

## Sector Focus

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# As safe as houses? Insolvency in the hotels sector

### KEY POINTS

- It is common for the ownership and operation of a hotel to be separated and this should be reflected in a lender's security package.
- In the event of financial distress, a review of the hotel holding and operating structure and security package is essential to identify pre-enforcement and enforcement options available to the lender.
- The practicalities of enforcement need to be considered alongside the legal options, including the position in relation to existing licences and short term funding requirements, as this will inform the strategy for how the asset will be developed/traded/marketed and ultimately value realised.

The hotels sector has experienced a mix of fortunes over the past decade. Many hotels suffered in the recession. As an asset class, hotels are capital intensive operations. They are also susceptible to volatile economic conditions, as consumer and corporate expenditure on hotels is generally viewed as a discretionary expense. The proliferation of alternative hospitality models such as Airbnb have disrupted the sector. On the other hand, weakening of the pound has supported an increase in tourism, boosting demand and occupancy in some areas. Whilst the ultimate outcome of the Brexit referendum is not yet clear, the potential impact on staffing and cost of imports such as food and alcohol in particular, is a concern for the sector.

There are various ways in which the corporate ownership of a hotel can be structured. This article concentrates on one of the most common structures in the hotel industry – the hotel management agreement (HMA).

It has become increasingly common for a hotel property to be owned, not by the chain that runs the hotel ('Hotel Operator'), but by a separate third party investor or developer ('Hotel Owner'). Typically, the Hotel Owner will finance part of the acquisition or investment/development cost with bank debt. To provide operational expertise and obtain for the hotel the benefits of being part of a larger operating platform or brand, the Hotel Owner enters into an HMA with the Hotel Operator. The HMA governs the way in which the Hotel Operator will run the business as part of its group/brand.

### OPERATION OF THE HMA STRUCTURE

Under the HMA, the Hotel Operator will usually have exclusive control of and responsibility for day-to-day operations including matters such as bookings, staff, supplies and maintenance, for which it receives fees, while the Hotel Owner will bear the risk of the business, and provide working capital. The Hotel Operator will generally act as an agent to the Hotel Owner, and be entitled to

enter into contracts with third parties, and to access the Owner's bank accounts to make payments in the course of running the hotel. The HMA will contain strict requirements for the Hotel to be maintained and operated in accordance with the standards of the Hotel Operator's system and brand.

The HMA is often accompanied by a non-disturbance agreement ('NDA') between the Hotel Operator and the Hotel Owner's lender. Typically, the lender agrees not to terminate the management agreement, or to procure or consent to its termination, on default by the Hotel Owner under the financing documents, or upon the insolvency of the Hotel Owner, and the Hotel Operator agrees to stay and operate the hotel for the lender should it enforce its security. This means that the Hotel Operator can be secure in keeping the value of the HMA and the lender knows the Hotel Operator cannot walk away immediately on an insolvency or enforcement in relation to the Hotel Owner, which is potentially extremely disruptive to the business.

In addition, a restriction can be registered against the title of the Hotel Owner at the Land Registry – in the event that the hotel is sold by the Hotel Owner or lender (in the case of repossession), the restriction will prevent a transfer of the title to the hotel from being registered without the HMA being transferred alongside the hotel. In practical terms this prevents a sale of the hotel asset with vacant possession.

The documentation typically used for this structure comprises:

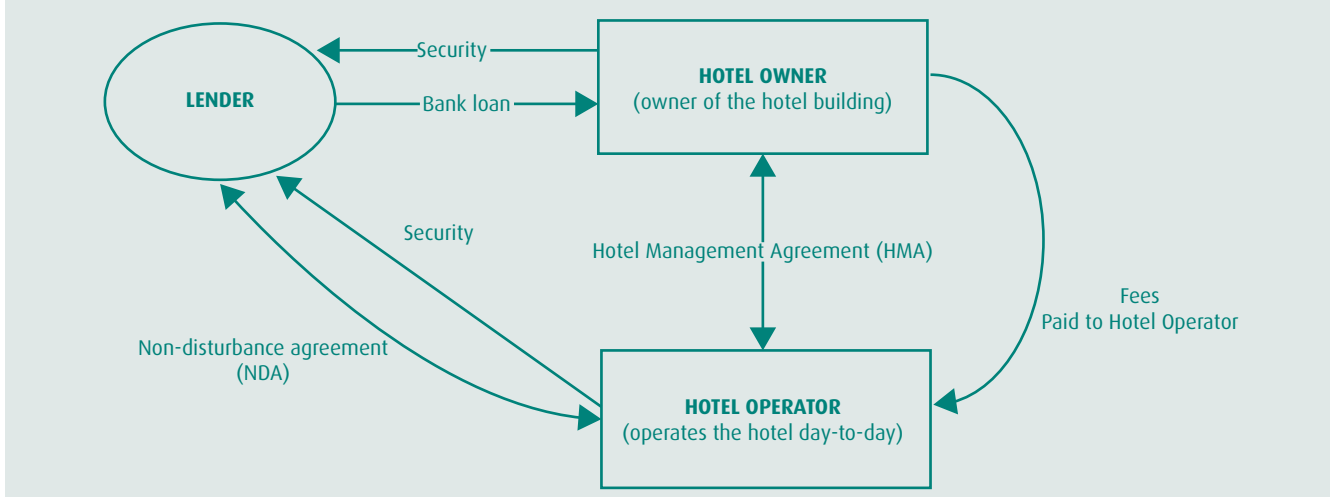
- Loan facility agreement between Hotel Owner and lender.
- Debenture from Hotel Owner in favour of lender containing fixed and floating charges, including a first fixed charge over the hotel property.
- Security over any intercompany loans, to facilitate a share sale if necessary.
- The lender should also take security over the Hotel Operator's fixtures, fittings and equipment – if the hotel ultimately fails, the lender will need to retain the fixtures, fittings and equipment in order to trade/sell the business as a going concern.
- Assignment of the Hotel Owner's interest in all major contracts entered into by the Owner, including the HMA, and NDA, development and contractor agreements (if not contained in the debenture).
- The HMA may also be secured by second ranking security, so an intercreditor deed may also be needed.

### PRE-ENFORCEMENT OPTIONS

Pre-enforcement options which may be available where the Hotel Owner is in financial difficulties include the following:

- amend and restate the loan to extend its term, or long stop dates;
- increase the amount borrowed;

FIGURE 1: HOTEL INSOLVENCY DIAGRAM



- debt for equity swap;
- relaxation of financial covenants;
- renegotiation of HMA;

in exchange for:

- a charged cash deposit;
- an equity injection;
- additional security from other members of the borrowing group.

## ENFORCEMENT

Before considering enforcement, a lender must ensure it has a thorough understanding of market values, the security documents, what enforcement (and pre-enforcement) options are available, and a strategy for how the asset will be developed/traded/marketed and sold. The primary aim will be to maximise value. This stage is likely to include a security review of the security granted in favour of the lender.

On the insolvency of the Hotel Owner, the lender will usually be entitled to appoint an administrator/receiver under the powers in the debenture/fixed charge. The lender should bear in mind that it will have less control over an administrator than a receiver, as an administrator is an officer of the court with a general duty to all creditors. However, it is also important to note that a receiver will not have control over floating charge assets. There may also be different tax consequences to the appointment of a receiver or administrator.

The officeholder to be appointed will need experience in the hotels sector, and there must be a clear strategy. The officeholder must be familiar with the terms of the HMA and any NDA, including any required capital expenditure needed to preserve or maximise value – is there funding available for this? If the HMA has been terminated, there may also be a requirement for funding if the officeholder is to continue to trade the hotel.

Any NDA will usually contain wording prohibiting the termination of the HMA by the Hotel Operator in the event of appointment of an officeholder over the Hotel Owner provided that breaches of the HMA on the part of the Hotel Owner (including potentially arrears of fees) are dealt with. This means that the Hotel Operator will remain in place

to run the business while the officeholder carries out his planned course of action, and the officeholder will not have full control of running the hotel. A good relationship between the officeholder and the Hotel Operator will be essential. Having the Hotel Operator in support of the proposed strategy will assist the officeholder in retaining control of the hotel, and prevent employee departures which would stop smooth running of the business. Also, the Hotel Operator's brand and booking system are often critical drivers of new bookings to hotels and very important to maintaining the business.

