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Key Legal Issues

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Mr. Bosch devotes considerable time to counseling hospitality industry clients on a broad range of issues, including the negotiation and enforcement of management contracts and franchise agreements, intellectual property matters, debt subordination and loan workout issues, and asset management. Mr. Bosch has successfully litigated cases on behalf of his clients in state and federal courts throughout the country, both at the trial and appellate levels, and has also handled numerous matters through alternative dispute resolution, including mediation and arbitration. Notably, Mr. Bosch was trial counsel in the landmark “Woodley Road” case that resulted in a multi-million-dollar jury verdict against a major hotel management company on behalf of the hotel owner.

Recent engagements include matters adverse to Marriott (including The Ritz-Carlton), Hyatt, Starwood (including Le Méridien), IHG, and other branded and non-branded operators. The issues Mr. Bosch regularly handles are many, and often involve allegations of breach of contract, fraud, breach of fiduciary duty, civil RICO, intellectual property infringement (patent, copyright, and trademark), trade secret misappropriation, false advertising, and unfair competition. His experience in these varied areas lends itself to the formulation of creative and effective dispute resolution strategies for an array of commercial concerns.

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In the toxic tort field, Mr. Cavanaugh has defended a leading chemical manufacturer in a series of medical monitoring class actions. Mr. Cavanaugh also has experience counseling clients in various state and federal regulatory proceedings. In addition, Mr. Cavanaugh has experience with commercial dispute resolution. He has counseled clients in the hotel and hospitality industry on a range of issues, including the negotiation and enforcement of management agreements.
contracts and asset management. He also has successfully represented manufacturers and distributors of military supplies in commercial disputes.

Mr. Cavanaugh was a member of a trial team that represented a drug treatment center in a discrimination case against a local municipality. The trial team obtained a jury verdict against the municipality on claims of intentional discrimination under the Americans with Disabilities Act and violation of substantive due process rights.

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Each hotel asset, owner, operator, flag, lender, customer, and vendor brings enough variables to the hotel ownership equation that it is impossible to anticipate all of the legal issues that may might arise. Certainly, some of the more mundane issues are addressed by innkeeper laws at the state and local levels. And there is always the risk of tort liability, because accidents do happen.

For the industry’s most sophisticated players, however, certain “big-ticket” legal issues arise more often than others. In this chapter, we provide a broad overview of some of those issues to help hotel investors stay ahead of the curve in maximizing hotel investment performance.

Emerging Areas of Concern

Safety and Counter-Terrorism

Hotels are becoming prominent targets for terrorists, as demonstrated by several recent incidents (most notably, a 2008 shootout on the top floor of the Taj Mahal Palace & Tower in Mumbai, and the 2009 bombings at the JW Marriott and The Ritz-Carlton in Jakarta). However, hotel investors and operators can take measures to protect themselves against the economic consequences of safety-related catastrophes. Two federal initiatives aim to enhance security measures by creating incentives for hotels to undertake preparedness and counter-terrorism efforts.

SAFETY Act. The Support Anti-terrorism by Fostering Effective Technologies Act of 2002, known as the SAFETY Act, limits liability for entities that sell and use anti-terrorism technology approved by the Department of Homeland Security (DHS). The SAFETY Act applies when an act of terrorism occurs and leads to legal claims against a seller or user of DHS-approved technology. If a situation meets these requirements, the SAFETY Act caps or eliminates the seller’s or user’s liability.

Most approved technologies have been tangible products, but the “technology” concept includes anything that reduces the risk of, or helps victims recover from, terrorist attacks. Examples of non-product technologies include physical security/screening services and best practices for security.
Hotel owners and operators already use products and operate programs (e.g., physical security, barriers, key card entries, guest identification measures, employee screening/training, surveillance) that could qualify as anti-terrorism technology. Hotels should seek DHS approval of these measures because the advantage is significant. With DHS approval, if a terrorist incident occurs and a victim sues a hotel for lack of appropriate security measures, the hotel can invoke the SAFETY Act to limit liability.

The DHS can approve technologies industry-wide, a fact that potentially saves money for hotel companies receiving DHS approval at the chain or ownership levels. Operating agreement provisions can help to ensure that owners and operators concur regarding security measures. For example, contracting parties might specify the existence of DHS-approved technologies or add provisions that require operators to implement security efforts in accordance with legislation.

**PS-Prep.** Private-Sector Preparedness (PS-Prep) is a partnership between DHS and the private sector that establishes national standards for emergency preparedness. Administered jointly by DHS and the Federal Emergency Management Agency (FEMA), PS-Prep has a broader reach than the SAFETY Act in that it mitigates the risks associated with any disaster, not just terrorism-related disasters. By offering emergency preparedness certification, PS-Prep encourages private companies and organizations to incorporate preparedness measures into their procedures.

PS-Prep does not provide formal liability protection like the SAFETY Act, but its certification can help companies defend themselves against legal claims by providing evidence that the companies maintain security measures. PS-Prep certification can also help companies reduce their disaster insurance premiums. However, PS-Prep is still in its early stages, and its ultimate real-world effect is unclear.

**Foreign Corrupt Practices Act**

In broad terms, the Foreign Corrupt Practices Act (FCPA)² forbids certain entities and individuals from giving anything of value to foreign officials in the hopes of acquiring unjustified benefits. Foreign officials include all government personnel, from cabinet ministers to low-level bureaucrats to political candidates, as well as their family members. The act also bans gifts to private individuals performing state functions, as well as employees of private companies owned in part or controlled by foreign governments.

The FCPA applies to an array of U.S. and foreign entities and individuals, including all companies doing business in the United States or listed on a U.S. exchange, as well as their employees; all U.S. citizens and nationals; and all non-U.S. nationals who perform acts in the United States. To violate the FCPA, an illegitimate “payment” need not be monetary; it can be anything of value so long as the giver offers it for the purpose of gaining an unjustified benefit.

