

LOAN AGREEMENT COMPLIANCE ISSUES

The following is presented from the perspective of a businessperson, is simply illustrative, and should not be construed as legal or transactional advice. Any such advice needed should be obtained from attorneys and other professionals that you have retained and have reviewed your loan agreement and guarantees and other relevant documents. The below is presented for informational and illustrative purposes and should not be relied upon for any transaction, financial communication or legal decisions.

If you would like to discuss any loan agreement issues, I may be contacted at jonathan@jfcap.com or at 917-238-6917.

In these unprecedented times, hotel owners and operators are taking aggressive and necessary steps to manage hotel operations with minimal customer demand. In many cases this has involved shut down of hotels or suspension of substantially all normal cause operations. This has been necessary to manage highly challenged cashflows and to pocket employees and customers. Borrowers have reached out to lenders and servicers and asked for concessions and relief. Many lenders have granted or will grant some interim relief.

Many of the relief requests have included:

- Waiver of one to three months interest expense and principal amortization
- Short term (90 day) deferral of interest and principal amortization
- Short term extensions of maturing loans (if maturing in next 6 months)
- Waiver for several months to a year of financial covenants and of newly triggered cash management systems such as hard lockboxes and cash sweeps into lender-controlled reserves
- Waiver of requirement for audited financials for borrowers and guarantors as a result of a short-term payment default
- Waiver of guarantor net worth and liquidity covenants

LOAN AGREEMENT COMPLIANCE ISSUES

- Allow use of some funded reserves, such as an FFE reserve or seasonality reserve in order to make payroll or pay critical operating expenses

At a certain point, the closed hotels will come back on line, business will slowly resume, and both borrowers and lenders will become more focused on how existing loans will be refinanced and how in a more normalized environment there will be compliance with operating covenants and with financial covenants. There are numerous potential issues that lenders may focus on and that borrowers and guarantors should be mindful of:

- 1. Approved Operating Expenses:** Approved operating expenses as part of any 2020 lender approved budget, likely do not include severance, payouts of accrued vacation days, etc. Additionally, at a point in time, borrowers will be asked for revised budgets and lenders may approve releases of funds only for approved operating expenses.
- 2. Cash Sweep Triggers:** Many loans have cash management provisions where cash is swept and in some cases trapped in lender controlled escrow accounts if the DSCR falls below a certain level; the DSCR test is usually based on a trailing twelve month basis. By the end of Q2 2020, almost all hotel borrowers will have DSCR'S below their covenant level. Loan agreements generally don't provide for release of any trapped funds until a higher DSCR is achieved for an extended period of time. This can create a strain on usable cash flow.
- 3. Required FF&E Reserves:** Most loans require FF&E reserves to be funded on a monthly basis; failure to fund may be a default; use of FF&E reserves for other purposes without lender approval may be a default. Some lenders are

LOAN AGREEMENT COMPLIANCE ISSUES

granting borrower requests to use some reserves for operating expenses or debt service. This may be a default under the franchise agreement.

- 4. Other Reserves:** Many loans require reserves to be funded for property taxes, insurance, ground rent, seasonality, completion of PIP. Use of any of these reserves for anything other than their specified purposes, without lender approval may be a default. Some lenders are granting borrower requests to use some of these reserves for operating expenses or debt service.

- 5. LTV- Loan To Value / Appraised Value Tests:** Any covenants or extension tests that are conditioned on an LTV test or an appraised value test may be difficult to satisfy financially and logistically as in most markets it is nearly impossible for an appraiser to visit and tour the hotel. It is also unclear how appraisers would create cash flow projections and clearly conclude on valuation given a lack of clarity in this environment.

- 6. Net Worth and Liquidity Covenants:** It will be very difficult to calculate or to satisfy net worth and liquidity covenants for borrowers and for guarantors. Liquidity may be quickly drained and future loan renegotiations or restructurings will involve heightened scrutiny over and detailed diligence of detailed analysis of liquidity.

- 7. Permitted Indebtedness:** Loan agreements generally include limitations on trade payables (which may escalate during a shutdown or slowdown as payments are stretched); Loan agreements generally include limitations on

LOAN AGREEMENT COMPLIANCE ISSUES

additional indebtedness which would preclude the ability to obtain a CARES Act PPP loan without lender consent.

