

Anatomy of a Hotel Workout

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Two Parts to the Presentation

1. Workouts Outside Bankruptcy
2. Chapter 11 Reorganization: Selected Issues

I. Workouts Outside Bankruptcy

- The “patient” in this presentation is an **insolvent hotel owner**.
 - Assume the owner is an SPE whose only asset is one hotel.
 - Assume the hotel is branded. We will examine scenarios involving brand management and third-party management.
- Two definitions of “insolvency”:
 1. Liabilities exceed assets
 2. **Inability to pay debts as they come due**
- The workout includes two categories of treatment:
 1. Changes to the owner’s business, to increase revenue and reduce costs
 2. **Seeking relief from the owner’s creditors.**

Hotel owners' creditors include:

1. Secured Lenders, including

- Traditional lenders
- Servicing agents of CMBS loans

2. Franchisors

3. Management Companies

- Sometimes branded, sometimes independent
- Under franchise agreements or management agreements

4. Others

- a. Mezzanine Lenders
- b. Vendors and Service Providers
- c. Employees and Unions

Creditors' Commonalities and Differences

Commonalities

- Each has an interest in being paid as much as possible of what it is owed.
- Each bears some risk of not being paid.
- Most have rights defined by previously existing instruments.

Differences

- Differences in seniority
- Some may have an interest in continuing a relationship with the owner (and its affiliates), while others may not.
- Hotel owner may be in default to some but not others

Basic Structure for Approaching Each Creditor

1. Considering Existing Instruments

- What instruments define the creditor's rights?
- Is the owner in default (or will it be)?
- What are the creditor's remedies upon default?
- Has the creditor begun exercising those remedies?

2. Seeking Amendment to Instruments or Forbearance from Remedies

- Is the creditor willing to amend the applicable instrument(s) to reduce risk of default?
- Is the creditor willing to forbear from exercising remedies upon a default?

3. Offering Consideration in Exchange for Forbearance

- What can the owner offer (and what will the creditor demand) in return for any amendment or forbearance?

Secured Lenders: Greatest Potential Relief

Existing Instruments

Loan Agreements (including mortgage agreements and deeds of trust) define defaults, cure rights and remedies upon events of default.

Guaranties give lenders recourse against one or more of the owner's principals or parent companies.

Agreements with Management Companies

- Include Lockbox Agreements, Cash Management Agreements and Subordination Agreements (including **SNDAs**) and Collateral Assignments of HMAs
 - Allow (and, to varying degrees regulate) a lender's ability to control management of the hotel before and/or after a default.
 - **SNDA often the key document governing a workout.**

Comfort Letter from Franchisor

- Assures lender that brand will remain after lender takes title through foreclosure, subject to certain conditions

Relief Sought from Lenders

- If already in default, **forbearance** from foreclosure and other remedies under the loan documents
 - Extra time to pay off amount past due (possibly rolling up outstanding principal and interest in a new loan)
 - Maybe forgiveness of some of the outstanding debt
- If the owner can't pay off the balance on maturity, **extension** of the note maturity date
- Relief from a personal guaranty

Why would a lender grant such relief?

Lender's objectives and motives include:

1. Recovering as much of the loan balance as it can.
2. Avoiding administrative costs of holding hotel on its balance sheet

The debtor can offer the lender:

- In a down-cycle, additional time for the hotel to recover value
- Additional time for a new business plan to take hold
- Possibly new value in the asset from a new investor
- An alternative to the debtor filing bankruptcy
- Avoidance of foreclosure sale for a highly discounted price

Assessing Debtor's Leverage against a Lender

How “underwater” is the hotel, where is the industry within the cycle, and is the owner's new business plan viable?

- If the hotel may later recover value, now may be a bad time for the lender to foreclose and sell.

Review the loan documents carefully.

- Oversights can be a source of leverage.
- What is included among the collateral?
 - Example of loan secured only by real estate and not FF&E.
- Were the loan documents not customized for a hotel?
 - A general “assignment of rents” does not encompass guestroom revenue.

CMBS Loans: Harder to negotiate with servicers

- They have less discretion
- Hard to get approvals from security holders

Franchisors: Existing Instruments

- Franchise Agreement
 - Often a 20-year license agreement
 - Franchisee gets affiliation of a brand and use of a reservation system
 - Franchisor gets a percentage of total revenues
- Personal Guaranty
- Comfort Letter
- Promissory Note for any Key Money

Hard to Seek Relief from Franchisor

- Franchisor's primary investment is in the **brand**
 - Poorly-performing property reflects poorly on the brand
- Key money investment less likely
- Franchisor has less control than management company
- Culture of brand managers vs. franchisors
- Utility company analogy
- **Nevertheless:**
 - PIPs deferred during the Great Recession
 - Brand standards enforced more flexibly during the Great Recession
 - FF&E Reserve relief during the Great Recession
 - Some franchisors do allow a lot of unpaid fees to accrue.
 - With soft branding, more franchised properties are trophy assets.

