LENDERS AND HOTEL MANAGEMENT AGREEMENTS

Why lenders can't treat hotel managers the same way as anchor space tenants.

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When a financial institution provides financing to a hotel owner and the hotel owner has engaged a third-party manager to operate the hotel, the lender must realize that it has also entered into a relationship with the hotel manager that is not always obvious or straightforward.

At first blush, a lender's relationship with a hotel manager is not too different from a lender's relationship with an anchor tenant. Both have the right to possess the lender's collateral. In exchange for that possession, the tenant or manager is supposed to generate a stream of income for the owner/borrower. If that income cannot support the loan, the lender will eventually foreclose.

Even if a hotel property does not throw off enough cash flow to pay the owner's debt service, though, the management contract may still generate satisfactory income for the manager. Moreover, hotel managers like being hotel managers. They do not like the idea of being thrown out of the hotel if the lender ever forecloses. Hotel managers always argue a lender's foreclosure should not affect them, because it's not their fault the borrower couldn't pay the loan.

This position is sometimes defensible. But it is also generally true that the unique strengths and weaknesses of a particular hotel manager have a substantial and direct impact on the success of a hotel as a real estate investment. This impact is much greater than the impact that the unique strengths and weaknesses of a typical anchor tenant will have on the success of a shopping center.

Recognizing this, when hotel lenders negotiate loans, they usually seek the right to terminate the hotel manager in the event of a foreclosure. Whether a lender can actually obtain that right depends on all the facts and circumstances and the relative strengths of the parties in the particular negotiation. The following variables, and others, will affect the outcome:

- Is the hotel manager already in place? Most refinancings involve an existing manager, while loans for new hotels are usually negotiated at the same time as new management contracts. If the hotel manager is in place, what does the management contract say the hotel manager must do to facilitate subsequent financing?
- Is the hotel manager providing guarantees to cover operating shortfalls, or is it making some form of investment in the hotel? Has the manager agreed to defer certain of its fees if the hotel

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does not achieve specified profitability or cash flow?

- Does the manager's relationship with this hotel indirectly give the manager's brand name special marketing benefits? (A "trophy" property is a pearl in the manager's chain.)
- How badly does the owner/borrower (and indirectly the lender) need this manager to make this hotel work at this site? (Management can sometimes be relatively fungible. Are other equally good managers available to manage this hotel?)
- Is the management contract a "rich" one for the manager?
- Does the management contract already contain termination rights? (Some contracts allow hotel owners to terminate if the manager performs inadequately in comparison against other managers of similar hotels in the market. Managers will prefer tailored termination rights like these over a lender's bludgeon-like unconditional right to terminate a manager after foreclosure.)
- How badly does this manager need this lender?

WHEN THE MANAGEMENT CONTRACT IS SUBORDINATE TO THE LOAN

In a lender's perfect world, the lender will always be able to negotiate a "pure" subordination of the management contract. If the lender ever forecloses, it has the option to throw out the manager. In that case, only three lender/manager issues remain to be negotiated:

- How long after foreclosure can the lender wait to make up its mind about keeping or firing the manager?
- If the lender decides to change managers, how is the transition from one manager to another made?
- If the management contract also provides the hotel with its brand name, but the lender wants to remove the manager, can the lender keep the brand name? What will retention of the brand name cost?

Usually, after a foreclosure, if the lender has a straightforward right to "kick out" the manager, the lender will probably use that right as leverage in negotiating a more favorable management contract. Of course, if the lender truly believes that bad management or the wrong brand name caused the hotel's financial problems, the lender will be very thankful for the "kick-out" right. The lender will then use that right precisely as intended—as a tool to help clean up the borrower's mess.

WHEN THE MANAGER HAS A RIGHT OF NONDISTURBANCE

If a lender cannot obtain a pure "kick-out" right, it will probably agree that the hotel manager can remain in possession after foreclosure and continue to manage the hotel. In other words, the lender grants the manager a right of "nondisturbance"—the right not to be disturbed in its possession of the hotel if the lender forecloses, just like the "nondisturbance" right that every chain store tenant demands and receives from shopping center mortgagees.

