

SPECIAL SECTION: **HOSPITALITY & GAMING**

Preparing for the Next Hotel Industry Downturn

How lenders, managers and franchisors can protect their interests

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As we enter 2017, there are contrary predictions on expectations for the hospitality industry. Expectations remain high for hotel performance generally¹. Yet, questions remain about the potential substantial default rate on over \$100 billion in loan maturities, particularly for securitized commercial mortgages, still a popular vehicle for hotel lenders and owners with multiple hotel properties². This article provides tips for lenders seeking to protect their collateral, hotel managers to ensure continued payment, and franchisors to defend their “brand.”

The Hotel and Underlying Agreements

Think of a hotel as a box. A prospective owner buys a box, often with the land (a separate ground lease will complicate matters, adding another party, additional debt and potential default risk), or buys the land to build the box. The owner then decides – based on location, cost, traveler/vacationer traffic, and other factors – whether to create a full-service hotel, which costs more to maintain but generates more revenue and revenue from sources other than rooms (like room service, business center, spa, restaurant), or a select-service hotel with lower costs and typically lower revenue, with reduced or no amenities.



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The Franchise Agreement. If the hotel will have a brand name (like Marriott, Intercontinental or Hyatt), an owner will need to enter into a franchise agreement, i.e., a license to use the brand precisely in the manner prescribed by the agreement, related manuals and programs. Franchise agreements are tremendously beneficial in plugging an owner into a potentially huge customer base, but they create an added, often non-negotiable cost.

A typical franchise agreement requires an owner to, inter alia, (i) license IT systems, (ii) fund marketing programs, (iii) purchase products, (iv) comply with company-wide vendor and customer agreements, and (v) update and upgrade technology, soft goods, furniture and building systems on a cycle set by the brand (six to 10 years). To ensure compliance, the franchisor will also require the maintenance of escrows, derived from a percentage of revenue, for repair and replacement of furniture, fixtures and equipment (FF&E). Franchisors take these requirements seriously because customers associate the hotel with the brand and the franchisor, not the unseen hotel owner. And unhappy customers translate into negative feedback on the internet. Courts also take these requirements seriously and will pull the “flag” from a franchisee in default, even in bankruptcy³.

The Loan. To create, refurbish or commence the operation of a hotel, the owner typically needs a loan. The loan should be secured by the hotel and underlying property (a ground lease creates a greater risk for the lender in a foreclosure). The lender will expect the owner to repay the loan from hotel and related facility revenue once the hotel opens for business. Therefore, the hotel must generate enough cash to pay all of its expenses, including management fees, payroll,

food and beverage, vendors, maintenance, and, if applicable, franchise fees, plus generate enough cash to repay the loan. Most hotels have a ramp-up period of one or more years during which an owner will need to invest more cash before the hotel can pay expenses. In addition to a payment default, a default under the franchise agreement typically results in a loan default.

The Management Agreement.

A hotel needs a manager; in fact, a management company. A manager can be a branded hotel company, an independent manager or an owner-related entity. An owner and manager enter into a management agreement that provides, inter alia, for (i) the manager’s role and the services to be provided; (ii) the term of the agreement (sometimes very long term); (iii) the management fees (usually “top line,” out of gross hotel receipts); (iv) the right to incur and reimburse expenses; (v) the yearly projections (prepared by the manager and key to addressing performance expectations); (vi) repairs, maintenance and escrows; (vii) the payment of any operating profit to the owner after all fees and expenses are paid; (viii) the management, payment and oversight of employees (are they the owner’s or manager’s employees); (ix) the default, cure and termination rights; and (x) the rights and obligations upon the transfer, sale or other disposition of the hotel, voluntary or otherwise. The management agreement is a two-party agreement between an owner and a manager, but a default typically triggers a loan default.

Customers don’t see the owner; they see the hotel’s brand.

How to Protect Yourself

Lenders:

Know at all times who controls the cash. Revenue may be a lender's "cash collateral" in a bankruptcy, but the hotel manager often controls the revenue to pay bills, payroll and management fees. The manager typically distributes the remaining cash to an owner's bank account. The lender should confirm that all distributions to the owner are in a controlled account, to perfect its security interest in cash. The lender should also confirm whether the manager manages more than one hotel and is co-mingling funds with receipts from other hotels. If so, the manager should be maintaining accurate records of hotel receipts from the lender's hotel to ensure that if a bankruptcy, receivership or foreclosure ensues, the hotel's funds are identifiable.

