

Expert Analysis

## Proactive Strategies for Distressed Hotels

By **Todd E. Soloway, Bryan T. Mohler, and Itai Y. Raz**

**T**he U.S. hotel industry continues to stage its recovery from the decimation caused by the COVID-19 pandemic. While there is optimism that this recovery will continue in 2023 as business and group travel resume, there are strong economic headwinds that threaten assets across the country. With inflationary factors, sharply rising interest rates and persistent staffing shortages leading to significantly increased operating costs, there is widespread concern that rising costs will outpace revenue gains in 2023.

Although previous predictions of a wave of foreclosures

*TODD E. SOLOWAY leads the Hotel and Hospitality Group at Pryor Cashman and co-heads the firm's Litigation Group. BRYAN T. MOHLER is a partner in the firm's Hotel and Hospitality and Litigation Groups. ITAI Y. RAZ is an associate in the firm's Hotel and Hospitality and Litigation Groups.*

due to the pandemic have been largely avoided, indications are that the current macroeconomic conditions are pushing some distressed hotel properties to the point of no return. In this article, we discuss some of the steps that the key stakeholders—hotel owners, operators, and lenders, should consider in evaluating how to deal with distressed hotel assets.

### **Owners of Distressed Hotels**

First and foremost, owners of distressed hotel properties need to be familiar with their rights and obligations under all relevant agreements (including franchise agreements, management agreements, and loan documents) to understand their options and, just as importantly, the consequences of each. Owners should also closely think through whether they



want to continue to own the hotel property, or whether other objectives—such as avoiding recourse liability or protracted litigation—are paramount.

Owners can maximize their options by vigilantly upkeeping the loan collateral—the hotel property—and maintaining cordial relationships with the lender and any hotel operator and franchisor. Particularly if the owner's goal is to potentially continue owning and operating the hotel, keeping open communications with the lender is crucial to fostering the possibility of a workout and staying off foreclosure. Ensuring

the hotel remains in the best possible condition provides a lender with comfort that its collateral is in good hands with the owner.

Proactive dealings with franchisors and operators may also allow for the hotel operator and flag in place, preventing potential loan defaults triggered by the termination of these key relationships.

Alternatively, should a hotel owner desire to divest of the hotel property, protecting the hotel and maintaining open lines of communications with relevant stakeholders may give owners the freedom to pursue a sale themselves that maximizes value—a well-kept hotel that is operating and generating revenue will likely secure a higher price than one that is shuttered and requires significant investment to open. Conversely, a sale forced by the lender may yield a lower price due to the time, expense, and perceived distress attendant to such a situation.

Among the key items to consider in a sale scenario is whether any applicable agreement provides any third party (such as the franchisor or operator) with sale approval

rights, or imposes any condition that the purchaser must agree to continue the terms of such agreements post-sale.

### Operators

In times of distress, hotel operators are often faced with insufficient revenues to cover expenses and an owner that—despite the obligation to do so—fails to provide working capital to bridge the gap. When considering how to handle

---

With inflationary factors, sharply rising interest rates and persistent staffing shortages leading to significantly increased operating costs, there is widespread concern that rising costs will outpace revenue gains in 2023.

such circumstances, particularly since unpaid vendors often perceive the operator, rather than the owner, as their customer, operators must consider their business goals and priorities. Is the priority to continue operating the property, or to minimize additional risk and liability? In making this assessment, operators must

remain mindful that while an owner careens toward a loan default and eventual foreclosure and/or bankruptcy, the operator may be left to shoulder the burden of any operating shortfalls. The earlier the owner is in the process, the more likely a resolution is far away, and the longer the operator may be at risk of taking on additional liability.

Hotel management agreements and Subordination, Non-Disturbance and Attornment Agreements (SNDAs), as discussed in detail in our article published on July 5, 2022, often outline the operator's rights upon a sale or loan default. Key terms to look for are whether the operator has the right to continue to manage the hotel in the event of a sale (whether under the same or new management agreement), and whether the lender has the right to terminate the management agreement upon a loan default.

An SNDA may also address the operator's rights and obligations upon a sale or foreclosure. Hotel management agreements may also provide the operator with the right to stay on after a transfer of ownership, increasing

the incentive for an operator to stay on and weather the storm.

In these situations, it is beneficial for an operator to have proactive discussions with the owner's lender, keeping the lender informed of an owner's defaults and shortcomings. While operators should be careful not to violate any contractual or other duties owed to the hotel owner in any such dealings with the lender, fostering trust may encourage a lender to make protective advances to cover liabilities and to keep the operator in place.

### **Lenders**

In addition to the relevant loan documents, a lender should also analyze its rights and obligations under any franchise agreement, management agreement, or SNDA. The lender should separately take steps to understand the facts on the ground by requesting financial and operational information from the owner and, if they have the right to do so, the hotel's operator. Armed with that information, the lender has several options to evaluate and consider.

First, if the lender is confident that the owner can improve the situation, or the owner intends to imminently sell the hotel, a lender may elect to enter into a workout with the owner that provides sufficient interim protection. Should the lender believe more protective measures are required, lenders may consider appointing a receiver if permitted to do so under the loan documents. The receiver can work directly with the hotel's existing operator, bypassing problematic owners and protecting the collateral. Additionally, the receiver may be able to complete a private sale of the property without the time, expense, and uncertainty of a foreclosure.

A lender may also seek a foreclosure of the collateral. This places additional pressure on the owner to engage in more lender-friendly solutions, reduces the risk of the lender assuming additional liability by stepping into the shoes of the owner of the hotel, and may lead to the extinguishment of other liens against the property.

Alternatively, when the borrower/owner is willing to

consensually surrender title, another option is a deed-in-lieu of foreclosure. This is faster and less expensive than foreclosure and provides more certainty. The lender can take full control of the property and may choose to either continue operating the hotel or sell the property without the owner's involvement.

### **Conclusion**

For any stakeholder evaluating a distressed hotel asset, it is critical that they be proactive and gather as much information as possible to fully understand their rights before taking any action. Fully analyzing your goals, the paths available to achieve them, and the potential consequences of each will place owners, operators, and lenders in the best position possible to handle a distressed hotel property.