THE FINANCEABLE HOTEL MANAGEMENT AGREEMENT

By K.C. McDaniel[1], © 2004

The current business cycle for hotels appears to be turning up after several years of uncertainty and declining performance. For some owners, the economy, SARS, and the Iraq war combined to drive hotel returns in 2003 below even the performance levels of 2001 and 2002. Approaching debt maturities, threatened increases in interest rates, and increased pressure for capital spending added to owners' problems. Mezzanine debt, taken on in 2001 and 2002 as a device to survive the sharp drop off of business in 2001, went into default. Faced with insurmountable debt burdens, some owners chose to hand back the keys. This was done directly or by cooperating in the hotels being offered for sale at the direction of lenders. By such arrangements, hotels have gone less visibly and less frequently into the hands of lenders in the last few years than they did in previous cycles. More conservative loan-to-value ratios kept debt burdens relatively low, and aggressive cost cutting helped hotels survive at performance levels that would have been fatal a few years earlier. Many hotels also were fortunate in holding large capital reserves in 2001, which allowed them a significant cash cushion.

Some analysts also attribute this better performance in this current cycle to the increased use of securitized hotel debt. The securitization requirements had caused owners to put their hotel assets into single purpose entities. Such owners more easily able to resolve their issues with lenders on a hotel-by-hotel basis without risk to other assets. These "owners" were often funds or groups of investors uninterested in increasing their commitment to a failed project. Handing the property to the special servicer or mezzanine lender was a relatively simple decision. Lenders acting through special servicers were perceived to be more remote, harder to communicate with in a negotiated settlement, and less flexible. With relatively less at stake and this higher barrier to successful restructuring, owners were in some cases willing to walk away. The lenders were able to accept back the properties, unlike lenders in the early 1990's who were themselves coming under the control of federal banking and state insurance regulators and could not take on the added costs of holding properties that they had taken back.

The smaller number and the lesser scale of the bankruptcies and litigated foreclosures and other failures in this cycle also come from other causes. There has been increased judicial and lender experience with litigated hotel workouts, producing an expanded awareness of the legal and statutory principles involved and the methods of resolution. Accurate or inaccurate, this awareness has led participants to identify and move toward consensus on some form of resolution. There have, however, also been some disappointments that have produced unanticipated results and have increased losses, costs, and delays to lenders in recovering value

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from their loans. This has resulted in reconsideration of basic assumptions about what works and what lenders should seek in hotel loan and investment documentation.

SETTING THE STAGE

The downturn in the current cycle of hotel performance is generally regarded as beginning in 2001. Contrary to frequent assertions by hotel operators that poor hotel performance resulted from the events of September 11th, the hotel industry was already under pressure much earlier in that year. The events later in the year severely accelerated what was already an existing trend downward. The previous performance cycle in the hotel industry had emerged from the depressed economy of the early 1990's, climbing to higher performance and perceived returns in the late 1990's. This had produced a new burst of construction and development at the end of the decade, some of which was not justified by financial prospects. It was this burst of new supply and marginal projects that was beginning to affect the market in 2000 and 2001.

The lowest point of the cycle of the 1990's had been early in the decade, but the litigation and workout of failed hotels continued through the years of improved performance that followed. Thus, lenders and owners were operating in the late 1990's against a background of legal decisions and jury verdicts in cases that had been on the court calendars since the depths of the previous cycle. Among the more significant developments that the industry confronted were:

- <u>Bankruptcy Reform Act of 1994.</u> The industry had come to shocked realization in the early 1990's that hotel revenues were not always deemed to be rents but might be accounts receivable. As such, hotel revenues did not remain in the control of the secured lender as cash collateral in bankruptcy and could be made available to other creditors. This gave borrowers greater reason to go into bankruptcy. This led in turn to intense conflict between, most typically, affiliates or unsecured creditors of the borrower on the one hand and the secured lenders on the other. Hotels were held hostage to threats of forced closure as cash collateral could not be used for continued operation. After a series of multi-million dollar losses and an increased number of forced hotel liquidations, new hotel loans became increasingly scarce. This adversely affected value just as a very large number of failed hotels were being put on the market. A lobbying alliance of labor, lenders and management companies attempted to secure an amendment of the bankruptcy law to obtain a more certain treatment of revenues. After some setbacks, they ultimately obtained a change in law in 1994. The bankruptcy amendments allowed lenders to provide that hotel revenues were to be secured and dealt with in the same manner as rents in bankruptcy.

