can easily constitute more than 60 percent of the total income from the hotel. Those items of income do not come from room revenues and would appear to still be subject to the old "rents vs. accounts" or "*Drake* vs. *Northview*" dichotomy. Undoubtedly, there will be a great deal of litigation in the bankruptcy courts in the next industry downturn to determine what the amendment to the Bankruptcy Code means.

Evaluating the Options

From the lender's perspective there are several options or alternative courses of action on a troubled asset. It can do nothing of course, or it can pursue a strategy that is directed toward one or more of the following:

- Workout
- Receiver
- Deed-in-lieu of foreclosure
- Foreclosure
- Bankruptcy

The workout typically leaves the borrower in possession or physical control of the asset, and the other alternatives all seek to move that control to someone else—a receiver, the lender, a buyer of the property, or a bankruptcy trustee.

KEY TO EVALUATING ALTERNATIVES: "BUTLER'S MATRIX"

The situation analysis should have considered all the relevant factors concerning the borrower, the hotel and their related considerations. Now it is time to consider these in light of the lender's goals and the available alternatives. Given the complexities of the typical special asset, it is sometimes helpful to boil it down to a summary form that may over-simplify, but at least provides a grid or framework for analysis.

One of this article's authors, Jim Butler, developed an analytical tool in the last great real estate and hotel downturn in the late 1980s that has come to be known as "Butler's Matrix" (see *Table 1*).

In applying Butler's Matrix, 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 a weak market

Table 1

BUTLER'S MATRIX

Issue	Workout	Take Possession from Debtor (Receiver, Deed-in-Lieu, Foreclosure or Bankruptcy Trustee)
Collateral	Limited or problematic	Full or satisfactory
Documentation	Problematic	Full or satisfactory
Borrower		
•Integrity	High	Questionable
•Financial strength	Strong	Weak
•Managerial strength	Strong	Weak
Management (operational)	Strong	Weak
Marketing	Focused	Diffuse
Franchise affiliation	Correct	Wrong image
Asset		
•Design	Good for market	Poor
•Physical condition	Well maintained	Deferred
Market	Weak	Strong

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.

SAG – PROFIT CENTER FOR THE 21ST CENTURY

How the SAG is run can make a critical difference. Utilizing the SAG as a profit center can make a difference in amounts recovered and how the bank is protected from lender liability claims. The bank can position itself to make a bigger impact on its profitability, more so than the commercial loan originations. In recognition of that, senior management should be given prompt access to decision-makers and other resources, including hotel lawyers and consultants. REI

NOTES

1. The terms of a hotel management agreement can easily add or subtract 25 percent or more to or from the value of a hotel.
2. James R. Butler, Jr., Co-Author, Chapter 14 "Special Legal Considerations for Hotel Investors," Hotel Investments Issues & Perspectives (2nd Ed. 1999), Educational Institute, American Hotel & Motel Association.
3. Baltin's Law was formulated by Bruce Baltin, Senior Vice President of PKF Consulting in Los Angeles, California. Mr. Baltin has more than 30 years of hotel experience.
4. The SNDA is the acronym for Subordination, Non-Disturbance and Attornment agreement, which is usually a three party agreement involving the owner, the operator and the lender of the hotel. Such agreements typically provide comfort to lenders that upon a foreclosure, deed-in-lieu or sale in bankruptcy that the lender or its successor in interest will continue to enjoy the benefits of the management agreement. This may be of great value in some circumstances. However, many such agreements also limit the lender's or successors' options in purporting to bind them to the terms of the agreement whether they want it or not. This poses many interesting issues where the lender or a successor want to remove or terminate a brand or operator.
5. *In re S.F. Drake Hotel Associates*, 131 B.R. 156 (Bankr. N.D.Cal. 1991) (minority view holding that hotel room revenues are "rents").
6. *In re Northview Corporation*, 130 B.R. 543 (9th Cir. BAP 1991) (majority view that room revenues are "accounts" and not "rents"). See also, *In re Ashkenazy Enterprises, Inc.*, 94 B.R. 645 (Bankr. C.D. Cal 1986) and *In re Mid-City Hotel Associates*, 114 B.R. 634 (Bankr. D.Minn. 1990).
7. Bankruptcy Code Section 552(b).

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