Given the law’s expansiveness, it has a broad application in the hospitality industry, spanning every aspect from development to operation of a hotel and potentially subjecting all participants (including lenders, developers, owners, operators, and employees) to its requirements.

The recent investigation of the Las Vegas Sands Corporation provides an example of the FCPA at work. Sands is a developer, owner, and operator of resorts
worldwide, including multi-billion-dollar casino and hotel developments in China and Singapore. In February 2011, the U.S. Department of Justice launched an investigation that began with a subpoena for documents showing the corporation’s FCPA compliance. The Department of Justice suspected Sands of improperly leveraging Chinese officials to hasten sales of apartments at the Four Seasons Hotel in Macau, China, and of accumulating negative information with which to pressure officials. As of the writing of this chapter, the investigation remains ongoing. The Sands investigation is a stark example of why hotel officials need to understand their obligations under the FCPA.

Other examples highlight the risks of FCPA ignorance:

- In China, hotel developments by foreign investors require numerous government approvals and permits. Foreign companies may participate in hotel development in China only through locally incorporated “foreign investment enterprises,” typically structured as joint ventures with local parties, which might or might not be state-owned. Local partners typically handle government relations and approvals. Because the foreign party might not understand this process, corruption risks arise. Consequently, U.S. developers in China must be sure they comply with the FCPA and with China’s own anti-bribery laws.

- FCPA exposure also arises when host governments make direct investments. This co-investment is common and, in some places, is fueled by a government-sponsored development agency targeting the hospitality industry. In India, for example, as part of the country’s development of its core infrastructure, the government explores investments specifically in convention hotels.

- When hotel investors seek financing or guarantees from multilateral government-backed organizations like the Overseas Private Investment Corporation and the World Bank’s International Finance Corporation and Multilateral Investment Guarantee Agency, they subject themselves to FCPA risk.

- For operating companies, key money to win a flag, for example, or junkets to existing resorts to win new business, could give rise to an FCPA violation if the objective is to influence a foreign government official.

- Any contractor seeking a commission to design, build, and install a hotel’s furniture, fixtures, and equipment and any vendor seeking to provide operational supplies or services must ensure its sales team adheres to high standards of conduct, especially when a government-related entity develops, owns, or finances the hotel.

Affected parties can take steps to avoid FCPA violations. First among them is the creation of a compliance program with procedures for making lawful payments, training employees, and reporting and investigating potential violations. Strong accounting controls, such as approval mechanisms for expenses and financial recording procedures, also reduce the risk of FCPA noncompliance.

**Labor Issues**

Labor laws affect a hotel’s relationship with its employees at all levels. Union and employee issues are important, and members of the hospitality industry should stay apprised of changes in employment laws.
Of potentially great significance is the Employee Free Choice Act (EFCA), proposed in 2009 but not passed as of this writing. The EFCA would implement a method of union organization known as card-check, under which employees could force employers to recognize unions if those employees signed authorization forms stating they wanted union representation. Once a majority of employees signed the forms, an employer and government would have no choice but to recognize the union. By authorizing card-check, the EFCA would eliminate the traditional method of union election—a secret ballot process supervised by the National Labor Relations Board.

The card-check system has several implications for hotel owners and operators. Small chains and independent hotels that had previously escaped union attention might find themselves suddenly bargaining with unions. Likewise, the system would compel hotels in locations with traditionally low union recognition to acknowledge new unions. Card-check and the EFCA would also change the terms of union negotiations. Current labor laws require only that an employer negotiate with a union at reasonable times and in good faith. The EFCA would impose strict time limits on negotiations that, should they fail to reach collective bargaining agreements, would lead to mediation and mandatory arbitration.

Some hotel owners and operators have taken steps to avoid card-check’s impact by entering so-called “neutrality agreements” with unions. Under a neutrality agreement, the hotel operator agrees to accept card-check as a means of unionization and to refrain from activities that discourage unionization during the authorization form process. In exchange, the employer gets “union peace.” Hotel owners should pay particular attention to neutrality agreements between a hotel’s employees and operator, because an owner who does not sign a neutrality agreement might still be bound by it. If the operator signs a neutrality agreement as the owner’s agent, the owner may be held to the agreement. (Agency relationships between owners and operators are discussed later in this chapter.) The bottom line is that hotel owners and all hospitality industry members should take note of potential changes in union negotiation tactics and weigh available options before choosing labor strategies.

Financial Restructuring: Workouts, Foreclosures, and Bankruptcies

Economic turmoil, strongly felt in the real estate market since the fourth quarter of 2008, has placed financial restructuring at the top of many hoteliers’ task lists. In some locations (for example, Texas and California), foreclosures came fast and furious. Nationwide, trends varied. Many lenders, borrowers, and operators engaged in an uneasy game of “kick the can.” However, some of those cans are now hitting the curb. Recent news of a mid-town Manhattan property’s bankruptcy filing reminds owners and lenders that the worst might be yet to come.

While several high-profile foreclosures (e.g., The Ritz-Carlton, Kapalua (Maui); The Ritz-Carlton, Bachelor Gulch (Colorado); and the W Atlanta—Downtown) have occurred, a number of factors reduce lenders’ and special servicers’ desires to proceed with foreclosures, or, in some cases, to memorialize loan defaults. For
example, market softness, structural issues with commercial mortgage-backed securities, and sensitivity to “mark to market” practices slow lender activity.

Even loan workouts, a staple of prior downturns, have become more challenging, as declining market values and poor operating forecasts spell trouble for future debt service payments, debt collateral ratios, and other indicia of a healthy, performing loan. Lenders’ exigencies have swept aside many hotel owners in seemingly random decisions. Some borrowers find lenders willing to push maturity dates several years into the future, while other similarly situated borrowers lose their properties, sometimes for no other reason than the fact that their loans were part of portfolio transactions.

The legal complexities are too numerous for explanation here, but any evaluation of legal remedies for financially troubled assets requires consideration of the following.