When the hotel manager wins nondisturbance rights from the hotel lender, the relationship between them can become far more complex than that between the shopping center lender and an anchor tenant. A hotel lender that fails to recognize, understand, and deal with these complexities may face unpleasant surprises down the road. These complexities all arise from the fact that a hotel management contract may impose a greater range of burdens on the hotel owner than a typical shopping center lease imposes on the shopping center landlord. When a hotel lender agrees to grant "nondisturbance" rights to the manager, the lender is agreeing to recognize that management contract and to live with everything in it.

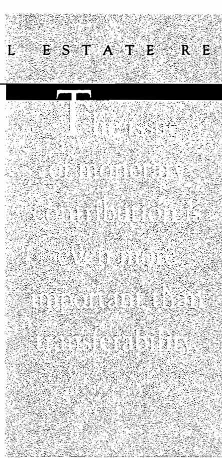
The Lender's Right to Transfer the Hotel

For example, hotel management contracts often restrict the owner's ability to sell (sometimes even to refinance) the hotel. Anchor tenant leases, in comparison, rarely give the tenants such power. A hotel lender needs to consider whether it can live with any transfer restrictions in the management contract, or whether those restrictions would unacceptably restrict the lender's exit strategy. If the hotel manager has any rights to restrict transfers, the lender will try, as part of the loan closing, to have the hotel manager agree to at least these two modifications:

- Any transfer of the hotel (to the lender or anyone else) made pursuant to a foreclosure

sale does not require the hotel manager's approval

- Any subsequent transfers or refinancings also do not require the hotel manager's approval.



A lender that cannot persuade the hotel manager to accept these limitations, and that nevertheless wishes to make the loan, will try as a "fall-back" to persuade the manager to agree to be "reasonable" and prompt about approving transfers. The lender might also ask the hotel manager to agree to pre-approve potential bidders if it becomes necessary for the lender to hold a foreclosure sale. The lender may be able to persuade the hotel manager to accept a listing of objective criteria for future transferees.

If the management contract gives the hotel manager the right to approve new financing (justified, for example, because the manager's incentive fee is calculated after debt service, or because the manager was nervous about a possible foreclosure), the lender can insist that the manager pre-approve certain types and amounts of financing from certain lenders.

If (as sometimes happens) the hotel manager has the right to restrict assignments of the lender's loan (even before foreclosure), the lender should consider seeking pre-approval of certain loan assignments that the lender may wish to make.

In negotiating the loan, the lender should also try to think ahead to a time when it might take title to the hotel and try to resell it, and might need cooperation or concessions from the manager. The lender should try to obtain any necessary commitments from the manager as part of the loan closing, and thus narrow the scope of any possible future discussions.

For example, if the lender likes the agreement it negotiated with the manager, the lender may want the manager to agree to sign the same agreement with any future lender, when the occasion arises.

To the extent that the hotel manager grants any concessions to a new lender, an astute manager will try to limit these concessions only to this particular lender or to the first transfer or refinancing of the hotel that occurs after a foreclosure. After that, the manager will try to have the original restrictions spring back into full force.

Although a one-time concession by the manager may create some immediate comfort, a lender needs to think more generally about future purchasers of the lender's position. Today's lender must make sure that if the lender ever takes over a hotel, that hotel will be an asset that can trade freely—without defects to which potential purchasers may object. For this reason, if the transfer restrictions in a management agreement are truly burdensome and inconsistent with current industry expectations, the hotel lender should insist that if it ever takes over the hotel, these restrictions are waived forever. The outcome of that discussion depends, of course, on the same considerations that affect all other lender-manager negotiations.

CONSEQUENCES OF A HOTEL MANAGER'S MONETARY CONTRIBUTION

As in any other real estate relationship, there is at least one issue that is even more important than transferability. That issue is money.

Hotel managers often agree to lend their owners money to cover operating shortfalls. Managers may also agree (either at the owner's request or the lender's request) to defer or subordinate some components of the manager's fees when the hotel is not producing sufficient cash to pay debt service plus, possibly, a specified owner's return on equity.