Management Companies: Existing Instruments

Hotel Management Agreement (HMA) — outlays:

1. Fees

- a. Base Fees (always)
- b. Incentive Fees (contingent, under most branded and some unbranded HMAs)
- c. System Fees (for shared services, chain services, marketing and sometimes a-la-carte services like accounting and revenue management)

2. Expenses

- a. Budgeted expenses
- b. Unbudgeted expenses (e.g. to respond to emergencies)

3. Reserves for FF&E and/or Capital Expenditures

Management Company Agreements with Lenders

- Management Co. may have to give up some control over operating account and FF&E reserve.

HMA Amendment or Forbearance, and Management Co.'s Consideration in Exchange

Form of Instrument:

- Branded Management Company: forbearance through a side letter agreement
- Independent Management Company: more possibility of an amendment or even a new HMA.

Fee Relief:

- For a **trophy property** of a brand management company, **maybe** a temporary reduction in the base fee (e.g. from 3% to 2.5%) in exchange for an increase in the incentive fee percentage or reduction in owner's preferred return (of which would be effective only after a recovery)
 - Utility company analogy again

HMA Amendment or Forbearance, and Management Co.'s Consideration in Exchange

Expense Relief:

- Revisit budget to reduce expenses
- Much of this is controlled by brand standards
- Property Improvement Plans (PIPs) postponed during Great Recession

Reserve Relief:

- Lender will have some say in this
- Also driven by brand standards
- Temporary reductions of FF&E reserve requirements during the Great Recession (with later required recoveries)

Performance Test—possible tradeoff

- If the hotel is failing its performance test and the management company wants to stay, Owner can offer to waive this, and/or agree to a temporary adjustment for future performance.
- Less potential if it is a “two-prong” test and the competitive set is also underperforming

What does the Management Company Get?

- Preservation of management of an asset in which it may have invested a lot
- Possibly preservation of a trophy asset
- Avoidance of bankruptcy
 - Management agreements can be rejected in bankruptcy.
- Release from any claims of mismanagement

- Advantages to branded vs. non-branded management companies

Others

Mezzanine Lenders

- Have warrants to acquire ownership in the event of default
- Often want to acquire ownership

Vendors and Service Providers

- Also like utility companies
- With thin margins, they are less likely to reduce fees.
 - Maybe in exchange for a requirements contract?
- They may work a hotel on extending terms (e.g. from 30 to 60 days)

Employees and Unions

- They may already be experiencing layoffs and cuts in hours.
- Don't expect them to accept pay cuts.

II. Chapter 11 Reorganizations: Selected Issues

Single Asset Real Estate (SARE)

What is “Single Asset Real Estate”?

Real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incident thereto.

SINGLE ASSET REAL ESTATE

Consequences of being a SARE: Pace of the case is dramatically accelerated.

Section 362(d)(3) of the Bankruptcy Code: Requires that the court grant relief from the automatic stay for secured creditors to proceed against the “single asset real estate” unless:

- (1) with 90 days of the date the petition is filed the debtor either files a Chapter 11 plan “that has a reasonable possibility of being confirmed within a reasonable time”; or
- (2) The debtor has begun making regular monthly payments to each creditor whose claims is secured by the real estate in an amount equal to interest at the then applicable non-default contract rate of interest on the value of the creditor’s interest in the real estate.

SINGLE ASSET REAL ESTATE

General Rule: Although merely calling a building hotel is insufficient to remove it from the definition of a SARE, “the operation of a full service hotel is more than the merely operation of property.

In re CBJ Development, Inc., 202B.R.467 (9th Cir.BAP 1996) (63 room hotel)

CJB Development – debtor generated income from the rental of hotel rooms, and the operation of bar, restaurant, and gift shop.

SINGLE ASSET REAL ESTATE

In re Iowa Hotel Investors, LLC, 464 B.R. 848 (Bank. N.D. Iowa 2011)

- 64 room County Inn and Suites
- 3 full-time employees, 23 part-time employees
- “The services include room cleaning, complementary breakfast, a whirlpool and swimming pool, a fitness center, laundry service, dry cleaning pick up and delivery, and internet and phone service.”
- Hotel includes a business center, and meeting rooms.

USE OF CASH COLLATERAL

Section 363(c)(2) of the Bankruptcy Code:

- A debtor “may not use, sell, or lease, cash collateral *** unless (A) each entity that has an interest in such cash collateral consents; or (B) the court *** authorized such use, sale, or lease *** ”

Section 363(a) Defines “Cash Collateral”:

- Cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property **and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in Section 552(b)** of the title, whether existing before or after the commencement of a case under this title.

USE OF CASH COLLATERAL

State Law is not Uniform:

- **Hotel Revenue - Component of Real Estate:**

- Perfected with an Assignment of Tents and Mortgage recorded with county Recorder

- **Hotel Revenue - Personal Property:**

- Perfected under UCC if you a valid financing statement with the Secretary of State.

USE OF CASH COLLATERAL

If Personal Property – What type?

- *In re Lexington Hospitality Group, LLC, 2017 WL 5035081 (Bankr.E.D.Ky.)* (Lexington Clarien Hotel and Conference Center, with Bennigan's restaurant)
- **3 Types of Transactions:**
 1. Room charges paid with cash;
 2. Room charges paid with credit card;
 3. Restaurant receipts.