**Problem Loans and Workouts**

Lenders whose borrowers default or are at risk of impending default may extend a “workout” option. In its basic form, a workout is a situation in which a lender and borrower renegotiate a troubled loan’s terms. However, the term “workout” more broadly conceptualizes various ways the owner can make debt service and otherwise perform. A workout has varied forms, including term extensions, rate reductions, longer amortization periods, and so on. However, this renegotiation is not a deal principals can simply “hammer out” without considering legal ramifications.

**Understand the Loan Documents.** The borrower (and lender) should start with loan documents. Some key factors to consider before a default occurs include:

- Does a personal guarantee exist? If so, when are personal assets put at risk, and does the lender have an incentive to underwrite modifications to the note when the guarantee can satisfy it?
- Do provisions exist that spring a personal guarantee to life if the borrower engages in certain “bad” acts? Even a non-recourse loan can potentially subject the borrower to personal liability, depending on what are colloquially known as “bad-boy carve-outs.” These provisions might help the borrower prioritize payments, sometimes even militating against payments to the lender.
- Do cross-default provisions exist, such that a default under one loan document might trigger default provisions under other loan documents?
- How often must the borrower provide financial statements, and what other notice provisions exist?

Knowing and understanding those provisions is an obvious but often over-looked pre-requisite to evaluating the prospects for a workout, and whether it is even advisable to approach a lender to discuss a workout.

**Prepare Accurate Updated Financial Statements.** Armed with knowledge of the loan documents, a borrower must examine its financial situation with honesty and integrity, because a loan workout is predicated on a good relationship between borrower and lender. Financial reporting must be accurate and timely. Too often,
borrowers in distress believe they can avoid defaults by making balance sheet “adjustments.” Not only could this act subject the borrower to default under the loan documents and undermine the lender’s trust, it could also subject the borrower to fraud claims. If the borrower has sub-investors to whom it owes contractual or fiduciary duties, the risks compound even further.

The Forbearance Agreement. Assuming borrower and lender are open to a work-out, the key legal document typically becomes the forbearance agreement. This agreement establishes a period during which the lender “forebears” in the exercise of its rights and remedies under the loan documents in connection with the borrower’s default. The agreement also needs to cover any guarantee agreements the default implicates.

Generally, this forbearance precludes the lender from initiating legal proceedings to enforce the loan documents or to execute against collateral, to accelerate maturity of the loan, to enforce guarantees, or to push the borrower into involuntary bankruptcy. In consideration, the lender typically requires a business plan that provides reasonable assurance that the borrower will be able to perform. The lender also may require additional loan collateral or other credit enhancements, consent to a receiver’s appointment upon expiration of the forbearance agreement if the defaults have not been cured during the forbearance period, or the borrower’s consent to relief from any automatic stay in the event the borrower becomes subject to a Chapter 11 bankruptcy reorganization. The lender typically also requires a broad release from the borrower and guarantor that encompasses lender liability claims.

Foreclosures

Foreclosure on real property provided as security for loans is a creature of state law and local practice. In some states, the courts must process all foreclosures (i.e., judicial foreclosures), while others bypass the courts altogether (i.e., non-judicial foreclosures). A number of states permit both, though local practice and legal wrinkles sometimes militate strongly in favor of one over the other. The only general advice applicable to all foreclosures is that there is no generally applicable advice.

Judicial Foreclosures. In some states, all foreclosures are “judicial,” meaning the lender initiates the process by filing a complaint in court and serving the borrower with a copy under local rules for effecting service of process. The lender provides notice to prospective purchasers (and title companies) by recording a “notice of lis pendens” in the real property records of the jurisdiction in question, effectively encumbering the property until the lender secures relief as appropriate. The complaint states the amount of the debt and the grounds for relief (“borrower’s default”). Unless the borrower presents a viable defense, the court may enter judgment in the amount of the remaining debt and for the reasonable costs of executing on the lender’s remedies. Once the judgment becomes executable, the lender may seek a “writ of execution,” which authorizes the local sheriff’s office or other authorized official to conduct a public auction of the real property serving as the loan’s collateral (thereby “executing” against the court’s judgment). If the
proceeds of sale are not sufficient to satisfy the judgment, most states give the lender the ability to pursue a “deficiency judgment” against the borrower.

Non-Judicial Foreclosures. In states that require or permit non-judicial foreclosure, statutes typically govern the foreclosure and auction process. Some states require newspaper publication of a Notice of Default and a Notice of Sale. Others require only a Notice of Sale. The advantage of a non-judicial foreclosure to the lender is that the process is much quicker than judicial foreclosure, usually spanning a few months. By contrast, judicial foreclosures are more expensive and time consuming. In some jurisdictions, a glut of residential foreclosures creates a judicial backlog of hundreds of thousands of cases, frustrating foreclosure relief. Courts in Florida, for example, used a $6 million special appropriation from the state legislature to reduce a foreclosure backlog by approximately 43 percent within the last year; however, more than 250,000 judicial foreclosures are still in the pipeline. A potential disadvantage to non-judicial foreclosures is that they might leave lenders unable to pursue deficiency judgments.

Deeds in Lieu/Short Sales. The lender may be willing to circumvent the foreclosure process and take a deed in lieu of foreclosure, because of the market discount that typically applies to properties being sold through a foreclosure auction process. If the lender seeks to avoid taking title altogether, it may consent to a short sale. In both instances, the borrower’s potential liability for any deficiency is an appropriate subject for negotiation. However, the lender’s forgiveness of any debt could subject the borrower to tax liabilities.

Lender Liability Claims

While hotel loan documents typically give a lender clearly defined and sometimes self-executing remedies if a borrower defaults, the lender still risks exposure to claims from borrowers or third parties (e.g., guarantors or operators) arising out of the loan. Such lender liability claims typically arise when the lender pursues foreclosure instead of a workout. These claims arise under a broad array of legal theories. In addition to statutory claims, lender liability claims for breach of contract, breach of fiduciary duty, tortious interference, and breach of the implied duties of good faith and fair dealing are common. These claims can fall apart, however, if the borrower does not allege (much less establish) that the lender has committed any act more grievous than hard dealing. In the absence of a breach of an express obligation or lenders acts or omissions that independently establish grounds for relief, a lender liability claim predicated merely on the lender’s decision to enforce its agreements without compromise is on shaky footing.