- Know the status of the franchisor/management agreement. A lender often only learns of strife in the franchisor/management relationship when a default notice is served – an act of last resort and potentially too late to salvage a relationship unless the lender has "cure" rights. A lender should periodically take stock of the franchisor/manager relationship by communicating with the owner and confirming that the hotel's expenses and payments to the franchisor/manager are current. After receipt of a default notice, the lender should communicate directly and immediately with the manager. The lender will need the manager's help in foreclosing or transitioning the hotel to a new owner to avoid disruptions in service.
- Periodically assess collateral. A lender should examine its collateral periodically to assess quality and value (this is, of course, true regardless of the industry). A lender can visit the hotel, review its books and records, and ensure that normal maintenance, escrows and payments are current. Default triggers in loan documents typically include the failure to maintain collateral. While lenders will not be required to loan additional funds in bankruptcy, even a secured lender may be stuck receiving repayment of its loan over time through a bankruptcy plan, or not at all (if the loan is secured by the stock of a bankrupt shell above the hotel owner). If the hotel is in bad shape, the lender runs the risk that the franchisor will pull the flag unless immediate and costly steps are taken to renovate.
- Know the ownership structure. An owner may have multiple lenders to multiple hotel properties or multiple loans on different facilities at the same property.

A lender should be aware that an owner may have divided loyalties between properties and may be balancing resources. An owner with limited resources may constantly be weighing which work to perform first to avoid default. A lender should have owner's updated organizational chart and know how the owner is managing cash and the hotel's assets. If the manager is an owner-related entity, the lender should understand how cash is being managed and transferred between the parties and multiple properties. Learning for the first time after default or during bankruptcy how money changed hands will make recovery more difficult and costly.

- Updated comfort letters. Probably the worst maintained asset of the lender is a comfort letter, the agreement between the franchisor and lender pursuant to which, inter alia, the franchisor agrees to notify the lender of an owner default and allow the lender an opportunity to "cure" the default before terminating the franchise agreement if an owner fails to do so. Lenders often forget to update the name of the lender in the comfort letter when loans change hands, or become securitized, thus creating the risk that a lender will not be entitled to cure a default. This is significant because removing the brand name from a hotel may devalue the collateral significantly and immediately. Since the owner often is not a party to the comfort letter, any dispute under this agreement may be outside of a court's purview in an owner bankruptcy, receivership or foreclosure.

Managers:

- Current payment of fees. Since the manager will often apply payments first to vendors, suppliers and payroll in order to maintain the hotel's performance, their own management fees, marketing fees and reimbursable expenses may be at risk. The management agreement provides for an owner to fund shortfalls on short notice. When times are tight, however, owners may be slow to pay. Therefore, a manager must maintain available cash to pay bills and itself, and save up for the hotel's slow periods, and make adequate and early cash demands on the owner. If an owner becomes the subject of a bankruptcy, receivership or foreclosure, a manager's prepetition fees and reimbursable expenses will be unsecured unless the lender is willing to allow the use of cash to pay past due amounts. The manager should stay current and ensure the owner is infusing capital when necessary.

