

### HOSPITALITY LAW

### Expert Analysis

# Considerations for Operators of Distressed Hotels

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In our previous articles, we detailed some of the issues and considerations for key hotel industry stakeholders in navigating the current distressed landscape, including the growing number of hotels headed toward loan defaults and foreclosures. While hotel owners, operators, franchisors, and lenders each have difficult and unique questions to answer, in today's climate perhaps no constituent faces a more complex situation than the hotel operator. When a hotel is not generating sufficient revenues to cover its expenses and ownership no longer supports a failing

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asset, its hotel, what happens next? The hotel still has guests checking in and out, complex operations to carry out, bills to pay, and reservations on the books. In this article, we explore some of the issues facing operators as they navigate these uncertain times.

### Owner Funding Is No Longer Assured

As a general rule, hotel management agreements require the hotel owner, upon demand from the operator, to provide working capital when the revenues cannot cover expenses. But what happens when the hotel owner cannot provide (or refuses to provide) additional funds? Perhaps the hotel owner is truly out of money and is facing loan defaults, among other issues. Perhaps the hotel owner has made a business decision that it no longer wishes to provide funds. Either way, the hotel



operator managing the business is left to deal with the fallout.

Hotel management agreements are generally drafted to provide operators protection against liability, both by making the hotel owner responsible for all of the hotel's liabilities, as well as indemnifying the operator against any claims (such as, for example, claims by vendors or a union for unpaid wages and benefits).

Hotel management agreements are also generally drafted to provide the operator protection in the event the operator is forced to terminate the management agreement. Management agreements generally make the hotel owner responsible for any post-termination claims by

vendors, employees, and unions, as well as any post-termination statutory liability such as ERISA withdrawal liability.

In the current climate, however, such recourse may be limited if the hotel owner is a single purpose entity with no assets save for the hotel itself. The hotel owner, perhaps facing defaults under its loan and at imminent risk of losing the hotel, may have little incentive to invest further in an asset it will not hold in the long term. Absent a guaranty providing the hotel operator with an additional avenue for collection, a hotel operator inevitably must consider whether it is financially prudent to continue operating the hotel—which may mean funding working capital itself—or if it should seek to end its relationship with the hotel owner and walk away.

### Important Considerations

As a matter of law, a hotel operator cannot be forced to continue serving the hotel owner when doing so is against the operator's interests, no more than a hotel owner cannot be forced to continue to employ a hotel operator against its wishes. It is reasonable for the hotel operator to take measures to protect itself from potential liability resulting from a hotel owner's

refusal to provide working capital for the hotel.

But in navigating these situations, the operator must act carefully. Depending on the parties' relationship and the terms of the hotel management agreement, the hotel operator may be deemed to be the hotel owner's "agent"—imposing on the hotel operator certain fiduciary obligations to the hotel owner, including a duty of loyalty and good faith performance, a duty

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to use care and skill, and a duty not to act in competition with the hotel owner's interests. In some jurisdictions, parties may modify, limit, or even potentially waive fiduciary duties by contract; in others, fiduciary duties cannot be waived.

Once a hotel owner makes eminently clear it will not perform under the management agreement (such as, for instance, by funding necessary working capital), the hotel owner and the hotel operator's respective interests begin to diverge. An operator may be faced

with decisions which reconciling its interests and its fiduciary duties to the hotel owner may be difficult or impossible, and a decision will detrimentally impact either itself or the hotel owner. It is possible that the hotel management agreement will set out exactly what the hotel operator may (or may not) do in such circumstances; however, it is important to note that the owner's failure to perform does not necessarily mean that the hotel operator is free to act in its own interests and without regard to its fiduciary obligations.

Some New York courts hold that fiduciaries retain obligations, with some obligations surviving even the termination of the fiduciary relationship. For instance, in one New York decision, *Servants of Jesus and Mary, Inc. v. National Committee for National Pilgrim Virgin of Canada*, 2022 WL 2438964 (W.D.N.Y. 2022), the court held that, where organizational interests diverge, the parties are free to terminate their relationship and compete; however, they could not do so unless and until the relationship was terminated. Similarly, New York courts have held that a fiduciary may often be prohibited from using opportunities or information it acquired while acting as a fiduciary.

Given the distressed nature of the current hospitality landscape, operators facing owners of non-performing hotels who have effectively given up their hotels may be maneuvering in a legal grey area. While the hotel operator should by no means put itself in a worse position, the operator must be careful in taking actions that help itself at the owner's expense, balancing how each decision will benefit or damage each of owner and operator's respective positions and the resulting potential legal risks.

### **The Lender Relationship**

Perhaps the most common test in this regard is the relationship between the hotel operator and the lender. Given the owner's financial struggles, it is likely the owner is (or will be) in default of its loan, triggering various rights on the part of the lender to, among other things, make protective advances to support the hotels operations, or even to step in as the "owner" of the hotel.

In our July 5, 2022 article, we discussed how Subordination, Non-Disturbance, and Attornment Agreements (SNDAs)—agreements often entered into between operators, owners, and lenders—outline each stakeholder's rights and obligations, including in the event of a loan default. Once a default tran-

spires, SNDAs become absolutely critical to establish what may happen next. For instance, it is common for SNDAs to permit the lender to demand that the operator stay on as operator and not terminate, in exchange for the lender paying any go-forward obligations.

Relying on SNDAs, the hotel operator can safely communicate with the lender in a proactive effort to stabilize the hotel and protect the operator from further liability. Assuming doing so is permitted in the SNDA, careful lines of communication will most likely not implicate any fiduciary issues. It is in an operator's interests to get the lender to take whatever actions it can under the SNDA that may provide the operator protection.

However, the hotel operator should proceed with caution as it relates to more creative solutions with lenders. For instance, the lender may try to negotiate different arrangements to protect the operator in the short term while not committing to any long-term protections. Alternatively, the lender may even approach the operator to see if it has any interest in buying the hotel. While this may be completely above board, this may open the operator to a claim by the hotel owner that the operator put its own interests above that

of the owner, breaching its duty of loyalty to the owner, and competing against the owner.

### **Conclusion**

With high inflation persisting and interest rates still on the rise, there remains a serious risk that a significant number of hotel properties will become distressed this year. Industry participants must carefully evaluate the legal and business risks attending to navigating these difficult times. Hotel operators, in particular, can and should take proactive steps to minimize its own risks, which may include fostering relationships with lenders who will remain after the owner is gone. In doing so, however, the operator must proceed cautiously and be ever-mindful of its duties by contract and at law.