Some Legal Wrinkles

SNDAs. Ordinarily, a contract entered into before the lender extends financing is superior to the lender’s lien. Subordination, non-disturbance, and attornment agreements (SNDAs) can reverse the default rule by subordinating the operating agreement to the lender’s lien. In consideration of this “subordination,” the SNDA contractually binds the lender to the terms of the operating agreement between the borrower (i.e., the hotel owner) and the hotel operator in the event of foreclosure.
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(i.e., the SNDA’s “non-disturbance” aspect). In addition, the operator agrees to treat the lender as the owner under the operating agreement (the “attornment”). With an SNDA in effect, a foreclosing lender typically must honor the operating agreement upon taking possession of the property and ensure that the lender’s successors do so as well. If the lender or its successor tries to eject the operator, it could face liability for breach of contract.

Appointment of Receivers. Typically, receivers are judicially appointed officers of the court who maintain and preserve collateral pending the lender’s resolution of a problem loan by workout, foreclosure, or another method. Loan documents often give a lender the right to seek a receiver’s appointment upon a borrower’s default. The appointment of a receiver is typically not self-executing; the lender must file a complaint and move the court to appoint a suitable receiver. In some states, courts essentially rubber-stamp motions for receiver appointments. In other states, the lender must demonstrate the receiver is in a better position than the borrower to maintain and preserve the collateral’s value.

In the hotel context, receiverships not only affect the owner/borrower’s right of control over the hotel, but also affect the hotel manager’s rights. The scope of the receiver’s authority depends on a number of factors, including the contractual agreements underlying a receiver’s appointment, as well as the provisions of any SNDA between the lender and the management company. “Lock-box” agreements, which let the lender control revenues and prioritize payments, could affect the operator’s fees and charges, as well as its control over day-to-day operating expenses. In some cases, the receiver might have authority to demand access to information the operator has withheld from the owner. Therefore, lenders who want to appoint receivers should evaluate not only the borrower’s ability and interest in preserving the collateral, but the operator’s as well.

While a lender might regard a receiver’s power and scope of authority as potentially useful, it comes with real and practical costs. Though the lender may select the receiver, the receiver is still a judicial officer who acts without regard for any party’s interests, and who might exercise his or her authority in a manner contrary to the lender’s preference.

Bankruptcy

Distressed borrowers holding hotel assets that serve as collateral do not always give up on their investments when operating shortfalls lead to loan defaults. Some owners hand the keys to the lender, deeming this the most financially savvy move, especially for non-recourse loans in which the hotel has no realistic prospect of generating sufficient operating income or sale value. Some hotel owners, however, believe that to maximize their investment performance, they must resort to bankruptcy laws. For example, Trump Entertainment Resorts, which owns the Trump Taj Mahal and other high-profile assets, has gone through three bankruptcy reorganizations. In short, bankruptcy gives a borrower relief by helping him or her meet, alter, or avoid debt obligations.

Bankruptcy is a creature of federal law. Title 11 of the United States Code establishes the system and procedure a debtor uses to seek relief from creditors. Each state maintains specialized federal bankruptcy courts to handle bankruptcy
petitions. In addition, the U.S. Trustee office under the Department of Justice plays an important role in bankruptcy proceedings.³

**Reorganizations Under Chapter 7.** For companies, as opposed to individuals, Chapter 7 (liquidation) and Chapter 11 (reorganization) are the most applicable bankruptcy provisions. A company that cannot meet its obligations may choose to liquidate under Chapter 7, effectively surrendering control and giving a court-appointed trustee the authority to dispose of company assets. Administrative and legal fees incurred in connection with the bankruptcy typically are satisfied first from unencumbered assets. Typically, secured creditors stand in lien priority order. Unsatisfied secured debts push affected creditors into the “unsecured” pool, where they can pursue their claims alongside all other unsecured creditors.

**Reorganizations Under Chapter 11.** For many hotel owners, however, liquidation is not the right answer, especially when the hotel asset continues to generate operating returns and has value as a real property asset. For these owners, Chapter 11 reorganization offers the best chance to maximize hotel investment performance, sometimes for both the borrower and the secured lender. Under Chapter 11, the debtor, in general terms, remains in control of the business and oversees the development of a reorganization plan, which must be approved by the court. Upon filing a petition seeking protection under Chapter 11, the debtor becomes a “debtor in possession,” and an “automatic stay” provides immediate relief from the debtor’s obligation to pay creditors. Upon filing the petition, however, the borrower can no longer conduct “business as usual.”

In the hotel context, an investor filing under Chapter 11 subjects all its business decisions to scrutiny by the court, the U.S. Trustee, and creditors. Disclosure statements publicly filed with the bankruptcy court detail assets and liabilities. Transactions that are not in the ordinary course are subject to court oversight and approval, and may be unwound if creditors did not have notice and an opportunity to be heard. The U.S. Trustee will typically require additional reporting. For single-asset real estate debtors (a status that applies to many hotel owners holding assets in special-purpose entities),⁴ the Bankruptcy Code gives secured creditors the opportunity to seek expedited relief from the automatic stay to pursue interest payments.⁵

In any Chapter 11 filing, a key consideration is the method through which a debtor can balance its interest in controlling and overseeing business decisions with the need to protect creditors and ensure the integrity of the reorganization process. These considerations must be addressed at the outset, typically through what is colloquially known as the “first day orders.” The first day orders come before the court on debtor’s motions (often a voluminous filing), and address a number of important issues, including the appointment of debtor’s counsel and other reorganization professionals, court authorization of business operations and practices, and the disposition of working capital and reserve accounts. Because these motions typically are heard before affected creditors have had an opportunity to be represented at the hearing, the U.S. Trustee is sometimes the only entity that tries to protect the interests of affected creditors.

