SUTHERLAND

LEGAL ALERT

March 31, 2010

Impact of Hotel Operators on Distressed Asset Workouts

A hotel property derives much of its value from its operator and brand. When a hotel owner is in distress with respect to its loan obligations, the operator also plays a critical role in the resolution of the workout process between the owner and the lender. The rights and obligations of the operator contained in its agreements with the owner and the lender affect any workout decision that the parties may make. This legal alert will discuss the impact that hotel operators have on workouts of loans secured by hotel properties, and will summarize the likely considerations that inform the decisions of lenders and operators in the workout process.

Universe of Documents

The agreements among hotel owners, operators and lenders will affect the bargaining stance of the parties in any workout. An understanding of the parties' rights and obligations, especially with respect to defaults and remedies, is essential to evaluating the parties' positions.

Loan Documents: A hotel loan features the typical lending documents between the owner and the lender, such as a promissory note, a loan agreement, a mortgage and perhaps personal guaranties.

Management Agreement: In addition to describing the operator's management obligations, the management agreement between the owner and the operator typically sets out the owner's obligations to fund all operating expenses, capital improvements (including reserves for renewal or replacement of furniture, fixtures and equipment), debt service, real property taxes and insurance. Events of default by the owner typically specified in the management agreement include: (1) foreclosure upon the property, (2) seeking or having appointed a receiver for the property, (3) failure of the owner to pay working capital, (4) the owner's entry into bankruptcy protection, and (5) the insolvency of the owner, even before foreclosure or bankruptcy proceedings. An event of default by the owner often allows the operator to terminate the management agreement. The management agreement is likely to favor the operator, depending on the brand, the property and the market at the time the management agreement was negotiated.

SNDA: The operator and the lender usually enter into a subordination, non-disturbance and attornment agreement ("SNDA"), although the provisions of an SNDA may be contained in a tri-party agreement among the operator, the lender and the owner. The lender seeks to subordinate the management agreement to the loan. In return, the operator seeks an agreement from the lender either (1) not to terminate the management agreement upon a foreclosure, as long as the operator is performing under the management agreement, or (2) to limit the lender's termination rights to a period of time following the foreclosure. Whether the lender will concede this point depends on the relative leverage of the parties. If the management agreement allows the operator to terminate the agreement following a default by the owner, the lender will want the operator, in the SNDA, to give the lender extensive periods following foreclosure to cure any defaults before the operator can exercise its termination right.

Operating Guaranties: An operator may agree to guarantee a hotel's performance up to a certain threshold. Lenders favor this feature and may require it as a condition to making the loan. Not surprisingly, many operators lately have sought reasons to extract themselves from such obligations.

Operator Investment Commitments: An operator may agree to invest in the property by a variety of methods, such as entering into a joint venture with the owner, issuing subordinate or mezzanine financing to the owner, or agreeing to make to the owner a so-called "key money" payment (which is amortized over the term of the management agreement, and the unamortized portion is returned to the operator upon a termination of the management agreement). These investment commitments may benefit the owner and/or the lender and are usually documented separately from the management agreement and the SNDA.

Considerations of Lenders and Operators in Workouts

In non-hospitality workouts, a lender will evaluate the property's tenants and cash flows, and the history and solvency of the borrower, in deciding whether to foreclose or modify the loan. Installing a new property manager in non-hospitality workouts is usually not a prohibitive consideration. While a hotel lender will still evaluate the cash flows and the borrower, issues regarding the operator will be a significant driver of the workout process due to the importance of the operator and the brand's effects on the overall performance of the hotel in the property's particular market.

Strategies of the Lender in Dealing with the Operator

In general, a lender will take one of the three following approaches when dealing with the operator in a loan workout, depending on the considerations below:

1. Keep the operator in place under the existing management agreement.

2. Terminate the management agreement and seek a new operator.

3. Keep the operator in place under a revised management agreement, either giving or receiving concessions depending on the relative leverage of the operator and the lender.

