Hotel Workouts: A Case Study

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Brent M. Cohen, Esq.
Jones Day
555 California Street, 26th Floor
San Francisco, CA 94104-1500
(415) 875-5879
bmcohen@jonesday.com

Timi Anyon Hallem, Esq.
Manatt, Phelps & Phillips, LLP
11355 W. Olympic Boulevard
Los Angeles, CA 90064
(310) 312-4217
thallem@manatt.com

JONES DAY

Brent M. Cohen

Partner

Profile

Brent Cohen represents investment banks, opportunity funds, and other institutional investors in transactions involving partnerships and joint ventures, acquisitions and dispositions, commercial lending, workouts, bankruptcy, and land use and development. He leads the Firm's Real Estate Practice in California.

Over the last decade, Brent has represented investors and lenders in their most complicated investment and financing activities, including equity and preferred equity investments, shared appreciation loans, loan participations, mezzanine loans, and mixed debt/equity investments. In addition, Brent advises real estate clients on insolvency issues including complex loan and equity restructurings both inside and outside bankruptcy, foreclosures, deeds in lieu of foreclosure, and the sale and purchase of whole loans and loan portfolios. Regular clients have included Contrarian Capital, D.E. Shaw, Lehman Brothers, Nomura, Olympus Real Estate, and Westbrook Partners. Brent also has been involved in numerous bankruptcies on behalf of New West Federal Savings, Wells Fargo Bank, the Unsecured Creditors Committee for Equitec, and the Unsecured Creditors Committee for Polar Air Cargo.

Brent serves on the national board of directors of the American Committee of the Weizmann Institute, a scientific research institute located in Rehovoth, Israel. Prior to joining Jones Day, he was the firmwide leader of the real estate group at Heller Ehrman.

CONTACT

bmcohen@jonesday.com

San Francisco
(T) +1.415.875.5879
(F) +1.415.875.5700

EDUCATION

Yale University (J.D. 1984; Editor, Yale Law Journal); University of California, Berkeley (Ph.D. 1981); State University of New York at Stony Brook (B.A. summa cum laude 1972)

BAR ADMISSIONS

California

EXPERIENCE HIGHLIGHTS

Starwood Capital-led consortium restructures more than $300 million of debt in connection with overall recapitalization of Terranea Resort near Los Angeles, California

ABM acquires Five Star Parking, Network Parking, and System Parking from L&R Group of Companies

Dendreon negotiates 150,000-square-foot lease for biotech facility in Los Angeles, California

AREAS OF FOCUS

Real Estate

HONORS & DISTINCTIONS

Northern California Super Lawyers (2006-2009)

Timi Anyon Hallem

Partner
Real Estate & Land Use
Chair, Hospitality
310.312.4217
thallem@manatt.com

PROFESSIONAL EXPERIENCE

Ms. Hallem is a partner in the Real Estate and Land Use Group at Manatt, Phelps & Phillips, LLP and is Chair of the Hospitality Group. Ms. Hallem's expertise focuses on all areas of real property and land use. Her practice covers all aspects of real property and hotel and resort ownership and development, including acquisition, entitlement, development, financing, leasing and disposition. She has represented clients in loan work-outs and restructures both in the real estate bust of the 1980's – early 1990's and over the past two years.

EDUCATION

University of California at Los Angeles, J.D., 1972.
Order of the Coif.
Managing Editor, *UCLA Law Review.*

Smith College, A.B., 1968.

REPRESENTATIVE MATTERS

Representing hotel developer in developing resort and conference hotels in California and other western states, including obtaining all governmental approvals required for Terranea, a 582-room hotel to be located on 102 acres overlooking the Pacific Ocean, and negotiating the ground lease and all loan and other documents for Estancia La Jolla, a 210-room conference hotel located on the campus of University of California, San Diego.

Representing Lowe Enterprises, Inc. in the negotiating and documentation of the restructure of $350,000,000 of first and mezzanine loans secured by Terranea.

Representing purchaser of the 25,000-acre Cojo and Jalama Ranches in Santa Barbara County, which include nine miles of Pacific coastline.

Representing developer in negotiating the Disposition and Development Agreement, Development Agreement and other documents needed for the purchase from the La Quinta, California Redevelopment Agency of sites to be developed with two new hotels and a retail center in the SilverRock area of La Quinta.

Representing developer in the acquisition, repositioning, reentitlement and redevelopment of a 105-acre, $150 million former manufacturing facility in Hawthorne, California, and negotiating and documenting the development agreement for the project, which provided zoning unavailable elsewhere in the city.