Another central feature of Chapter 11 bankruptcies is the formation of committees to represent different classes of creditors, including the “official committee
of unsecured creditors” and, in some instances, a committee for secured creditors or other interested parties. For public companies in Chapter 11, this could include stockholders. Securities may continue to trade during Chapter 11 pendency, but in most reorganizations, stockholders get wiped out or substantially diluted after secured and unsecured creditor claims are addressed.

One of the primary tasks of these committees is to review and, as appropriate, recommend that creditors vote for or against the debtor’s “plan of reorganization.” During the first 180 days post-petition, the debtor has the exclusive right to submit a plan of reorganization. The bankruptcy court may extend this exclusive period up to eighteen months. After this exclusive period expires, any creditor or committee may submit its own plan of reorganization.

The reorganization plan may include a new debt structure, new equity investments, a revised business or marketing plan, conversion of hotel units to condominiums, disposition of spa/food and beverage outlets, and any number of changes to the existing operation. The Chapter 11 debtor may also forgo reorganization and submit to a liquidation, which gives the debtor more control over the process than might occur under Chapter 7.

In connection with a plan of reorganization, the Chapter 11 debtor also may “reject” executory contracts, meaning contracts that have not been fully performed, and effectively walk away from ongoing contractual obligations. For hotel owners and lenders, this could include the rejection of the hotel operator’s management contract. This rejection right is an especially attractive feature of Chapter 11 (recognizing, of course, that the operator may then qualify as an unsecured creditor with respect to its management fees). Where the operator has committed defaults or otherwise caused harm to the interests of the owner/borrower and/or secured creditors, an “adversarial proceeding” may further inure to the benefit of the bankruptcy estate as a whole.

To comply with the Bankruptcy Code, a reorganization plan must identify different classes of creditors (e.g., secured, unsecured with priority, general unsecured, equity holders) and describe how the reorganization plan treats each class. If some classes will not be paid completely, they are considered “impaired.” In this case, the court cannot approve the reorganization plan unless one non-insider impaired class votes in the plan’s favor. This situation requires the approval of creditors holding “at least two-thirds in amount and more than one-half in number of the allowed claims” in the impaired class. Ultimately, the Bankruptcy Court decides whether to approve a plan of reorganization, after giving notice and an opportunity for a hearing. Even after a plan is confirmed, the debtor in possession must report to the court and, once the plan has been fully administered, apply for a final decree so that the debtor exits bankruptcy protection.

**Pre-Packaged Bankruptcies.** Pre-packaged bankruptcies are bankruptcy plans that a company’s stakeholders negotiate and accept before the company enters bankruptcy proceedings. Pre-packaged bankruptcies emerged in the hospitality industry as early as 1992, when Donald Trump implemented a pre-packaged bankruptcy for his Plaza Hotel.

Upon filing for bankruptcy reorganization under Chapter 11, a company essentially seeks the court’s “stamp of approval” on its pre-packaged bankruptcy
plan. This method substantially reduces a reorganization’s length and expense. However, a number of legal and practical considerations might militate against a pre-packaged bankruptcy. The debtor must still obtain the approval of at least one “impaired” class of creditor (a task more likely achieved when the number of creditors is low). If the reorganization plan calls for rejection of the hotel operator’s management contract, the need for “friendly” impaired creditors who have sufficient claim to vote their approval could be a stumbling block. In addition, unless the hotel owner’s financial distress is obvious, the fact that the owner is approaching creditors to solicit approval before filing for relief (and securing the breathing room of an “automatic stay”) will tip off the creditors and possibly trigger an involuntary bankruptcy filing seeking liquidation under Chapter 7 of the Bankruptcy Code.

The Owner/Operator Relationship

Hotel investment performance is often a direct function of operator competence. The romance that characterizes the operator selection process is often short-lived. While some owner/operator relationships manifest a mutual desire to maximize owner’s return on its investment, this is not uniformly the case. In many instances, alert owners and asset managers soon discover that there is a sharp departure from pre-contract promises of strong customer loyalty, talented on-property management, and regional/corporate support. Items that were not tied down during negotiations get lost in the fray of ongoing operational issues and concerns. Even when owners invest in property improvement plans (PIPs) and other capital improvements, some operators try to excuse their poor performance by blaming the facilities. To these types of operators, owners are merely banks to fund management fees and brand development efforts.

Consequently, investors must determine which operators are “good” before signing contracts with them. For this task, it certainly makes sense to identify which operating companies have been embroiled in owner disputes. Owners are not in the business of litigating against operating companies, and typically do not retain large legal staff (as do some operating companies). If an owner pursues a claim against an operator, the claim likely follows months of efforts to work with the operator and reach a business compromise.

As a rule of thumb, better operators reach compromises, and arrogant operators do not. Hotel investors will see this rule reflected not only in the number of lawsuits or arbitrations filed against an operator, but in the ways the operator negotiates its operating agreements. An operator that is unreasonable at the contract stage will likely be even more unreasonable once it occupies the owner’s hotel, hoists its flag, and internally books long-term management fees and other benefits.

Tensions between owners and operators are not necessarily tied to financial performance, but it should come as no surprise that, as operating returns have shrunk during the recent economic downturn, owners and lenders have been scrutinizing operators more closely. Some operators have lost sight of their fundamental duty to operate for the account of the owner and instead have prioritized their own pecuniary and brand interests. Consequently, these operators should
not be surprised when owners, asset managers, lenders, special servicers, receivers, and other interested parties demand more disclosure, more transparency, and more performance.

In the negotiation and performance of hotel management contracts, many investors get the proverbial “short end of the stick.” The following sections outline areas of concern.

The Nature of the Relationship

A perpetual point of contention between hotel owners and operators is how to define their relationship under a hotel operating agreement. Operators have been wrestling with the implications of having their management contracts give rise to an “agency” relationship. Characterization of the owner/operator relationship is important not only in determining the parties’ respective rights and obligations throughout the relationship, but also in resolving disputes between owner and operator and, if necessary, terminating a nonperforming operator.