- 8. PIP Work Commencement and Completion Dates:** Many loan agreements refer to underlying franchise agreements or on their own specify the dates by which PIP work or capex work must commence, and the dates by which the work must be completed; Many of these dates will need to be extended as hotels are closed, and construction work in certain municipalities is considered to be non-essential. Additionally, many borrowers will be looking to value engineer the PIPs previously agreed to by waiving certain items or reducing certain scope which may extend the previously agreed upon timelines.
- 9. Rating Agency No Downgrade Letter:** Certain lender / special servicer approvals for CMBS loans are conditioned on receiving no downgrade letters from the rating agencies that rated the CMBS bonds; In the current environment, it is highly unlikely to get rating agency no downgrade letters on a timely basis if at all.
- 10. Payment of Taxes:** Non-payment of property taxes may be a loan default if there are funds on hand to make the required payment.
- 11. Maintain Franchise:** Loan agreements have requirements to maintain, preserve and protect all franchises and trade names. Certain actions taken might jeopardize the franchises.

LOAN AGREEMENT COMPLIANCE ISSUES

12.Maintain Good and Safe Condition: Loan agreements have requirements to maintain the hotel in good and safe condition. It is unclear what this means from a safety and sanitization perspective for employees, customers, and the physical buildings themselves, in the current COVID-19 environment.

13.Performance of Other Agreements: Loan agreements have requirements to remain compliant with and to perform under the key terms of other agreements (such as ground lease agreements, parking agreements, F&B operator agreements). Failure to remain compliant with these other agreements may cause a default under the loan.

14.Hazardous Substances: Loan agreements have requirements to maintain the hotel free of hazardous and dangerous substances; Loan agreements have requirements to remediate any hazardous or dangerous conditions; Loan agreements have requirements to notify lender of any hazardous substances. It is unclear if COVID-19 will fall into any hazardous substance definitions.

15.Material Leases: Loan agreements require that lenders approve of or consent to the execution of material leases; Loan agreements also have restriction on the modification of lease terms; A lease to a municipality, hospital or other group may require lender consent.

16.Minor Leases: Minor leases may require lender approval unless they conform to pre-approved lease forms including subordination and other guarantee provisions.

LOAN AGREEMENT COMPLIANCE ISSUES

17.Change in Use: Loan agreements have restrictions on change in use of the property without lender approval. A lease to a municipality, hospital or other group might constitute a change in use.

18.Management Agreement: Loan agreements have restrictions on change in management agreements or their terms without lender approval. Waiver of certain key terms may potentially cause a loan default.

19.Franchise Agreement: Loan Agreements have restrictions on changes in franchise agreements or their terms without lender approval. PIPs are actually a part of the franchise agreements, so changes to the timing or scope of a PIP without lender approval may possibly cause a default.

20.Notices: Failure to provide notices on a timely basis or at all may trigger a default under loan agreements. In a chaotic operating environment, certain required notices may be overlooked. Additionally, certain notices sent by mail or FedEx may be delivered to empty offices.

21.Financial Statements: Loan agreements have requirements to provide borrower and guarantor financial statements; loan defaults may trigger a requirement for audits or for increased financial reporting.

22.Default Provisions: Loan agreements have numerous default provisions which generally fall into the following general categories:

LOAN AGREEMENT COMPLIANCE ISSUES

- a. Non-payment of interest or principal on a timely basis
- b. Non-payment of property taxes, insurance or other fixed expenses
- c. Non-payment of debts as they come due from borrower or guarantor
- d. Covenant breaches- operational, legal, and financial
- e. Breaches of net worth and liquidity covenants for guarantors
- f. Modification of franchise agreements, management agreements or other material agreements.

23. Guarantees: Loan agreements generally have numerous guarantees including those for environmental issues, repayment, interest and principal amortization, carry (including taxes and insurance). There are also non-recourse carveouts essentially transforming a non-recourse loan into one that is fully guaranteed. Non-recourse carveouts have expanded substantially over the last decade and should be carefully reviewed.

The above is illustrative of loan agreement issues in general. Each loan agreement and each set of guarantees is unique. If you would like to discuss your situation, I may be reached at jonathan@jfcap.com or at 917-238-6917.