Hotel Owners, Managers, Workouts and Other Irritants

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The hotel management agreement negotiating process is replete with subtleties and nuances. Obviously, there are significant financial terms to be negotiated, but, once those are resolved, there are other important matters as well. Two principal issues to address are whether the management company (a) contributes capital in some form to the owner and (b) receives a Subordination, Non-Disturbance & Attornment Agreement ("SNDA") from the owner's lender(s). This paper will attempt to shed some light on both those issues and relate them as appropriate.

An owner which does not thoroughly analyze and negotiate a management agreement to eliminate as many conflicts as possible or which believes, even though it does not need a management company capital contribution, however characterized, that it is "giving" something away if it takes on a manager without receiving capital or a guarantee (colloquially called "**skin in the game**") may be approaching the process incorrectly. Appropriately negotiated management agreements should not necessarily require that management companies have "skin in the game" to properly, tightly and profitably manage a hotel, especially when the owner does not need the manager's money. Of course, if the owner truly needs the capital to do a transaction worth doing, then, by all means, the owner should get the money from whatever source is prepared to provide it.

A manager which is a partner not only owes but is owed a fiduciary duty with respect to the owner. A manager which provides a "top up" or other cash flow guarantee does not want to be told how to operate the property that might require it to fulfill the obligation created by the guarantee. A manager which pays "key money" to buy a management contract wants less oversight from an owner and negotiates accordingly. After all, if the manager provides "key money" (or other capital) for a contract, then, it is likely to say to an owner, *"We bought it, we paid for it, it's ours."*[1] The manager whose management agreement is carefully negotiated to provide approvals, controls, input and information to and for the owner and to require regular meetings with the owner or its asset manager may not need to have committed funds to have the right incentives to manage properly. Stated differently, the best management transaction is not in the negotiation of the deal,

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[1] This does not quite have the weight attached to it when then-Governor Ronald Reagan made this same declamation about the Panama Canal (criticizing the 1977 Treaty returning sovereignty over the Canal Zone to Panama).

but in the implementation and execution of an operating plan put forth by a manager, consistent with the owner's vision for its hotel, and carefully and actively watched over by the owner (or its asset manager). The negotiation, though crucial, sets the stage for the implementation.

There are circumstances when the manager ***should*** make a contribution to the capital stack (or, as discussed below, to the solution and the potential salvation of the owner's hotel). One such circumstance arises if the manager believes that providing capital gives it an advantage in the manager selection sweepstakes; then, its capital contribution should be forthcoming. As there are not many developments or acquisitions in the current marketplace, one need not discuss needs in those situations other than stating the obvious: a developer or buyer with a shortfall in its capital Sources/Uses stack might turn to a manager to get capital, regardless of whether it takes the form of "key money", equity, mezzanine debt, second mortgage debt, or guaranties of operating levels. Moreover, in the acquisition (when that marketplace returns) of a hotel with a manager in place, an owner might offer a favorable (to the manager) modification of the existing management agreement concurrently with the request for capital. Understanding what the manager wants and, therefore, can offer, might prod the transaction along. In this time of difficulty, it may not be enough for the manager to "contribute" by reducing its operating costs at a hotel or relaxing its brand standards in a time when capital is short. This is where "skin in the game" should be sought, and both owners and lenders should be seeking it.

During the early 1990's, the last time that defaults were ominous and foreboding (interestingly, though many point to the post-9/11/2001 period as an indication of the last significant downturn, there was a "pull together" mind-set that seemed to negate significant numbers of loan defaults and concomitant workouts), there was a perceived need to find a longer-lasting solution than is seen now. The significant reason for this, of course, is the simple fact that loans were more often held as "whole" loans by one lender, usually a bank or insurance company. Accordingly, an owner-borrower needed to satisfy only one lender and could speak to someone who actually spoke for the lender-creditor.

In today's workout arena, a manager is not only a necessary party to the potential solution, but – perhaps more critically – a source of any necessary contribution to a solution. An owner should and must invite the manager to the table to discuss the workout with the lender. Perhaps the manager is looking for something: relief from a performance standard failure (real or potential); partial or complete lifting of an exclusivity provision; a longer term. Perhaps the manager is willing to reduce its basic fee, or take a larger potential incentive fee when the recovery comes, in return for these. If it can be said that the allocation of responsibility requires a sharing of the pain, then a corollary to this is that any party that wants to be part of the sunrise following a recession needs to hunker down and cooperate during the darkness of the recession.

The manager should be considered as a source of help, as a significant part of that manager's entity value is tied up in its management contracts. A reduction of a point or two of basic fee or a subordination of an incentive fee may be far more palatable to the manager (and less damaging to its share price) than the potential for a fight in bankruptcy or a battle with the special servicer over the meaning of an SNDA.

