Hotel Lawyer: Hotel and restaurant distress from COVID-19/Coronavirus demands prompt action to deal with loan defaults, layoffs, shutdowns, recapitalizations and stand down agreements

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Hotel owners, operators and lenders are under stress – hotel defaults, layoffs, and shutdowns loom. Prompt action is critical.

For the last three to five years the pundits have increasingly speculated that the longest economic recovery in history could not endure and that we were due for a recession. We hope that the extraordinary measures being taken now may defer some of the worst fears, but clearly the US economy has been plunged into distress, and the pain is particularly acute in hotels, restaurants and related travel and tourism businesses.

The shelter at home edits of the Federal, state and local governments are literally requesting that people stay at home for the next two weeks. Many hotels have plunged into single-digit occupancies and slashed revenues to cover fixed and operating expenses. Restaurants struggle to see if they can survive on takeout and delivery services alone. Furloughs and layoffs are imminent.

Lenders and borrowers alike are seeking relief, clarity, and resolution. It feels like some blend of the 1990s and 2008. And it is time to go back to the basics or distressed loans: Quick assessment, preparation of plans, transparency, communication, and cooperation for mutual benefit.

The lawyers who comprise JMBM’s Global Hospitality Group® have extensive experience and resources that can help hotel stakeholders answer these questions. The issues involved are too numerous to address in one article, and the answers will vary widely depending on each hotel asset and how it is structured.

Today’s article will address how the “structure” of hotel ownership and operations impact the interests of the various stakeholders.

Coronavirus: Creative strategies to mitigate financial impact
Loan defaults, lender rights & recapitalizations
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Facing the realities of low hotel occupancy and dwindling operating revenue

Lenders, equity providers, borrowers and operators are facing hard realities regarding the performance of their hospitality assets due to the Covid-19 pandemic.

What are the parties’ rights? What remedies can be pursued? What is the best approach for both the short term and the long term?

Understanding the structure of the hotel asset will help stakeholders answer these difficult questions.

The “operating business” is key

It is often said that hotels are a special real estate asset with an operating business. It really is the other way around: hotels should be thought of as a unique operating business first, within special purpose real estate. This is true not just for hotels, but for assets like timeshares, casinos, gasoline stations, movie theaters, and restaurants. The operating business comprises a large component of the asset’s value.

It is also the operating business that raises thorny problems when cash flow drops dramatically due to matters outside the control of any party – such as a global pandemic or a declaration of national emergency.

Identify and work with all stakeholders

It would be a serious mistake for any stakeholder to believe it holds all the cards in directing the final outcome on asset direction following a calamity.

The operating business will often involve many stakeholders including investors, lenders, sponsors, third party management, and franchise affiliations, as well as many issues such as licenses and permits, extensive vendor relationships, marketing efforts, a significant workforce, and so on. Many of these aspects of the operating business are critical to the value and success of the asset and the recovery to be realized. These various stakeholders and their varied interests, however, make for complex solutions to complex issues.

Any stakeholder that takes a unilateral approach, without considering the interests of the other stakeholders, may find hotel value evaporating very quickly in the mishandling of the troubled hotel asset. Lenders who have made this mistake in the past have found out the hard way that it can take enormous losses and reinvestment to resuscitate its secured assets.

For example, what is the value of the underlying real property of a branded hotel – such as a Marriott, Hilton, IHG 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 a 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 the quality is not maintained, rumors of bankruptcy taint expectations of service, inventories fall below acceptable levels, and relations with critical vendors are damaged?

Understanding the interests of the various stakeholders, as well as the “structure” of hotel ownership and operation is critical.

**The structure of a management or franchise agreement can add or subtract millions to the value of a hotel**

Many lenders and servicers are unfamiliar with the business and legal “structure” of special assets. The typical hotel, for example, is owned by an individual, institutional investor, or investor group. This owner is usually the borrower on a hotel loan.

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 – the “flag” – is a separate entity that will manage (or manage and franchise) the hotel. For example, that big Marriott sign on top of a hotel likely means that the hotel is branded – or branded and managed – by one of Marriott’s flags.

In other words, the owner of that hotel has entered into a franchise or management agreement with Marriott to brand the hotel and plug into Marriott’s extensive reservation system and expertise. In many instances, the hotel is managed by the branded hotel company. But often the hotel will have a franchise from one of Marriott’s many branded hotel companies, and an independent management company – unaffiliated with the brand – will manage the hotel under a separate agreement.

In the jargon of the hotel industry, these independent management companies are often called “independent operators” because they do not own a brand and are a third party to the owner-franchisor relationship. 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.

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 workforce, 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.

**Look at all agreements, licenses and permits**

Depending upon the nature of the property, there are likely to be a host of important agreements, licenses and permits. Resort properties often have “use agreements” or perhaps leases that provide access for hotel guests to park, use 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, marina 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 or other amenities, or can’t serve liquor at large events. And, of course, it is almost certain that there will be a significant workforce 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.