An agent/principal relationship is significant to hotel operations in several respects. To hotel owners, perhaps the most important point is that an agent (i.e., the operator) is a fiduciary of the principal (i.e., the owner). As a fiduciary, the agent owes the principal a variety of fiduciary duties. Breach of any of these duties subjects the agent to liability independent of its liability under any existing contract between the parties.

Foremost among the agent’s fiduciary duties is loyalty, which requires that the agent act in the principal’s best interest when working in connection with the agency. The agent’s own interest is subordinate to the interests of the principal. For example, the agent cannot use its position to “acquire a material benefit,” particularly when doing so would conflict with the principal’s interest. Other duties the agent owes the principal are due care, diligence, and competence in actions pursuant to the agency relationship. If the operating agreement gives broad discretion to the operator, the operator must competently exercise such discretion in good faith and with due care.

The agency relationship also is relevant in the owner/operator context because agency relationships are terminable at the will of the principal (here, the owner). Importantly, an agent does not need to have breached a duty owed to the principal in order for the principal to end the agency relationship. The relationship ends as soon as the principal notifies the agent that the agent no longer has authority to act on the principal’s behalf. A hotel owner, therefore, should be free to terminate the operating agreement with the operator at any time, regardless of whether the operator violated its duties to the owner. If the termination is wrongful (that is, there is no justification for the termination), the terminating owner may be subject to damages for wrongful termination. However, the flag must still come down.

A seminal case regarding a hotel owner’s right to terminate its relationship with an operator is Woolley v. Embassy Suites, Inc. Embassy Suites operated hotels for the plaintiff owners, who sought to terminate their management agreements with Embassy Suites for nine of those hotels. Embassy Suites obtained a court order enjoining the terminations, but the appellate court reversed the injunctions. The court explained that “a principal who employs an agent always retains
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the power to revoke the agency” and held that Embassy Suites was an agent of the owners. According to the court, “it should always be within the power of the principal to manage his own business and that includes the power of the principal to reassume the control over his own business which he has but delegated to his agent.”

Even though the weight of authority recognizes that the relationship between an owner and a hotel manager (as distinguished from a franchisor) is a principal/agent relationship, the industry continues to face debate over whether and under what circumstances an operating agreement gives rise to an agency relationship. Many operators engage in efforts, individually and collectively, to avoid the duties incumbent upon agents. They do this through clever drafting of operating agreement terms, forceful advocacy in front of tribunals predisposed to interpret contracts narrowly, and, in Maryland, through statutory relief.

Some owners have not been well advised during management agreement negotiations and have unwittingly helped operators avoid their implied duties of loyalty, due care, diligence, and competence. A prudent owner should wonder why some operators work so hard to avoid an agent’s fiduciary duties.

In their form operating agreements, many hotel operators assert that they are “independent contractors.” By using this language, operators set up the argument that they are not agents (although, independent contractors can also legally be agents). Some operators are particularly clever, insisting on language that disclaims any relationship “like a partnership or joint venture,” though they do not expressly disclaim agency.

As a matter of law, the ways in which parties define their relationships should not matter. However, these contractual provisions easily confuse courts and arbitrators, who may wrongly conclude that the provisions manifest the parties’ intentions to give the operator authority and discretion over the hotel’s day-to-day operation without subjecting the operator to the fiduciary duties of loyalty, due care, and good faith. By chipping away at the agency relationship, operators are essentially telling owners that operating agreements will be interpreted narrowly, and that owners cannot terminate these long-term agreements unless they are prepared to litigate and prove an ill-defined default (with an ill-defined measure of “materiality”) in the context of an agreement broadly delegating discretion and authority to the operator. Owner beware.

Employment Issues

Whether an owner manages its own property or hires a branded or non-branded third party for that purpose, there is no substitute for good operational practices, accounting controls, reporting, and recordkeeping. Some companies tout costly and unproven “systems,” but ultimately human talent—a limited resource—drives successful operations.

As brands shuffle general managers and other key executive personnel from property to property, individual hotel owners realize the development personnel who sold them on the brand are not the same personnel who will execute the business plan. As a brand’s flag covers more and more hotels, the pressure to recruit and train competent managers increases.
In many cases, the owner learns the hotel’s executive team is incompetent only after the owner has signed the contract delegating hiring authority to the operator. In hotels with unionized employees, owners sometimes discover that operators’ interests diverge from their own. Even if the contract states that the owner or owner-affiliate employs the hotel’s staff members, a savvy investor should not assume it will have access to those employees. Some operators physically block access to hotel staff and otherwise interfere with owners’ ability to communicate directly with their own employees.

These are not hypothetical issues; each is part of a large branded operator’s standard conduct. Yet hotel owners continually express surprise when operators put their own interests first, rotate unqualified personnel through senior management, and pay out bonuses to hotel staff from owners’ accounts even when their hotels don’t generate returns. Owners should address these business and legal issues during the contract stage, but often overlook them as the parties focus instead on economic terms.

**Performance Termination Clauses**

Operating agreements sometimes contain provisions that let owners terminate the agreements upon operators’ failure to meet performance test requirements. Performance termination clauses typically relate to net operating income (NOI) hurdles and/or revenue per available room (RevPAR) thresholds relative to a competitive set of hotels. Two-pronged thresholds (i.e., termination tests tied to both NOI and competitive set hurdles) tend to favor operators.

When the owner’s ability to terminate an underperforming operator stems from the hotel’s performance relative to other properties, both parties should define a suitable competitive set when they negotiate the operating agreement. An inappropriate competitive set can skew the subject hotel’s relative financial condition and lower the performance standard. Operators have an incentive to defer selection of competitive hotels—it gives them time to ensure they can easily clear hurdles.

