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Everything Old is New Again: Hospitality Industry Financing and the Pandemic

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Everything old is new again. A decade after the Great Recession, the pandemic has once again pushed the real estate and hospitality industries to the brink. The overwhelming majority of hotel owners, managers, operators and licensors find themselves in financial distress.

In a letter sent just last month to the President, the American Hotel & Lodging Association, along with senior executives from 78 hotel and hospitality-related companies and organizations, reported that more than two-thirds of hotels estimate that they will only be able to survive six more months at current projected revenue and occupancy levels. This, of course, has significant implications for the finance industry.

We find ourselves back in the world of foreclosures, UCC sales, special servicing, bankruptcies, and note sales accompanied by heavy legal diligence on potential borrower defaults and the available remedies. The stakeholders are digging through their loan documents and trying to figure out their exposures, strengths, weaknesses, and leverage points. All of this will require an in-depth analysis of the various loan documents and how they interact with the array of hospitality industry contracts found on nearly all of the projects across the country.

While we cannot reflect on all aspects of the current landscape in one article, we look at some of the current finance issues - labor and employment, priority of interests, and covenants.

All of this will play out over the course of the upcoming years (yes, "years"); to paraphrase Al Pacino in Scent of a Woman: "We're just gettin' warmed up".

Acquiring a Hotel Subject to a CBA Merits Increased Scrutiny

The COVID-19 pandemic has significantly depressed hospitality assets and, as a result, presents opportunities for would-be buyers of assets or the loans secured by such assets. Diligence on these assets by would-be acquirers and diligent monitoring by current lenders is critical where market forces threaten to default hospitality-backed loans and push hotels into insolvency.

One customary area for due diligence and lender monitoring is the labor dynamics at the hotel. Many hotels, particularly those in large urban areas such as New York City, Boston, and Washington, D.C., are parties to collective bargaining agreements that address such issues as wages, hours, and terms and conditions of employment. Since these agreements have a significant impact on the cost of doing business, both by imposing wage and benefits scales and by affecting the ability of hotel owners and managers to reduce or restructure the hotel's workforce, all of the parties evaluating these assets, buyers, sellers, workout specialists, managers, lenders – have long scrutinized these factors when considering a hotel asset.

But while these attributes of a union hotel are well-understood, would-be acquirers and debt owners alike historically have been less focused on CBA provisions requiring that any successor owner of the hotel assume and be bound by the CBA. While this standard CBA language has often been of secondary concern – the common thinking being that there would always be a willing buyer to assume the CBA when the time came to dispose of the asset – the disruptive impact of the pandemic requires a rethinking of this assumption.

This year's economic upheaval has made clear that, more than ever, industry stakeholders must be mindful of how CBA assumption language may render a hotel asset unmarketable in the future – not a theoretical dynamic, but rather one currently playing out in real-time all across the country. A simple reason for this is that, in addition to establishing workforce levels and wage rates, CBAs generally also contain provisions requiring hotels to pay severance to laid-off employees and contribute to the union's health benefits fund and pension plan.

While these costs were thought to be controllable (in the case of severance) and manageable (in the case of health benefits and

pension funding) when an operating, income-generating hotel was presumed, the pandemic has created a dire new reality. With many hotels now shuttered or marginally operating, hotel owners lack both the income to maintain staffing levels and the cash reserves to pay severance obligations, which can add up to millions or even tens of millions of dollars depending on the size and seniority of the workforce.

Compounding this situation, even if the hotel can fund employee severance, that does not mean the hotel is no longer subject to the CBA. If the hotel reopens, the union will expect it to rehire union employees. Moreover, any effort to permanently close the hotel and convert the property to alternative use, thus avoiding any further CBA obligations, has its own pitfalls. For example, a permanent closure may trigger withdrawal liability under federal labor law, requiring the hotel to pay its proportionate share of the multiemployer pension plan's unfunded vested benefit liabilities. The calculation of any withdrawal liability, done pursuant to a statutory formula, can often equal millions or tens of millions of dollars, again depending on the workforce's size and seniority.

This thicket of liabilities and uncertainty is causing stakeholders to reassess hotel assets. Among other things, lenders appear reluctant to foreclose even when a hotel asset is worth more than the debt. Out of concern, no bidders will surface, leaving the lender to take the title and thereby assume the CBA with its potential severance and pension liabilities. Prospective buyers of assets or the loans secured by such assets should exercise the same caution and carefully review potential union obligations, which it may be expected to assume. As this year's uncertainty makes clear, a discerning market participant must underwrite all possibilities and factor that into its diligence process.