Hotel managers tend to think of these arrangements as investments or as a sharing of risk for which they deserve to be compensated and protected. Owners and lenders would argue that these measures do not constitute "investments" at all — merely exercises in good judgment and good taste, acknowledging the manager's share of responsibility for the hotel's financial distress.

When a hotel lender analyzes the manager's financial commitments to the hotel, it should consider the implications of those commitments at two important stages: before foreclosure and after foreclosure.

Before Foreclosure

If the manager has agreed to make advances to cover operating shortfalls, the lender may want the right to obtain these advances directly from the manager. The lender is not necessarily protected by the hotel manager's agreement that the

lender can requisition the money. The lender must instead understand exactly how the manager's funding mechanisms and funding conditions work. The lender must be able to satisfy those funding conditions, or require that the manager waive them when the lender requests advances. Otherwise, the lender has no way to assure itself that the manager's money will be available when needed.

Furthermore, should the loan go into default, the borrower would be able to use its control over the loan disbursement process as leverage against the lender.

Manager commitments before and after foreclosure must be addressed.

After Foreclosure

Because the lender cares a great deal about precisely what happens to the manager's financial commitments and to any related manager claims after the loan goes into default, the lender needs to understand the answers to each of the following four questions:

If, at the time of foreclosure, the owner owes the manager money (either deferred management fees or repayment of manager loans), does the manager retain or lose the right to be repaid those amounts?

If the manager retains the right to repayment, exactly what is the priority of the manager's rights? Unless the manager's claims are highly subordinated and contingent, they can easily become the functional equivalent of a prior mortgage on the property.

If the manager's right to repayment is subordinate to payment of debt service, how does the management contract deal with the fact that a full foreclosure, by definition, terminates the lender's loan and therefore no further debt service is payable on the loan? If the management contract does not provide for an imputed, hypothetical, or substitute debt service calculation, the lender may find that after foreclosure the manager's priority has "leapfrogged" ahead of the lender's. (A lender must consider the same issue in analyzing the subordination or deferral of any subsequent management fees, and the operation of any cash flow waterfall in the management contract.)

If the hotel continues to suffer losses after foreclosure, must the manager continue to defer or subordinate its fee, and must it make additional advances to the new owner? If so, how and when are those advances or deferrals repaid? Does the new owner face any risk of personal liability?

Related Issues

If the lender ever must foreclose, it may want the right either to make certain specific changes in the management arrangements for the hotel or in the terms of the management contract. These changes normally will be site-specific and based on the lender's particular objections to the particular management contract. For example, if the management contract does not give the lender (as possible future owner) absolute protection against personal liability for risks and losses arising from the hotel, the lender may wish to add appropriate protections that are effective upon foreclosure. The time for the lender to raise these concerns, of course, is during the due diligence and closing for the loan.

OTHER MANAGEMENT CONTRACT ISSUES

Although any hotel lender is always concerned about "worst case" possibilities after foreclosure, the lender-manager relationship also raises issues that matter even if the loan never goes into default. And, again, these issues are more significant than those addressed in a nondisturbance agreement between an owner and a space tenant. They arise because the hotel manager plays such an important role in creating the cash flow and value of the hotel and in controlling (almost to the exclusion of the borrower) the physical asset that is the lender's collateral.

Financial Records

Given the hotel manager's total control over the physical hotel and all hotel operations, a hotel lender may conclude that the hotel manager has much better information than the borrower about the hotel, and much greater control than the borrower over compliance with major nonmonetary covenants in the loan documents.

A lender may therefore selectively ask the manager to agree to provide the lender certain financial reports regarding the hotel.

A lender may also ask the manager to assume responsibility for certain loan document obligations relating to hotel operations and maintenance, such as providing insurance, maintaining

a specified standard of operations, funding reserve deposits directly from hotel cash flow, and proposing budgets for the application of those reserves.

Managers will, of course, refuse to do anything that could force them to spend their own money rather than the hotel's cash flow, and they will limit any obligations accordingly. Subject to that caveat, however, managers may regard the assumption of responsibilities to the lender as a welcome opportunity to clinch control over the hotel.