To defend against performance terminations, some operators assert “force majeure” or “extraordinary events” clauses. The law does not favor these arguments, as general economic declines are not only foreseeable, but expected. However, hotel investors should remain vigilant when operators attempt to insert such language.

**Budgets and Profitability**

The story line has become almost commonplace, yet for many owners, it spells tragedy: developments and acquisitions predicated in part on operator-provided pro formas yield to less rosy budgets, and then, sometimes, to abysmal performances. After development teams leave and operators must deliver, owners belatedly learn that not even the most highly respected brands can stand behind their forecasts.

Look at the disclaimers on those forecasts, pro formas, and budgets because the operating companies mean it when they say you cannot rely on them. And yet, many owners and lenders do anyway. Often, they have little choice, because operators are uniquely situated to evaluate their own prospective performances. Once
again, the operator’s interest in avoiding enforceable guarantees clashes with the owner’s and lender’s reasonable expectation that the operator has provided good-faith forecasts and is not merely “puffing” to win the contract.

While the partial solution is to engage a third party to evaluate the pro formas, and to provide real financial carrots and sticks for operators that do not come close to hitting financial projections, the truth remains that hotel investors cannot always rely on the operator to provide accurate information to facilitate business planning. This often becomes evident during the annual budgetary review and/or approval process. Some owners confronting tough economic conditions find that operator-supplied budgets are meaningless. Some operators deliberately short their revenue forecasts without commensurately adjusting expenses. Operators also delay, obfuscate, or cursorily respond to owners’ requests for information substantiating forecasts or expense items.

Even if the owner has an express, contractual right to participate in the budget process, this right is often hollow, as many operators draft operating agreements whose “budget review” provisions let owners merely make comments. While some operators consider owner comments in good faith and make adjustments, some do not. Some hotel management companies frustrate owners’ review and control even further by delaying budget presentation and/or by being slow or non-responsive to owners’ comments and requests for information.

Even if owners have approval rights, operating agreements might still give operators the right to submit budget disputes to industry experts. These experts are often individuals who have worked with or for the large, branded operating companies. One of the largest branded operating companies has gone so far as to assert that all disputes theoretically relate to the budget and therefore must enter a circumscribed express resolution process. As explained later in this chapter with respect to arbitration, operators favor alternative dispute resolution for a reason—it favors them.

The best way hotel investors can ensure the emergence of a new paradigm is to inform themselves about operating companies’ approaches to the owner relationship. One way investors can confound uncooperative operators is to insist that operators share the metrics they use to establish revenue budgets. Investors should also insist that operators provide more information on variable expense items. Assuming the parties agree on a budget, the industry-standard language that the operator will use “reasonable efforts” to comply with the budget is wide enough to drive a truck through. To ensure operators focus on profitability, owners should insist that operators keep them apprised of all variances and tie management fees and bonuses to flow through rather than budgeted revenue.

Too often, operators dictate the terms of operating agreements, while owners hope for the best. However, some large owners have worked out their own arrangements with operators, sometimes through “restructuring agreements” that span several operating agreements. Some operators insist that their form contract language is non-negotiable, but that is only true if owners make it so.

Financial Statements/Books and Records

Most operating agreements require that operators maintain financial statements reflecting hotel operations in accordance with the Uniform System of Accounts for
the Lodging Industry and generally accepted accounting principles, and to periodically give copies to owners. Operators usually must also give periodic accountings to owners.

Operating agreements often do not specify the level of detail necessary to fulfill the operator’s obligations with respect to financial statements. Owners and operators generally expect that gross revenues, operating expenses, and management fees will be included. However, difficulties arise on other levels. For example, a financial statement might summarize an expense or cost, but not itemize the expense’s components. Without a breakdown of each cost, the owner cannot assess the change’s propriety and, therefore, cannot verify whether the operator is managing the hotel efficiently and responsibly.

Most operating agreements also require operators to maintain and make available the hotel’s books and records, especially those relating to operations. Some operators believe that materials relating to the hotel’s operation that are not property-specific (e.g., chain service allocation materials, regional sales office data) are not books and records. Some operators also withhold the owner’s books and records on the grounds that they are proprietary to the operator, even refusing to turn over guest lists, audit reports, and standard operating procedures.

Operators might want to avoid discussing these matters during management contract negotiations. However, given the fact that operators not interested in transparency and disclosure are advancing opportunistic contract interpretations, hotel investors must press these issues.

Arbitration or Court?

Owner/operator disputes sometimes escalate to a point that requires third-party resolution. Operators almost uniformly try to push operating agreement disputes outside the court system and into alternative dispute resolution.

Mandatory arbitration clauses stem from arbitration’s perceived benefits (i.e., arbitration is cost-efficient, fast, and conducted by arbitrators experienced in the hotel industry). In practice, however, these benefits do not always materialize, especially for hotel investors. Arbitration generally favors operating companies, which control access to information and are repeat players (that is, payers) for arbitrators with industry experience. Hotel investors must recognize that arbitration typically does not facilitate open and extensive discovery, and that access to evidence is limited (a fact clearly favoring operators). Appeal rights are also limited, which means that arbitrators who ignore the law or disregard an owner’s evidence might not face scrutiny. In addition, because arbitrators charge for their services, often by the hour, arbitration can be as time consuming and expensive as civil litigation. As a general rule, hotel investors should avoid mandatory arbitration provisions at all costs.

Corporate Charges

How much will the owner pay the operator to run the hotel? This simple question calls for a simple answer, but some operators can’t—or won’t—provide it. For these operators, management fees and incentive fees are the tip of the iceberg. “Corporate charges” (i.e., above-property level fees, charges, expenses,
assessments) can be many times the amount of management fees; however, these charges rarely appear in pro formas, nor are they spelled out clearly in operating agreements.

Some operators make these charges transparent, while others claim their methods for offloading corporate charges onto individual properties are too complicated for even the operators to explain. However, hotel investors must demand transparency. They must steel themselves for the possibility that their operators are imposing corporate charges, fees, and assessments for programs and services that might not be proper, might not benefit the property, and might contribute to the operator’s bottom line while eating away at the owner’s net operating income.