Overriding these issues in the face of the coronavirus pandemic are the various third party contracts with different so-called “force majeure” clauses that can significantly impact performance obligations and remedies. See our previous articles on force majeure and how the issues concerning the triggering and impact of force majeure can be approached:

- Coronavirus COVID-19 force majeure: Contract provisions and governing law are important
- COVID-19 coronavirus as force majeure contract defense: history and origins
- Coronavirus as Force Majeure Event – What Hotel Owners and Operators Should Consider
- Coronavirus & the Hotel Industry – Responsibilities, Liabilities, Implications

Issues specific to hospitality loans

Hospitality loans (and loans on other special assets with operating businesses) present at least four categories of issues that lenders don’t usually encounter with traditional real estate loans such as those on office buildings or apartment houses. These special issues should all have been addressed in initial loan underwriting. But, more often, they need to be reconsidered and reviewed as a loan gets into trouble. This should be any secured lender’s first step in evaluating a troubled asset. They include:

- **Subordination Agreements**

  Subordination agreements (often called SNDAs – subordination, non-disturbance and attornment agreements) are frequently encountered with hotel management agreements. The lender’s rights are often vitally affected by the terms of a subordination agreement, 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, many surprised lenders have learned that buyers for certain hotel properties selling above a certain figure 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.

Likewise, some subordination agreements grant the lender the ability to terminate a hotel management pre-foreclosure once a borrower is in default. This can appear to have great value, but such a right without being thought through how it will be exercised, can practically defeat its purpose.

The typical subordination agreement with a large branded management company will usually contractually obligate the lender to the terms of the management agreement, 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 agreement or be obligated to execute a new one 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, there are a number of techniques lenders can use to navigate breach of the subordination agreement. For example, the use of a court-appointed receiver may not constitute a breach of a subordination agreement by a lender, and certain sales pursuant to a plan of reorganization in bankruptcy may also avoid a breach of a lender’s obligations under even the most stringent subordination agreement. Long-term management agreements will generally be viewed as executory contracts that can 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. Of course, much will depend on the equity in the hotel.

- Brand matters

Most hotels in the United States operate under a brand name. They acquire the right to use that brand name in one of two ways: (a) as part of a “bundled” deal with a branded management company, where the management agreement typically provides that the operator will manage the hotel and include branding rights for free as long as the operator runs the hotel; or (b) in a separate franchise or license agreement with the brand, and not including management. Where a hotel has a franchise agreement, it will also likely be self-managed or have a “third party” management agreement with an independent (i.e. unbranded) operator. An industry rule of thumb is that the right brand and operator can easily raise or lower the nominal value of a hotel by 25% or more. In other words, a hotel nominally worth $100 million might be worth only $75 million or as much as $125 million, depending on the quality of the management and franchise agreements.

- Access to vital 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 be certain that it has access to such vital information, and hopefully the loan documents were drafted so that the lender has adequate remedies if there is deterioration in certain operations or procedures reflected in the borrower’s financials. Often, “adequate remedies” means a great deal more than just calling a borrower into default, giving the lender an acceleration and foreclosure right. If the loan remedies are not properly considered on the front end, the lender may be at risk.

**Lender liability**

There is a much better balance today between the lenders’ needs to protect their collateral and realize its value and aggrieved borrowers to obtain redress for excesses and abuses of over-zealous 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. Further, the lender may not be the only creditor. Operating unions, pension plans, employees, local governmental authorities, vendors and the like may also be significant creditors or have a significant stake in the outcome of a lender claim, and have arsenals with which to deal with uncooperative, overly aggressive lenders.

In dealing with union multi-employer pension plans, lenders can sometimes find themselves with liabilities that exceed their outstanding loan balance. Also, lenders cannot ignore the significant number of foreign investors in today’s hotels, many of which include EB-5 investors, and many of those investors may have separate legal counsel to protect their interests.

**What does it all mean?**

Before lenders and investors deploy their special servicers, workout teams and turnaround specialists to deal with a troubled hotel, time-share or other hospitality loan, it is critical they understand that troubled special-purpose asset loans present unique problems due to an asset’s operating business – and it is that operating business that comprises a large component of the special purpose asset’s value. Enhancing that value can make a huge difference for all parties involved.

Check the Hotel Law Blog for future articles that will discuss techniques that lenders can use to enhance the value of their assets while protecting their downside.
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For troubled hotels, Guy develops and executes strategies for CMBS, whole loans, and REOs. He also assists investors with recapitalization of distressed loans and purchases of troubled assets and notes. Guy has assisted major lenders in revising and structuring their hotel lending programs and documentation, including their hotel construction lending. Guy’s practice is both domestic and foreign; he has advised on hotel and real estate matters throughout the United States, Canada, Mexico, South America, Middle East, Caribbean, Western and Eastern Europe, Asia and Scandinavia. For more information, please contact Guy Maisnik at mgm@jmbm.com or +1 (310) 201-3588.

This is Jim Butler, author of www.HotelLawBlog.com and founding partner of JMBM and JMBM’s Global Hospitality Group®. We provide business and legal advice to hotel owners, developers, independent operators and investors. This advice covers critical hotel issues such as hotel purchase, sale, development, financing, franchise, management, ADA, and IP matters. We also have compelling experience in hotel litigation, union avoidance and union negotiations, and cybersecurity & data privacy.

JMBM’s Global Hospitality Group® has been involved in more than $87 billion of hotel transactions and more than 3,900 hotel properties located around the globe. Contact me at +1-310-201-3526 or jbutler@jmbm.com to discuss how we can help.