

Hospitality

March 23, 2017

Ongoing Issues in Negotiating Subordination and Non-Disturbance Agreements in the Hotel Industry

Negotiating hotel management agreements on behalf of Hotel Owners and Hotel Operators has become increasingly complex. One of several key issues that arises is the Hotel Owner's ability to obtain financing to develop or acquire the hotel, and to provide security to its lender over the hotel and related assets. This needs to be considered relative to the Hotel Operator's desire to ensure its hotel management agreement (the "HMA") and 'brand' remain in place and protected for the stated term of the HMA. Hotel Operators often address this issue in the HMA by requiring the Hotel Owner to obtain a subordination and non-disturbance agreement (an "SNDA") from its lender as a condition to entering into any such financing, whereby the lender agrees to honour (i.e., not disturb) the HMA if the lender ultimately enforces its security over the hotel.

Negotiating an SNDA in a manner that protects the Hotel Operator's rights and also accommodates the Hotel Owner's need to obtain financing requires that counsel also consider (i) the lender's avenues of enforcement against the hotel and related assets if the Hotel Owner defaults under the loan; and (ii) the Hotel Owner's permitted transferees if the lender ultimately enforces.

I. ENFORCEMENT OF THE LENDER'S SECURITY

A Hotel Operator (and perhaps to a lesser extent, the lender) is keenly interested in ensuring that the HMA will be honoured and continue in place during and after the lender's enforcement of its security over the hotel or related assets. The Hotel Operator's ability to protect against this concern depends largely upon whether the hotel is located in a civil law or a common law jurisdiction.

A. Civil Law Jurisdictions

In civil law jurisdictions, the Hotel Operator will want to negotiate terms in the SNDA that prevent (or delay) the lender's ability to enforce any security over the hotel by way of a public or judicial sale conducted through the courts of the relevant jurisdiction, which, in most cases, is the only viable remedy available to a lender to recover its loan. Typically, in civil law jurisdictions, once the courts are involved for the purpose of enforcing the lender's security over the hotel or as a result of the Hotel Owner's insolvency, the parties lose any ability to control the sale process and prevent the HMA from being terminated. The HMA is simply a contractual relationship between two parties and as such would not be binding under applicable law against the hotel purchaser in a public or judicial sale process.

To pre-empt or delay the possibility of a public or judicial sale, the Hotel Operator should negotiate the right in the SNDA to purchase the loan and the lender's security from the lender at par, together with all accrued and unpaid interest owing on the loan. Lenders are typically amenable to this right.

In addition, the Hotel Operator should consider negotiating terms in the SNDA whereby the lender must:

- (a) take security over assets in addition to the hotel and related assets, such as a pledge of shares of the Hotel Owner, and enforce its rights under the other security before being entitled to enforce any security over the hotel itself or enforcing through a public court process;
- (b) provide the Hotel Operator with the ability to cure defaults under the loan agreement; and
- (c) refrain from taking any steps to render the Hotel Owner "insolvent" which could automatically trigger the requirement to proceed by way of public or judicial sale process.

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B. Common Law Jurisdictions

Concerns over losing the HMA automatically in a public enforcement process are lower in the case of enforcement in a common law jurisdiction. Rights negotiated by a Hotel Operator in the SNDA requiring a lender to follow specific steps in enforcing its security and to honour the HMA may be enforced by the Hotel Operator in a public or private sale proceeding to some extent, and damages can be claimed against the lender for failing to honour its contractual agreement. However, the lender's obligations may still be subject to the jurisdiction of a bankruptcy court to nullify an executory contract such as a HMA.

The foregoing is a summary of just two of the major issues which typically arise in negotiating an SNDA between a lender and a Hotel Operator in the context of a hotel transaction. Stay tuned for our next client communication where we will discuss additional issues of concern in these negotiations.

II. PERMITTED TRANSFEREES AND THE LENDER'S FORECLOSURE RIGHTS

To protect their brands, Hotel Operators customarily attempt to negotiate restrictions on who may be a "permitted transferee" of the Hotel Owner in a foreclosure or sale process. Some of the factors in determining who may be a "permitted transferee" include (i) whether the proposed transferee is a competitor of the Hotel Operator; (ii) the financial ability of the proposed transferee to perform the obligations of the Hotel Owner under the HMA; and (iii) whether the proposed transferee is a party with whom the Hotel Operator is prohibited from doing business under applicable sanctions and anti-terrorism laws.

A lender will typically resist some of these criteria as they limit who the lender can sell the hotel to in order to realize sufficient proceeds to repay its loan. For example, many lenders are now only agreeing to exclude persons who are competitors or prohibited persons. Lenders are seeking to remove any criteria relating to financial ability on the basis that if the foreclosure purchaser is able to purchase the hotel, any financial ability criteria will have presumably been satisfied.

Depending on how "permitted transferee" is ultimately defined in the SNDA, a Hotel Operator may also want to negotiate a right to purchase the hotel from the lender, or to purchase the loan and all of the lender's security, thereby acquiring the flexibility to sell the hotel to an acceptable third party, while at the same time maintaining its rights under the HMA.