The SNDA is a document, executed and delivered between a property's lender and the management company at the outset of the loan transaction (but customarily required under the management agreement) that provides a level of protection to both parties in the event their common contractual obligor – the hotel owner – defaults in its obligations to either of them.[2] Representing the manager's attempt to create for itself something akin to an interest in real estate from a contractual commitment, the customary SNDA provides for the following (among many other provisions):

- In all respects, the management agreement is subordinate to the loan and its attendant security interest in the Hotel itself (this is the "**subordination**" part).
- In the event of a default on the debt, the lender obtains the right to step into the owner's shoes if it forecloses, takes the keys, or otherwise succeeds to ownership, and the management company agrees to recognize the lender as the owner.
- In the event of a default by the owner under the management agreement, the management company agrees to send notice to the lender, give the lender the opportunity to cure the default if the owner does not, then requires the management company to give the lender time to step in (a default under the management agreement usually being a default under the loan).
- In either case, the lender agrees prospectively to recognize the management company's contract, as if the lender itself were the owner (this is the "**non-disturbance**" part), and the management company agrees to recognize the lender as the owner (this is the "**attornment**" part).
- Whether the lender is obligated to cure the owner's default vis-à-vis the management company depends in large measure how strongly the management company negotiated the SNDA.
- During the potentially very long process between default and the lender taking title, the parties agree as to the application of the funds, with both typically wanting the Hotel to operate "business as usual".

Accordingly, hotel management companies obtain a sense of "comfort" in these uncertain times in the hotel business. If the lenders step into the shoes of their owners through

[2] For the most part, the "manager" referred to herein is a branded hotel company manager (*e.g.,* Hyatt, Marriott, Hilton, Starwood, etc.). If any of these brands franchise their brand to an owner and a third party manager, the true third party manager typically would not fight for an SNDA nor would a lender likely agree to deliver one. More likely, the franchisor would deliver to the lender a "Comfort Letter", providing the lender assurance that the brand's franchise agreement will continue under the lender's stewardship (if not outright ownership) as long as an "approved operator" manages the hotel.

foreclosure or receivership (or a handover of the keys), and if there is a SNDA in place in its customary form, the management company then treats the lender as the owner.

In the early 1990's, when a loan went into default, usually all the parties in interest (an owner, one or two lenders (the extent of loan syndication on individual hotel deals), and the manager) could meet in one room and discuss what to do. If the owner had more than hope that its equity would be good, the owner very well might have arrived at the table with more funds to cure or, at least, reform, a default or, as necessary, to undertake capital expenditures, the lender might have been willing to extend term, reduce rate or, possibly, write down the loan, and the manager would have been prepared to negotiate its basic fee somewhat or provide some needed capital (in return for one or more of the benefits mentioned above); all would contribute to a satisfactory solution, and life went on. Bankruptcy was threatened, and, if the parties could not complete a workout, a bankruptcy filing might occur; there the risks changed.

A hotel management agreement, to the extent of the remainder of its term, is an executory contract. Because in bankruptcy, most matters are frozen – a foreclosure by a lender does not proceed, lawsuits by creditors are stayed – as long as current bills are being paid, the *status quo* obtains. However, if there is a solution to the bankruptcy, where the creditors are satisfied with a potential workout or sale of the asset, and the borrower/bankrupt is indifferent, part of the solution might be the rejection of the executory management contract, as the buyer or new investor in the deal decides that the existing manager is part of the problem in the first place (or a strategic buyer is a brand or an investor affiliated with a brand). In that instance, the management contract is terminated by the bankruptcy court, the management company makes a claim for the value of its breached contract, the bankruptcy estate is insufficient to satisfy all the creditors, and the hotel management company might get nothing. The SNDA may offer limited – at best – protection against the impacts of bankruptcy. Management companies' attempts to put "bankruptcy protection" clauses in the SNDA may themselves be nullified by bankruptcy courts.[3]

As long as owners and lenders undertake non-bankruptcy workouts, management companies with SNDAs can take comfort that their contracts will continue, especially where the management company is part of the solution. However, if more companies

[3] " . . . [I]f any "Foreclosure Purchaser" shall acquire title to any of Owner's interest in the Hotel, the Foreclosure Purchaser shall accept an attornment from Manager, . . . this [Management] Agreement shall continue in full force . . . for the . . . remainder of the Term subject only to termination in accordance with its terms. . . . For purposes hereof, a "Foreclosure Purchaser" shall mean the (i) Lender, any Affiliate of the Lender, or any party designated by Lender to take title to any of Owner's interest in the Hotel, . . . ***(v) any trustee in bankruptcy or Owner in its capacity as debtor-in-possession under bankruptcy . . . , and (vi) any party acquiring title to any of Owner's interest in the Hotel pursuant to a plan or reorganization or liquidation of Owner pursuant to applicable bankruptcy, insolvency or reorganization laws*** (emphasis added). It may be legally challenging to bind the trustee or a party acquiring title pursuant to the order of a bankruptcy court.

with multiple contracts or more individual hotels are subjected to bankruptcy proceedings, the managers' contracts may be in jeopardy. Still, strong brand managers insist upon the delivery of an SNDA and strong owners object to the requirement that they deliver one.[4] On the whole, lenders would likely prefer not to provide SNDAs.