- Assess and address hotel performance and manage expectations. If the hotel is not generating sufficient revenue to pay expenses or is underperforming relative to the market, the manager should discuss options with the owner. Poor performance is often a metric entitling the owner to terminate the manager unless the manager shows that the performance results from the owner's failure to fund improvements or reasonable plans for increasing revenue. Ask for capital expenditures (CapEx) and other improvements during the yearly budgeting process when necessary and provide accurate assessments of the hotel's anticipated performance. Offer practical solutions when the hotel's performance is poor or at risk. Attempts to improve performance bode well for a manager before a court or expert.
- Know your rights to termination damages. Read your management agreement. Termination damages may decline over time or may be long term, requiring payment for a decade or longer (often reduced to present value). An owner attempting to terminate a manager for poor performance will begin creating a record to avoid damages. A manager should assess its right to termination damages particularly when a dispute is brewing, an owner is not infusing capital or the hotel's performance is suffering. Since a manager's damages in bankruptcy for termination of a management agreement may be unsecured claims paid at the end of the case with whatever cash is left after secured lenders and administrative claims are paid, strategizing early is important⁴.
- Avoid signing large contracts. Although a manager may pay vendors, suppliers and payroll, the management agreement generally does not require the manager to fund expenses. Certainly the manager is on the front lines with customers and vendors and may want to avoid complaints or cessation of services by purchasing goods and services, and the manager at least should be signing "as manager for," but a manager should demand that the owner execute substantial contracts. One case in point is the collective bargaining agreement (CBA), which if terminated may result in substantial damages, including WARN Act damages⁵. Similarly, big customer contracts should be signed by the owner since, if terminated, the manager may be compelled to repay the customer. In bankruptcy, any cash paid prepetition by a manager for an owner's benefit may be viewed as the manager's unsecured claim for damages, and if the estate is administratively insolvent,

even postpetition amounts paid by manager may not be recoverable.

- Owner agreements or upstream contracts. The owner typically creates one entity that owns the land and one that owns the hotel. Owners with multiple hotels will have a more complicated ownership structure and many more SPEs or holding companies. The manager should ensure that in addition to the management agreement, it has an agreement with the owner of the land, particularly if the landowner is a hotel owner related entity to avoid limiting its right to damages to just the hotel revenue.

Franchisors:

- Ensure franchise payments are current. Failure to pay franchise fees denotes a problem. A franchisor should withhold or offset fees for guest reward stays if payments are not made (when customers stay on rewards points, a franchisor pays the owner or manager an agreed fee for the stay). Timely payment of marketing and other fees also should be addressed quickly, as mounting debt may result in consistently late payments. Franchisor fees are unsecured claims in bankruptcy, and postpetition rewards fees may not be offset against prepetition fees, which means a franchisor may be providing unsecured "funding" to an owner in bankruptcy. Of course, "assumption" of the franchise agreement will require the owner to pay all unpaid amounts due.
- Monitor performance standards. Customer comments are often measured separately by

franchisors, typically through third parties, and signify hotel performance. While some performance standards are tied to timeliness of renovations, there may be more serious issues identified through customer comments. Identifying and notifying the hotel owner of problems quickly will protect the brand, particularly since there may be a long lead time between discovery of a problem and removing a hotel from the franchise system. Ignoring comments until a bankruptcy ensues may make the termination of the franchise agreement more difficult, though franchisors may seek to terminate franchise agreements during a bankruptcy.

- Ensure compliance with all franchise agreement terms, including FF&E escrows. To meet renovation cycles, an owner should be setting aside sufficient funds to fund renovations over time, which can be expensive. Even in a good market, hotel owners caught by surprise by renovation costs may be scrambling for a loan or attempting to renegotiate timing of renovations. To avoid a dispute, monitor available FF&E escrows and ensure that the owner or manager is meeting its requirements. Renovations may be demanded and performed during a bankruptcy, but should be pursued early by franchisor when the initial cash collateral budget is determined⁶.
- Check on owners, particularly larger ones. Check in with owners of one or more premium hotels that are significant to franchisor's portfolio, or those with multiple hotels. Check-ins should include real analysis of

performance, quality and discussion of options, including an offer to re-flag a hotel with another of franchisor's brands where expenses may be too high vis-à-vis performance. More talking will avoid surprises. Checking in on even the smaller owners to ensure that, for instance, the ownership structure has not changed, is important. A change in control of the owner is often a default trigger under the franchise agreement and at least requires the owner to provide new guarantees from the new significant investors, and may warrant a property improvement plan and an amendment to the current franchise agreement.

- Look out for receiverships. Franchisors are not always notified when an owner's hotel is thrown into receivership. Suddenly the franchisor receives a copy of a receivership order that provides for the receiver to manage the hotel using the franchisor's brand name and product. A receivership may trigger the change in control provision of the franchise agreement, but more importantly will require the franchisor to more closely monitor the hotel and use of the brand. Sophisticated hotel receivers work well with franchisors in ensuring maintenance of the status quo and an orderly transition to a new owner, but outliers can create costly problems for franchisors who are wrestling their rights back from a receiver empowered by a badly drafted court order.

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