SNDAs

"What's an SNDA?" is a question we are hearing a lot these days. Hospitality players are not as familiar with the term as the real estate industry – and with good reason: it's a common tool in commercial real estate financing but truly a square-peg/round-hole for the hospitality world. So what IS an SNDA?

In the real estate context, Subordination and Non-Disturbance Agreements hew pretty closely to the name. The holder of an interest in the real estate will confirm that it is subordinate to the holder of a superior interest (i.e., the first mortgage holder). In exchange, the senior lienholder will agree that in the event of a foreclosure, it will not "foreclose-out" (or "not disturb" the junior interest holder). Most commonly, an anchor tenant in a large office building might not be willing to invest tens of millions in a modern, first-class build-out and the commensurate A-Building rent, only to be foreclosed in the event the owner defaults on its mortgage. So the parties, tenant-owner-lender, enter into an SNDA to protect the anchor tenant's interests in the event of a default and foreclosure.

With the hybridization of hospitality industry contracts, a number of traditional real estate concepts have made their way into management agreements. SNDAs have been utilized by managers to protect their interests and, in particular, in an effort to lock in their management of an asset even in the event of a default by the hotel owner under its loans – a common occurrence these days. Often managers will seek to protect their management contract by requiring, as part of the original deal documentation, an SNDA which may provide for the protection and continuation of the management agreement in the event the owner defaults under the loan documents – including foreclosure and sometimes even in bankruptcy.

The usage of SNDAs to protect a manager's interests from foreclosure is, in fact, an oddity. Unless the parties have agreed otherwise, typically, the manager has no interest in the real estate at all – it is a contracted-for third party. Hence, it would not even be necessary for a lender to enter into such a protective agreement, and even where such an agreement does exist, it is not clear that it would protect a manager's contractual right to continuing managing in the event of a foreclosure (whether in court or by a UCC sale).

The manager holds no lien interests, so agreeing to be subordinate to a first mortgage holder is superfluous; and gaining non-disturbance language in the event of a loan default may very well be ineffective because there is no interest in the property to be protected. On the flip side, the manager will surely point to the SNDA to protect its interests even if the agreement does not necessarily match the parties' legal rights, so the leverage in that regard is real.

Any party evaluating its options with respect to a distressed hospitality asset should carefully examine the rights and remedies generated by SNDAs.

Borrower Covenants Can Present Potential Liability for Buyers of Performing Asset Loans

An obvious target of diligence in any acquisition outside of foreclosure (or monitoring for lenders on hospitality assets) is the governing loan agreement and related guaranties. In the current market, with many borrowers in the hospitality industry facing financial difficulties arising out of the COVID-19 pandemic, critical attention should be paid to these borrower covenants and guaranties, which can prove a source of tension (and potential liability) in the event of a default, presenting challenges to the lender and pitfalls to a would-be acquirer who has not fully vetted its acquisition.

For example, it is common in hospitality financing that the lender effectively has a veto right over any termination of the borrower's hotel operator by requiring that the lender approve any termination by the borrower of the management agreement for the subject hotel. As the COVID-19 pandemic places a strain on borrowers' relationships with their operators, particularly in locations that have shuttered temporarily or indefinitely as a result of the COVID-19 pandemic, borrowers are likely to seek to terminate their management agreements in the belief that the properties are more valuable when not being subject to such agreements.

While, as discussed above, an SNDA typically governs the primary relationships between the lender and the hotel operator/manager, the loan agreement's covenants concerning termination can become an additional source of dispute with a borrower determined to terminate its management agreement. Critical attention should be paid to these covenants when lenders face any requests to approve a termination, which underscores the need to thoroughly understand the covenants in the context of any diligence.

Moreover, non-recourse financing in the hospitality industry typically includes covenants restricting or eliminating a borrower's ability to take on take on some or all forms of debt, as well as restricting certain borrower actions – like dividends, distributions, or sale/transfer of interests – during any events of default or without lender approval. These borrower actions are all typically subject to monitoring or confirmation by a lender, so having a clear understanding of such monitoring requirements is critical to avoid any surprises in an acquisition transaction.

Finally, in non-recourse financing, these borrower covenants often interact with one or more recourse carveout guarantees, subject to a guarantor (typically a creditworthy person or entity with interest in the borrower) personal liability for all or part of the outstanding loan. Understanding the nature of these guarantees, as well as whether any such guaranties have been triggered, is key, as such information can directly impact a lender's ability to recover on its note short of foreclosure and, in extreme cases, provide a lender recovery in the event of any deficiencies in a foreclosure sale.

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Extended Biography

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