The discussion above is an oversimplification of the entire process of the application of SNDAs; many other issues not touched upon here affect the negotiation of the SNDA between lender and manager, and many of them are critical to the ultimate resolution of the document itself. However, it may help to think about the impact of the economic crisis on actual hotels – regardless of whether there is an SNDA in place.

Consider this scenario: a hotel that is operated by a third party is in payment default on its debt; the owner has offered to "give back the keys", but the lender does not want to take back the hotel. The manager has been directed to send any cash flow to an account controlled by the lender (fairly commonplace in hotel loans). When the owner has no real economic interest in the hotel and is no longer a real party in interest, no owner is "at home"; call this a "latchkey" hotel.

In a latchkey hotel, how does the manager deal with capital expenditures, FF&E Reserve expenditures, and maintenance of brand standards? How does the manager address necessary repairs and maintenance (other than those that clearly are required to maintain the condition of the hotel)? Other than the manager, who cares how funds are spent to maintain the hotel and maintain brand standards? To whom does the Annual Plan and Budget get sent, and who reviews it? These are all hallmarks of management agreements, and, typically, the owner (or its representative) is the overseer and provides the answer to these questions.

A critic of management companies (particularly, the branded management companies) who might be a proponent of "skin in the game" likely would say that, just as nature abhors a vacuum, a management company probably loves one. That critic would suspect that the management company would spend any funds over which it maintained control to the maximum extent it could justify such expenditure under the management contract. To extend this metaphor (with a slight variation), this is akin to a teenager having a party when his folks are out of town. For the most part, in this situation, the critic is probably right.[5]

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[4] An owner does not wish to seek and find its best possible financing package then learn that the financing is not acceptable because the lender is unwilling to offer an SNDA to the management company on terms acceptable to the management company.

[5] For a very good – though arguably biased – article on Hotel Workout problems from one such critic, *see* "How Hotel Projects Go Wrong And What To Do About The Management Contracts" by K. C. McDaniel, http://inbrief.pli.edu/2009/05/beyond-a-lack-of-mints-on-the-pillows-when-hotel-projects-go-wrong-.html.

However, the management company, as a fiduciary, would rather have someone to provide pushback – which, at the same time, provides *cover*. The last thing a manager of a latchkey hotel wants in this situation is a lender (or servicer) to swoop in and claim that the manager exceeded its authority and took unilateral, unjustified and unauthorized action with someone else's money. In a time where owners and their successors (*i.e.*, lenders) are making claims of manager mismanagement,[6] providing lawsuit fodder is not on the agenda of most managers today.

Accordingly, at this time in the economic cycle, with the prognosticators suggesting a hotel demand (and, therefore, RevPar) recovery beginning sometime in 2010 (perhaps 3Q at the very earliest) and continuing robustly for the next few years thereafter, some of those cap ex and FF&E Reserve replacements and expenditures that may have been put on hold probably ought to be undertaken and, sooner or later, deferred brand standards requirements ought to be pursued. However, the latchkey hotels might lag any recovery until the lender gets around to dealing with its security, unless the management company takes that unilateral action.

Nevertheless, there are glimmers – perhaps they are "green sprouts" – that factors are pushing owners and managers to a problem-solving mode. Recent news that the Hyatt Regency Jacksonville was removed from the jaws of the Special Servicer by assistance from its manager, Hyatt Hotels Corporation, was reported in the *Wall Street Journal* "Development Blog".[7] Hyatt reportedly provided some debt service protection to its owner, some assistance in payment for items of FF&E, and, possibly, a management fee reduction in return for an extension of its management agreement. There were likely some other provisions of relief (*e.g.*, performance standard, non-compete) to Hyatt in return, and one could surmise that the debt service protection offered is a higher priority in the capital stack than the owner's equity. In addition, because the lender was at the table, one would not be at all surprised to learn that the Hyatt SNDA was tightened to Hyatt's further satisfaction. Further, the lender likely gave up some interest or extended the term or made other concessions to put this hotel workout in the "win" column. Clearly, this is the circumstance where management company "skin in the game" is a means to the solution of a problem, rather than a knee-jerk request from an owner.

It is only too easy to criticize management companies for getting away with one-sided management agreements; their goal, after all, is to negotiate the most favorable agreements they can obtain. To the extent that those agreements are now the subject of workout, restructuring or foreclosure, then there is no doubt that the management

[6] As of the time of writing this article in early 2010, one arbitration case involving an owner claim of mismanagement has recently been decided in favor of the manager and another is awaiting a decision from the arbitrator. Based on the author's experience, these two suggest that many more (if not multiples of ten) similar claims are now being discussed between owners and their managers; some percentage of those will turn into litigation or arbitration in 2010.

[7] http://blogs.wsj.com/developments/2009/11/25/helping-hand-by-hyatt-hotels

companies – as Hyatt in the Jacksonville circumstances — should be (indeed, should be required by their owners or their lenders to be) significant contributors to the solution.

As in a divorce, it is seldom true that only one party is to blame. Bringing all the parties to the table and getting "skin in the game" when it is required may negate the need to battle over the terms of the SNDA.

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