In deciding the best available approach to take with the operator in the workout process, the following issues will be among the lender's considerations:

Property-Specific Issues: Is revenue from the property sufficient to cover operating expenses? How is the property performing compared to the rest of its market segment?

Identity of the Operator: How important is the identity of the operator to the performance of the hotel? For example, a luxury hotel in a unique central location likely will be analyzed differently than a motel clustered with competitors at a suburban highway exit. Separately, a lender will consider the difficulty and expense of rebranding the hotel and reaching an agreement with a new operator. For a hotel operating at a loss, a lender may consider allowing the hotel to go dark while it seeks a new operator. However, operating a hotel at a loss may prove less costly to a lender than allowing the hotel to "go dark," depending on the expenses of maintaining a vacant building and the lender's ability to rebrand and sell the property.

Management Agreement/SNDA Issues: A lender will evaluate whether foreclosure, under the management agreement and the SNDA, will (i) allow the operator and/or the lender to unilaterally terminate the management agreement, (ii) require the payment of damages to the operator, or (iii) impose liability on the lender for amounts owed to the operator by the owner prior to foreclosure (such as deferred incentive management fees). A lender also will consider whether the terms of the management agreement are incompatible with operating the hotel profitably over the near- to medium-term, whether the agreement conforms to current market terms, and the burden of meeting required capital expenditures and maintenance of the operator's "brand standards."

Credit Enhancements: If the operator is bound by guaranties or capital commitments, or if the operator has given the owner subordinate financing, what effect would foreclosure have on such credit enhancements?

Strategies of the Operator in Dealing with the Lender

In general, an operator will take one of the three following approaches when dealing with the lender in a loan workout, depending on the considerations below:

1. Remain in place under the existing management agreement, either with the current owner or the lender following foreclosure.

2. Terminate the management agreement (if permitted by the SNDA) and vacate the hotel, although operators typically disfavor termination absent exigent circumstances.

3. Remain in the hotel under a revised management agreement, either giving or receiving concessions depending on the relative leverage of the operator and the lender.

In deciding the best available approach to take with the lender in the workout process, the following issues will be among the operator's considerations:

Property-Specific Issues: How profitable is the property for the owner and the operator? Is the property producing incentive fees for the operator? The operator will evaluate the strategic location of the property and the value of the property to the brand, as with an iconic location. The operator also will consider the ability of the property, to maintain the operator's "brand standards" either under the current owner or under the lender following a foreclosure.

Identity of the Operator: In addition to determining whether its ability to manage the property is unique, an operator also will evaluate the lender's perceptions about the operator, including the time and expense that the lender believes it would incur in replacing the operator.

Management Agreement/SNDA Issues: Does the management agreement allow the operator to terminate the agreement unilaterally, either with or without foreclosure? If so, do the operator's agreements with the lender allow such a termination? Would the operator receive damages? The operator has a unique interest in the owner's potential bankruptcy, because a termination of the management agreement in bankruptcy would convert the operator's damages claim into an unsecured claim against the owner. The operator will evaluate the lender's obligations to cure pre-foreclosure defaults of the owner or to pay amounts owed to the operator attributable to periods prior to the foreclosure. Finally, the operator will consider the value of the management agreement when faced with current projections of occupancy and revenue.

Credit Enhancements: Like the lender, the operator will consider the impact of any action on its obligations under any credit enhancements that it has given to the owner or the lender. Depending on the burden imposed on the operator by such enhancements, the operator's ability to restructure these obligations may be one of its primary considerations.

Conclusion

Unfortunately, there is no standard method to approach or analyze issues involving operators of distressed hotel properties. Due to the multiple considerations, the answer to any question will often be that "it depends." However, the complex relationship among the operator, the owner and the lender arising from the various agreements will require the parties to consider the impact of any workout decision on the operator. Borrowers and lenders that fail to incorporate considerations regarding the operator into the workout process at an early stage will do so at their peril.

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If you have any questions regarding this alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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