

## Hospitality

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

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Negotiating hotel management agreements on behalf of Hotel Owners and Hotel Operators has become increasingly complex. As we discussed in Part I of this Hospitality Law Update, one of several key issues that arises in the negotiations 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 (a "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.

In Part I of our Hospitality Law Update dealing with issues arising in negotiating a SNDA, we focused on considerations relating to (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. In this Update, we will focus on two potential issues relating to inconsistencies between the lender's rights against the Hotel Owner under the loan documents versus the Hotel Operator's rights against the Hotel Owner under the HMA. Hotel Operators typically prefer to address any inconsistencies in the

SNDA rather than the HMA as the SNDA will survive for the term of the loan, while the HMA will typically have a much longer term.

### I. Hotel Bank Accounts

The HMA typically provides the Hotel Operator with control over the hotel's operating bank accounts (including any reserve accounts established to fund routine repairs and replacements of furniture, fixtures and equipment ("FF&E") and other minor capital expenditures). This is to ensure the Hotel Operator has access to sufficient funds to operate and maintain the Hotel to the "standard" required under the HMA. The Hotel Operator is extremely reluctant to cede these rights to the Hotel Owner or to a lender (by virtue of the terms of a loan agreement) as it leaves the Hotel Operator in a situation where it may not have access to funds to operate or maintain the hotel at a standard necessary to protect the Hotel Operator's brand without having to pay necessary expenses out of its own pocket.

Providing the Hotel Operator with control over the operating bank accounts typically conflicts with the lender's desire to control various assets of the Hotel Owner under the loan agreement or under its security documents. This issue is sometimes resolved in favour of the Hotel Operator by obtaining the Hotel Operator's agreement to pay directly to the lender any share of operating revenues the Hotel Owner is otherwise specifically entitled to be paid from the accounts under the HMA terms after payment of operating expenses (including the Hotel Operator's fees, charges and expenses) and the funding of FF&E and working capital reserve accounts. Other lenders may require strict "lock box" type arrangements regarding operating revenues, in which case the Hotel Operator will need to negotiate exceptions to permit sufficient revenues to be released to meet the continued operating and maintenance needs of the hotel on a basis necessary to comply with the HMA

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terms. As part of these “lock box” arrangements, lenders will typically require the right to pay certain hotel-related expenses from operating revenues that, if unpaid, would rank in priority to the lenders’ security over the hotel.

## II. Insurance and Condemnation Proceeds

Inconsistencies also occur with competing rights to insurance proceeds arising from damage to, or interruption in the operation of, the hotel. The competing concerns of the lender and the Hotel Operator with respect to insurance proceeds are not dissimilar to those relating to the operating bank accounts. The Hotel Operator wants to ensure that (i) business interruption proceeds are available to allow it to continue operating the hotel to the requisite “standard” and to compensate the Hotel Operator for its fees, charges and expenses owing under the HMA and (ii) casualty proceeds are available to repair any damage to the hotel. On the other hand, the lender wants control over the insurance proceeds to ensure there are sufficient funds to service or repay the loan and to protect the value of its collateral. Similar considerations arise in the context of rights to condemnation proceeds.

Quite often this issue is resolved by permitting insurance or condemnation proceeds to be used to repair and maintain the hotel where the level of damage or destruction to, or condemnation of, the hotel is below some agreed upon percentage threshold(s) or where the amount of the proceeds is below some agreed upon dollar threshold(s). If these thresholds are exceeded, the SNDA will provide the lender with the ultimate right to determine how and if the casualty or condemnation proceeds may be applied for repair or whether the proceeds must be used to repay the loan. In addition, the lender and Hotel Operator often agree that the business interruption proceeds will be handled and applied in accordance with the HMA, including the Hotel Operator being entitled to proceeds of business interruption insurance to the extent necessary to compensate the Hotel Operator for lost fees and expenses during the period of any business interruption.

If properly insured, the business interruption insurance will also insure the Hotel Owner’s debt service costs and, accordingly, the application of the business interruption proceeds becomes less of an issue from the lender’s perspective.

The foregoing is a summary of just two of the major issues which typically arise in negotiating a SNDA between a lender and a Hotel Operator in a hotel transaction. Great care and understanding of the issues is required to accommodate the mutual interests of the Hotel Operator and the Hotel Owner and its potential financiers.