- <u>Government Guarantee Fund et al. v. Hyatt Corporation</u>, 95 F.3d 291 (3d Cir. 1996). A local dispute over hurricane insurance proceeds and the reinstatement of a management company after reconstruction of a hotel developed into a highly significant United States Court of Appeals decision. The court upheld the right of owners and lenders to terminate hotel managers at will and without cause under agency principles. Because the hotel in question was in a U.S. territory, the state law questions presented in the case were decided in a federal district court within the Third Circuit. The appeal from the case was ultimately taken to the same United States Court of Appeals that has jurisdiction over, among other states, Delaware. Moreover, the willingness of the management company to litigate every point or theory produced a comprehensive decision by the Court of Appeals on at-will termination. Long-term management agreements suddenly looked much less secure.

- 2660 Woodley Road Joint Venture, et al. v. ITT Sheraton Corporation et al. Making use of the precedent of Government Guarantee, an institutional owner filed a claim in Delaware federal district court on the basis of Sheraton's incorporation in Delaware. The case involved, among other claims, antitrust claims under the Robinson-Patman Act and tort, common law and contract claims relating to purchasing practices. The case was widely regarded in the industry as one about management company practices in soliciting and accepting undisclosed payments from vendors to managed hotels. A large ($50+ million) verdict has now been whittled down in subsequent motions and appeals to a few million dollars, but the termination of a long term contract without compensation stands. The core findings of breach of contract, tort liability and eligibility for a punitive damages award also remain intact. The case was an education for the industry in the consequences of fiduciary obligation imposed on management companies.

Against the background of these developments, and in particular the change in treatment of revenues, some lenders resumed lending on hotel collateral. Many did not, but their absence was not conspicuous because a new wave of securitized lenders filled many of the niches left empty in the market. There was a general assumption that the changes in law would be sufficient to restore hotel lending to a predictable and stable industry and to make hotel lending the equivalent of conventional real estate lending. Lenders also attempted to use some techniques familiar from corporate lending to reduce risk in hotel lending. These included use of standby lockbox arrangements, three-party agreements with major contractors, and broad rights to take over the business upon default. The general approach of lenders was to try to assure themselves that they could strip the hotel of other obligations and foreclose upon the collateral.

PLAYING OUT THE DEFAULT SCENARIOS

As hotel problems worsened in and after 2001, hotel owners went into default with some frequency. Many defaults were initially handled by new lending, forbearance arrangements, cash traps and interim restructuring intended to maintain the properties in operation until the economy could recover. A few hotels already under stress went into bankruptcy, generally in reaction to efforts by special servicers to foreclose securitized loans. An early surprise to the lenders was the discovery that hotel owners not only could file for bankruptcy, they could also survive motions to dismiss their bankruptcies. The owners proved able to achieve the practical effect of consolidating their cases, notwithstanding all of the opinions given in securitization on substantive consolidation. Using established bankruptcy principles, the owners and their operators could get access to the hotel revenues for use as cash collateral, keeping the hotel doors open and employees paid in a prolonged bankruptcy. This cash collateral could be reached through action by the borrowers directly, by affiliated but not insolvent management companies, by management companies not affiliated with the borrower, and/or by unsecured creditors. The strong bias of bankruptcy courts to keep businesses operating and to preserve jobs was a major factor in this. For lenders or their servicers who assumed that they had an easy path to control and liquidation of hotel collateral, the result was unsettling.