Representing developer in negotiation and documentation of major mixed-use developments, including negotiating development agreements and related entitlement documents with cities, including a 39-acre site in Brea, California, developed with office and retail uses, a 20-acre site in Santa Monica, California, developed with office, residential and retail uses, and a project in the civic center area of Azusa, California.

Representing developer in drafting and negotiating a purchase and loan documents and the development agreement for an exclusive golf course and residential development in Palm Desert, California.

Representing The Trustees of the California State University in connection with documenting the terms and conditions of development by a private entity of the Home Depot Center, a new soccer stadium, tennis stadium, USSF training facilities and other athletic facilities on the campus of CSU, Dominguez Hills, including ground leases, an implementation agreement, a joint use agreement and multiple other agreements governing the site.

Representing developer in the acquisition, development and leasing of a $100 million 30-acre "build-to-suit" corporate campus developed with 440,000 square feet in Irvine, Calif.

Representing ground lessee in negotiating and documenting a ground lease of vacant land from a church for development with a one-million-square-foot new residential, office and retail complex.

Representing a Canadian investment company in negotiating a long term lease for an office/research complex in Rancho Bernardo, CA.

MEMBERSHIPS & ACTIVITIES

Member, Planning and Program Committees, USC Gould School of Law/LACBA Benjamin S. Crocker Symposium on Real Estate Law and Business, 2007-2010.

Member, City of Los Angeles, Industrial Development Policy Advisory Committee, 2003, 2004.

Member, Urban Land Institute; Sustainable Development Council

Member of the Board, SoCal Chapter, NAIOP, 2000-2009.

Director, YWCA of Santa Monica, 1996-2002; President, 1999-2001.

Member, Los Angeles County Child Care Advisory Board, 1989-1996.

President, Santa Monica-Malibu Education Foundation, 1988-1993.

Director, Alumnae Association of Smith College, 1985-1988.

State Bar of California Conference of Delegates Executive Committee, 1981-1984.

Trustee, Los Angeles County Bar Association, 1979-1981.

Women Lawyers' Association, President, 1979-1980; Board, 1973-1981.

HONORS & AWARDS

Named One of SoCal's Most Influential Women in Real Estate by *Real Estate Southern California*, 2000-2006.

The Best Lawyers in America, 2006-2011.

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HOTEL WORKOUTS
A CASE STUDY

I. INTRODUCTION.

We will discuss today a "typical" workout of a hotel construction loan. The "typical" workout, of course, involves numerous parties with different and conflicting legal rights and remedies. We will focus on the challenges to the two dominant participants—with Timi for the borrower and Brent for the lender—as borrower and lender attempt to reach agreement between each other and attempt to address the hurdles presented by other parties--mechanic lien holders, investors (in both borrower and lender), employees, and other stakeholders. We will discuss (using public information only) how the issues came into play in the case of a large conference hotel in California in which 2 loans with combined balances in excess of $330,000,000 which was worked out in a transaction that closed in 2010. In that transaction, Timi represented the borrower and Brent represented the lenders. We will start will Timi's describing the facts regarding the resort, which are typical of the kinds of issues faced by hotels build or refinanced within the last 5 years.

II. WHY A WORKOUT?

Real estate workouts occur in a crisis. On the one hand, there is a borrower in need of more time or money or both, and on the other a lender who has lost confidence in the borrower or the market or both or who is simply the holder of a loan secured by property which has less value than the amount of the loan. As you know, workouts occur under the shadow of threatened litigation with all parties especially mindful of their existing contractual rights, particularly as they relate to lien priority, and against the potential backdrop of re-ordering of those rights through bankruptcy or other litigation.

III. LITIGATION.

Litigation, if it need be said, is always a long, expensive distraction from the immediate business needs of the client and the client's business. Simply put, in the absence of an irreparable breach of trust, clients prefer a consensual workout. A workout—usually in the form of restructuring the underlying enterprise and contractual relationships of the stakeholders should be viewed as a global settlement of both threatened and actual litigation. Time is the biggest practical challenge of all workouts – it is both the carrot and the stick in dealing with litigation delays, litigation deadlines, uncooperative parties (pre-negotiated or pre-packaged bankruptcy).

IV. TYPICAL STRUCTURE/FACT PATTERN.

A. Senior Mortgage Debt, Mezzanine Debt (Sometimes With Mortgage) And Equity.

B. Hotel Ownership and Management:

1. Manager an affiliate of JV

2. 3rd party manager

C. JV Agreement:

1. Capital structure (see attached chart of a sample ownership structure)

2. Scope of major decisions

3. Call of additional capital

4. Transfer of interests

5. Removal of managing member

6. Buy-sell and other exits

D. Where there are multiple lenders, documentation will include intercreditor and subordination agreements which will set forth the respective rights of the lenders regarding modification of loan or management agreements, exercise of remedies upon default, change in ownership, and replacement of management for equity JV and hotel.