*Each type of proceeds must be properly perfected.

CASH COLLATERAL USE – ADEQUATE PROTECTION

- **Section 363(e):** Provides that a secured creditor can condition a debtor’s post-petition use of cash collateral on receipt of “adequate protection.”
- **Section 361:** Provides examples of adequate protection which includes:
 - Periodic cash payments;
 - Providing additional or replacement liens; and
 - Granting the security creditor the “indubitable equivalent of such entities interest in just property.

CASH COLLATERAL USE – ADEQUATE PROTECTION

Adequate Protection for Real Estate:

- (i) Keeping all real estate taxes current;
- (ii) Maintain all levels of insurance on the property as prior to filing the bankruptcy petition;
- (iii) Maintain the property to ensure that it does not depreciate in value, or provide the creditor with monthly payments to reflect the decrease in property value.

Adequate Protection for Room Revenue:

- Debtor generally may use cash collateral to reasonably maintain the property.

CASH COLLATERAL USE – ADEQUATE PROTECTION

Special Treatment – Rents & Hotel Room Revenue

Section 552(a) – The General Rule: “[P]roperty acquired by the estate or by a debtor after commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before commencement of the case.”

Section 552(b) – Rent & Hotels Room Revenue: If the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, and other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts or other payments acquired by the debtor after the commencement of this case to the extent provided by such security agreement.

CASH COLLATERAL USE – ADEQUATE PROTECTION

Courts Split: On how to deal with Issue.

Single Valuation Approach:

A bifurcation under § 506(a), made as of the filing of the case, fixes the interest of the secured creditor in property of the estate for all purposes, including adequate protection.

Continuous Valuation Approach:

Recognizes that a creditor which hold both a mortgage in real estate and a security interest in room revenue has 2 distinct security interest, both entitled to adequate protection.

CASH COLLATERAL USE – ADEQUATE PROTECTION

Dual Valuation Approach:

Adequate Protection:

For purpose of adequate protection, the claim of the secured creditor is fixed as of the date of filing, i.e., § 552(b) proceeds increase the collateral securing the claim, but do not increase the claim for purposes of adequate protection.

Consequence:

Hotel room revenue can be used for administrative expenses.

At Confirmation:

The secured claim is revalued. Any proceeds under §552(b) that have not been expended by the debtor, and are not necessary to pay expenses of reservation. Increase the amount of the secured claim.

CLASSIFICATION ISSUES

Rule No. 1 – Classification of Claims:

A plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interest of such class. (Section 1122)

Rule No. 2 – Special Rule for Secured Claims:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest *** is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property *** and is an unsecured claim to the extent that the value of such creditor's interest *** is less than the amount of such allowed claim. (Section 506(a))

Example: \$100 loan, collateral worth \$75, secured to \$75, unsecured \$25.

CLASSIFICATION ISSUES

Rule No. 3 – Three Ways to Get a Plan Approved: With respect to each class of claims or interests –

1. Such class has accepted the plan; or
2. Such class is not impaired under the plan. (Section 1129(a)(8))
3. If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including the acceptance of the plan by an insider. (Section 1129(a)(10))

Rule 4 – How a Class Accepts a Plan: A class has accepted a plan if such plan has been accepted by creditors *** that hold 2/3's in amount and more than 1/2 in numbers of the allowed claims of such class.

CLASSIFICATION ISSUES

- **Goal of Debtor's Counsel:** Try to separate classes of creditors in the hope of securing an impaired class of creditors that will vote in favor of the plan.
- **Example of the Issue:**
 - **Hotel:** Had a FMV of \$2.5 million
 - **Secured Debt:** \$3,250,000
 - **Unsecured Debt:** \$150,000
 - **Licensing Agreement:** Arrearage of \$67,000

CLASSIFICATION ISSUES

When Can You Place Similar Claims in Different Classes? The case law is muddled.

One Clear Rule: “Thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan.” *In re Greystone III Joint Venture*, 995 F.2d 776 (5th Cir.1991)

Other Tests:

1st Circuit Test: The general rule regarding classification is that all creditors of equal rank with claims against the same property shall be placed in the same class. *In re Granada Wines, Inc.*, 748 F.2d 42 (1st Cir.1984)

Legitimate Business Reason Test: Separate classification is appropriate if the proponent has a legitimate business reason for treating the claims differently. *In re Novinda Corp.*, 585 B.R. 145 (10th Cir.BAP 2018)

Distinct Voting Interest Test: Each class should represent a voting interest that is sufficiently distinct and weighty to merit a separate voice. *Matter of Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213 (Bankr.D.N.J.2000)

Venue

- **28 U.S.C. §1408 – Venue of Cases Under Title 11:**

A case under title 11 may be commenced in the district court for the district

- In which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of such case have been located for the 180 days immediately preceding such commencement.
- In which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership

Corporations:

Residence: At their place of incorporation.

Principal Place of Business: The place where corporation's officers direct, control and coordinate the corporation's activities

Questions and Discussion

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