**Purchasing**

Purchasing activities can lead to conflict between owners and operators. Operators typically purchase hotel food and beverage, operating supplies, and capital goods for the owner’s account, using the owner’s credit. In this respect, regardless of the owner/operator relationship’s definition, the operator acts as the owner’s agent, subject to attendant fiduciary duties. However, some operators do not even acknowledge their obligations to purchase in good faith, much less honor them.

Hotel investors also might assume that operators engage in competitive bidding, but this is not necessarily the case. Astute owners ask for competitive bidding files for major purchases. A number of operators do not routinely engage in reasonable purchasing practices—in part because they are using the owner’s money, not their own.

Some larger branded operators offload purchasing responsibility to collective purchasing organizations (which themselves are sometimes related parties of the operators). These purchasing organizations ostensibly use the combined purchasing power of participating hotels to negotiate agreements. However, when hotel owners ask for those agreements’ terms, operators often won’t provide them.

Even if owners have access to agreements, they might have trouble discerning net prices. For example, the agreements might contain rebates, allowances, marketing dollars, and distribution fees. The rebate amounts and recipients might be obscured, potentially indicating that the operator or the collective purchasing organization receives a hidden form of consideration that otherwise would reduce net cost to the property and, hence, to the owner.

Because these purchasing obligations are typically not clarified, owners operate at a disadvantage. Having delegated purchasing authority to the operators, hotel investors rely on operators not only to conduct purchasing activities properly, but to disclose and otherwise account for them. Optimally, owners would be better informed about operator purchasing practices before they sign operating agreements, so that they can spell out the operator’s activities, obligations, and limitations as the owner’s purchasing agent.

**Encroachment**

Operators grow by expanding the number of flags under their active management. Sometimes this growth occurs within a brand, and sometimes it occurs by brand extension (e.g., Marriott acquiring Ritz-Carlton). Brand growth also occurs
geographically and within/across market segments (e.g., group and transient or luxury and corporate). For many hotel investors, the task of learning which types of hotels compete for a hotel’s business is not simply a matter of evaluating geographically proximate hotels or even hotels in the same category. Convention hotels, for example, might compete across extended geographic areas (perhaps even internationally) and within/across many brands. A conflict of interest exists. Operators want to maximize the number of hotels under their flags, while owners want to limit them to reduce the number of competing hotels.

A hotel investor’s leverage, vis-à-vis its operator, is typically greatest during the contract negotiation phase. At that time, an investor can negotiate territorial restrictions that prevent the operator from operating a competing hotel in the investor’s market. However, conflicts can arise as operators want to limit such restrictions in time, brand, and geographic scope. Operators and courts might interpret territorial restrictions narrowly, so careful drafting is imperative. If a court interprets a territorial restriction as applying only to the flag on the owner’s hotel, it might allow the operator to open a full-service Marriott right next to the investor’s brand-new Courtyard by Marriott, which would likely upset the investor.

**Conclusion**

In a perfect world, hotel investors could trust their operators to put owner interests ahead of their own and to operate the owner’s hotel for the owner’s account, maximizing the owner’s return on investment. The hotel industry has many operators that endeavor to meet this ideal. But many do not. Competing or conflicting interests are simply fundamental to the industry, given the fact that so many owners do not operate their own hotels. Disclosure and transparency, as well as more balanced and informed contract negotiation, would go a long way to avoiding disputes. Until then, hotel investors must educate themselves. To that end, this chapter serves merely as an introduction. *Caveat emptor.*

**Endnotes**

3. “The United States Trustee Program is a component of the Department of Justice that seeks to promote the efficiency and protect the integrity of the Federal bankruptcy system. To further the public interest in the just, speedy and economical resolution of cases filed under the Bankruptcy Code, the Program monitors the conduct of bankruptcy parties and private estate trustees, oversees related administrative functions, and acts to ensure compliance with applicable laws and procedures.” “About the United States Trustee Program and Bankruptcy,” The United States Department of Justice, http://www.justice.gov/ust/eo/ust_org/index.htm (30 August 2011).
4. The Bankruptcy Code defines “single asset real estate” as “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 incidental.” 11 U.S.C. § 101(51B) (2006).
5. *Id.* § 362(d).
6. *Id.* § 1129(a)(10).
7. *Id.* § 1126(c).
8. Restatement (Third) of Agency §§ 1.01, 8.01 cmt. b (2006).
9. *Id.* § 8.01.
10. *Id.* § 8.01 cmt. b.
11. *Id.* § 8.02 & cmt. b.
13. *Id.* at 1525.
14. *Id.*
15. *Id.* at 1529.
17. Woolley, 227 Cal. App. 3d at 1530–31 (citation and quotations omitted). A narrow exception to the rule that agency relationships are terminable at will exists when the agency is “coupled with an interest.” See, e.g., *id.* at 1529 (“Save in the case of an agency coupled with an interest, a principal has the power to revoke an agent’s authority at any time before the agent has completed performance.” (citations and quotations omitted)). When an agency relationship is created for the benefit of the agent and the agent receives, in addition to authority, “a specific, present and coexisting beneficial interest in the subject matter of the agency,” the agency relationship becomes irrevocable. *Id.* at 1532 (citations and quotations omitted).
18. At the request of a number of hotel operating companies, the Maryland state legislature enacted Title 23 of the Commercial Law section of the Maryland Code, which applies specifically to parties involved in hotel operating agreements. The statute subordinates common-law agency principles to the express terms of an operating agreement. Among other implications, the statute suggests that the owner and operator can agree that no agency relationship exists despite factors that would otherwise indicate an agency relationship. Hotel investors should therefore be wary of contract provisions seeking to apply Maryland law.
19. See Restatement (Third) of Agency § 1.02 (2006) (“An agency relationship arises only when the elements...are present. Whether a relationship is characterized as agency in an agreement between parties...is not controlling.”).