> Proper drafting of the owner's rights to terminate may give it valuable flexibility!

Terminating the Management Contract

During loan negotiations, lenders should analyze the owner's rights to terminate the management contract. Those rights may give the owner valuable flexibility, depending on whether the management contract over time becomes an advantage or an albatross for the hotel.

In certain circumstances, the timing and structure of a termination option can give the borrower leverage over the lender. For example, a borrower might have a termination option—but by its terms it might expire well before any likely foreclosure sale, or it might be conditioned on the existing owner's remaining in title. In these cases, the borrower may be able to use its control over the termination option to obtain leverage in workout discussions if the loan ever heads toward default.

Hotel lenders need to understand exactly how any termination option works and who controls it, with an eye toward preventing the borrower from using it for future leverage.

A lender may also be concerned that the manager will make loans to the owner to cover operating losses or capital requirements, above and beyond any loans already required by the management contract. Although such loans may help postpone the owner's day of reckoning, a lender should be concerned that they may complicate the owner's balance sheet and violate "single-purpose entity" restrictions in the loan documents.

One response might be to ban these loans outright. Another, depending on the importance of "single-purpose entity" status, might be to require that if the manager makes loans of this type, the manager's claims must be deeply subordinated and otherwise restricted in a way that preserves the simplicity of any possible bankruptcy proceeding.

As part of closing the hotel loan, the lender will want to obtain a variety of factual confirmations from the manager, starting with the usual "tenant estoppel" confirmations but also including confirmations tied to the peculiarities of hotel management and the particular hotel management contract.

For example, the lender may want to know the exact status of all monetary rights and obligations between owner and manager — not just the status of management fees, but also reserve account balances, loan balances, incidental fees, pending capital expenditures, and any financial variables that might be unique to the particular project (as identified in the lender's due diligence review).

If the management contract provides for special rights or protections for certain mortgagees, the hotel lender will want to make sure that it qualifies for those rights or protections. If any ambiguity or uncertainty exists (for example, if the lender does not fall strictly within the definition of "institutional lender"), the lender will want the hotel manager to make an appropriate "clarification" in the management contract.

The hotel lender will want the hotel manager, not just the owner, to assure it of the soundness of the owner's projections for upgrades, product improvement requirements, and other "fuzzy" obligations that the management contract may impose on the owner now or in the future.

Does the hotel comply fully with the manager's physical requirements, or did the owner need to obtain "quality control" waivers after the last inspection? When will those waivers expire? What happens then?

Even if the owner is generally in compliance with the management agreement, the lender should ask whether the manager has validly imposed expensive upgrade requirements that must be completed within a specified period. The lender should also ascertain what happens if the owner cannot complete those requirements.

Any hotel lender will also want to know that the lender's collateral includes all the real estate necessary for the hotel to operate. For a "plain vanilla" limited service hotel, this may be an easy determination to make, but for a resort hotel or a large hotel with extensive amenities the lender

may ask the manager to confirm the correctness of the lender's determination of completeness.

ROUTINE ASSURANCES

In addition to considerations that are unique to the financial structure of a hotel, hotel lenders have the same concerns as any commercial real estate mortgagee negotiating a nondisturbance agreement with an important tenant. Specifically, they seek the following assurances.

- If the loan goes into default, the hotel manager will pay the owner's remittances directly to the lender upon request.
- If the lender does take over the real estate, it will be able to do so without suffering the consequences of problems created by the prior owner: amendments and waivers to the management contract that the lender did not approve; defaults and bad acts by the owner; negotiated terminations that the owner agreed to without lender consent; and so on.
- The manager will give the lender "advance warning" of problems between the manager and the owner, and give it the right to "cure" any owner defaults, so that the lender can preserve the management contract if it is inclined to do so.
- In the event of casualty or condemnation, the loan documents will govern the application of loss proceeds as against any inconsistent provisions in the management contract.

Finally, the lender must ask itself whether, as a hypothetical future owner, it can live with the management contract or whether the management contract imposes unacceptable burdens and obligations. If it cannot live with those terms, the hotel lender should either reconsider the terms under which it makes the loan, or refuse to make the loan at all.