

Investing in Distressed Hotel Assets— What to Consider

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With government support instigated by the COVID-19 pandemic coming to an end, there is an inevitability that some hotel owners will sadly not have the liquidity to continue to operate in the medium term. Eager investors are seeing opportunities and are waiting to deploy capital. This article examines the main considerations for investors who are looking to purchase distressed hotel assets out of an insolvency process.

The UK Insolvency Service published its latest company insolvency statistics for Q2/2021 on July 30, 2021, which demonstrated that, as a result of the strength of government support measures, insolvency rates remain significantly below pre-pandemic rates.

With forced closures, London occupancy levels at a record low and restrictions on travel continuing despite the vaccine roll-out, the UK hotel sector has been one of the hardest hit real estate sectors during the COVID-19 pandemic.

The low levels of corporate insolvencies have been driven by the support offered by the UK government, such as the moratoria on forfeiture and winding up petitions, the unprecedented scale of the coronavirus job retention scheme and the availability of HMRC deferrals and VAT reductions, amongst other measures. But the support is coming to an end.

There is an unfortunate inevitability that certain hotel owners, some of whom have not paid landlords or suppliers since the pandemic began, will not have the liquidity necessary to continue to operate in the medium term. This has grasped the attention of investors, who are getting ready to deploy capital once the distressed opportunities materialize.

This article examines the main considerations for investors looking to purchase distressed hotel assets out of an insolvency process.

Acquiring the Business and Assets of a Hotel Owner Out of a UK Insolvency Process

When accelerated mergers and acquisitions (“M&A”) processes are run, bidders will often be faced with the possibility of acquiring the target business and assets through a pre-packaged administration sale as opposed to a

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more customary acquisition from a solvent (albeit stressed or even distressed) seller. But what does that mean and what, in a hotel context, should a bidder be giving particular consideration to when acquiring a business and assets from an administrator (rather than on a solvent basis)?

A pre-pack is where a sale of all or part of a distressed company's business and assets is negotiated prior to administrators being appointed and is then completed very shortly after the administration commences. While pre-packs have long attracted criticism and been the subject of lobbying for reform (leading to the recent change to UK insolvency law requiring independent evaluation of a pre-pack to a connected party), they remain an important part of the UK restructuring landscape. They also have some particularly attractive benefits for purchasers who are able to "cherry pick" the valuable assets of the group, leaving behind liabilities, unviable contracts and other less desirable assets of the business.

Whether bidding to acquire a hotel asset as part of a pre-pack or whether a bidder is making an acquisition from administrators who have already been appointed and are continuing to trade the hotel, the key point in both cases is that the investor is no longer negotiating opposite a solvent company. Instead, you are transacting with an insolvent company acting by administrators, who are qualified insolvency practitioners whose objective is to realize the property and assets of the seller for the benefit of its creditors. The key focuses for the administrators in this sale process will be:

- Speed and certainty of execution by a buyer;

- Maximization of day one value to obtain the best price reasonably obtainable;
- Ensuring the relevant secured creditors have approved the deal on the table; and
- Transacting on a basis of non-recourse to the administrators with the usual protections for administrators being included in the documentation.

The latter is the most important point which a buyer should be aware of, as the administrators will not be in a position to offer the buyer any of the usual contractual protections.

An administration asset purchase agreement will look both strange and familiar to buyers and their counsel. The key difference is the clause headed "exclusion of personal liability and warranties." With the administrators having limited information about the business and assets, they contract on the basis that no representations, warranties, conditions, or indemnities will be given. A buyer's first mark-up typically introduces great swathes of such protections but they are almost certainly a non-starter from the administrators' perspective, delaying matters and potentially damaging the buyer's credibility opposite the administrators and the secured creditors in the background.

While the administrators may possibly assist with due diligence queries—on a strictly non-reliance basis—ultimately an investor has to accept that they are buying whatever right, title and interest (if any) that the seller has in the underlying business and assets and on a "sold as seen" basis. The onus is therefore on the buyer and its counsel to focus on the assets of value and of strategic importance to the business to get as much comfort as to title

and condition as can be achieved in the time available. Typical recurring issues in a hotel context include:

- Who owns the hotel's furniture, fixtures, and equipment ("FF&E") and branding?
- Who are the critical IT and other suppliers and what is their current payment arrears position?
- What intellectual property licenses are in place and do any of these terminate on administration?
- Regulatory issues such as the position regarding any liquor or premises license, and wedding and other licenses and permits.

While innovative warranty and indemnity insurance products such as synthetic warranties may be available, it can come at a costly premium and ultimately insurers will likely expect a detailed due diligence process to be carried out. This can obviously affect an acquisition timeframe and may ultimately cost the buyer the sale if another buyer is willing to contract without insurance in place.

Other Considerations for the Administrator

As well as the lack of the usual contractual protections, administrators will require a wide range of broad indemnities from the buyer for liabilities which may arise against the seller or the administrators in connection with the business and assets sold. Buyers should expect the following matters to all come within such wide indemnities:

- The business's employees;

- The use by the buyer of IT, intellectual property, and trading names;
- Personal data/General Data Protection Regulation; and
- Title to any third party or leased assets at the hotel that are included in the sale.

With limited time for due diligence and potentially a lack of available information, priority must be given to areas such as these which could expose a buyer special purpose vehicle to significant or unexpected liabilities. In a hotel context, the issue of whether title to stock remains with an unpaid supplier under retention of title provisions is often a particular issue to get to the bottom of as soon as possible, given that the buyer must take on that risk.

The onus is also on the buyer to ensure that formalities for the transfer of assets are dealt with and, while administrators will typically assist in executing title transfer documents subject to the usual protections and disclaimers around representation and warranties, a buyer will need to make sure that everything critical is properly transferred to the extent possible at completion.

Further assurance provisions may often need to be called upon for assistance from the administrators post-completion but these provisions are often short term in nature and come with the requirement to pay the administrators' costs, together with those of their lawyers, so getting issues dealt with pre-completion can be a big cost saver for the buyer.

One final issue is whether the buyer will agree to honor deposits and prepayments

made for bookings at the hotel post-completion. While customers may have potential claims under Section 75 of the Customer Credit Act or the “chargeback” scheme, failure to take on such bookings can lead to goodwill

and business reputation issues, notwithstanding the deposit or prepayment will have been received pre-administration and is not available to the buyer.