1. Guaranties: payment guaranties, "bad boy" guaranties, including full springing recourse for bankruptcy, lien-free completion guaranties

V. FIRST STEPS.

A. After discussions have broken down, the first formal step is a default letter—start clock running, make demands for payment, turnover of collateral, assert claims against guarantors.

B. Notice of foreclosure (in Calif. Notice Of Default)—notice to 3rd parties, adverse impact of publicity, employees, customers.

C. Pre-negotiation agreement/letter: confidentiality provisions, excluded from evidence in litigation.

D. Immediate challenges: how to get more cash into project?

1. Additional advances—priority issues

2. Receivership—priority issues, loss of control

3. Intercreditor issues/consents

4. Ongoing operations/sales of collateral

E. Diligence: how deep is the hole?

1. Lender-- appraisals, title (broken priority?), mechanics lien litigation, stop notice litigation (in California), securities litigation re sale of hotel condos

2. Borrower—potential claims against lender

F. Legal diligence: assembling the legal team.

1. Tax consequences of restructure for borrower and lender

2. Bankruptcy risks for lender and borrower

3. Litigation—construction litigation, 3rd party litigator, lender exposure (stop notice, mechanics liens, sale of units, borrower claims)

VI. RESTRUCTURING.

A. Financial condition of project.

1. Appraisals—how much debt can this property fairly valued support, how much debt reduction is needed?

2. Cash drain—how much cash needed to address short term cash shortfalls, hangover construction liabilities?

B. Conflicting strategies of borrower and lender.

1. Junior debt—"fulcrum security"

2. Senior lender risks in bankruptcy:

a. Superpriority lien of DIP lender

b. Cramdown plan by borrower in conjunction with junior lender (with junior lender making dip loan)

3. Lender options:

a. Reach agreement with borrower to provide dip financing in bankruptcy and reduce junior loan principal/lien to fair market value (cramdown junior lender)

b. Challenge: how to address junior debt?

c. Options: buy junior debt and restructure both loans with borrower

d. Buy junior debt to block borrower purchase of junior debt or purchase by vulture investor

4. Borrower options:

a. New investor—control issues

b. Capital commitments

c. Performance default, removal, buy-sell

VII. TERM SHEET—MULTIPLE TRANSACTIONS

A. Loan Modification:

1. Typical terms: extension of maturity date, increase interest rate, capital infusion and equity kicker

2. Borrower issues: tax treatment, sequencing of transactions

3. Lender issues: usury, and guaranty protection, loan covenants, approval rights re management changes at joint venture level and at project level

B. Junior Loan Purchase:

1. Release and indemnity issues—[FDIC]

2. Equity kicker—"schmuck" insurance

3. Borrower's issues

C. New Capital—Restructuring The Joint Venture:

1. Lender Issues:

a. Use of proceeds –stop notices, mechanics liens, other litigation

b. Size of capital commitment:

(i) Seasonal nature of business

(ii) Required capital expenses

(iii) Dilution of equity kicker

c. Approval Rights, Change In Management

d. Equity Kicker:

(i) Buy-sell

(ii) Transferability

(iii) Liquidity

D. Borrower Issues.

E. Documentation.

VIII. CONTRACTORS AND LIENS.

In a construction project which runs into trouble, there are invariably liens, stop notices, and contractor claimants who must be dealt with. Since the loan restructure cannot close unless clean title can be incurred, the borrower must reach agreement with the contractors subject to payment on the closing of the restructure. For example, in our transaction we had over 170 recorded mechanics liens and another 150 or so non-lien creditors who needed to be paid. This meant dealing with each claimant, executing a settlement agreement with each that would be paid after the restructure closed, and setting up an escrow at the title company funded with sufficient funds to get the title company to issue clean title and which provided for claimants to come in, deliver executed and notarized (if needed) releases and dismissals of lawsuits and in return get a check for the amount owed. It tool weeks of meeting with contractors to reach the agreements needed to prove to the title company that it would have sufficient funds to issue a clean title policy.

IX. ISSUES UNIQUE TO CONDOMINIUM HOTELS.

Condominium hotels present unique issues relating to the impact of loan defaults on condominium sales. Timi will discuss lessons learned in 2010.

Typical Ownership Structure