The officeholder may find it difficult to terminate the HMA in any event, even if he wishes to, and he will therefore have to act in accordance with its terms. These terms will include the exclusive right to run the hotel on a day-to-day basis free from Hotel Owner (or other) interference, and can lead to difficulties. This can be an issue where the officeholder is reluctant to allow the Hotel Operator to continue without supervision, but interference from the officeholder may amount to a breach of the Hotel Owner's obligations under the HMA, and could leave the officeholder's actions open to challenge by the Hotel Operator and give the Hotel Operator the right to terminate the HMA.

Generally, a trading hotel will be more valuable than an empty, non-trading hotel. However, in some cases, the existence of an HMA can mean that the value of the property is compromised, rather than enhanced, and the officeholder may want to sell the hotel quickly with vacant possession, while the Hotel Operator may want to remain in occupation. This could arise if, for example, a competitor operator was interested in purchasing the business or if third party purchasers perceived there to be value in rebranding or repositioning the hotel or converting it to alternative use, or if a 4\* hotel was built in a location more suited to a budget hotel. The officeholder, whether an administrator or a receiver, has an obligation to obtain best the price for the hotel on a sale, and he will need to consider whether the cost of any liability arising from a breach of the HMA or NDA, or from a termination of the HMA or NDA without proper grounds, would outweigh the benefit of selling with vacant possession.

In these circumstances, it can be very difficult to see a way to

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### Biog box

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remove the HMA from the picture, and release the value of the property, without incurring significant time and expense.

If there is no option but to sell the hotel with the HMA in place, the officeholder should also:

- Check whether the Hotel Operator has any rights of first offer or last refusal. This must be dealt with, as other potential purchasers may not want to be involved while this right remains outstanding.
- Check whether the Hotel Operator has any other rights, such as maintenance of brand standards, confidentiality clauses; is there any prohibition on sale to a competitor? These may impact on timing and sale price.
- Depending on the nature of the assets, and in so far as is possible, locate relevant regulatory compliance documents, for example, fire risk assessments, asbestos reports/logs, and check that they are up to date. If the officeholder is able to assign the benefit of these documents, or hand them over on a sale, this will increase the speed at which a sale may be completed, and may increase the value of the assets (or avoid a potential price chip).

### FUNDING CONSIDERATIONS

The officeholder will need to consider funding as soon as s/he is appointed. Is there funding to trade the hotel in administration/receivership (including potentially arising arrears of fees not paid to the Hotel Operator)? Is there any planned capital expenditure that must be met? Does the hotel make enough money to cover immediate costs? Is the officeholder able to honour all bookings and deposits received before appointment?

The Hotel Operator will of course want the Hotel Owner (acting by the officeholder) to continue to cover all of these costs, but the officeholder may not want the Hotel Owner's assets to be used to cover these payments. Any new obligations entered into by the Hotel Operator may also give rise to payments which must be made as expenses in an administration, and an officeholder will want to have control over these obligations. As outlined above, this could lead to conflict with the Hotel Operator.

### REGULATORY REQUIREMENTS – LICENSING, PERMITS, CONSENTS AND RELATED MATTERS

The operation of a particular hotel may require a number of different permissions to be in place in order to allow the facilities offered to guests to be lawfully provided. These might often include:

- a premises licence granted under the Licensing Act 2003 (potentially authorising all or any of the following; alcohol sales, entertainment and late night refreshment);
- where spa facilities are offered, a special treatments licence;
- a 'wedding' licence;
- a premises licence and operating licence or other form of permission granted under the Gambling Act 2005 (some hotels have casino licences associated with them by way of example or may offer gaming machines); and
- a tables and chairs licence in respect of the use of public highway space.

These are important permissions for two main reasons. First, any permissions already held will be required to allow the hotel to continue to trade lawfully. Trading without such a permission is backed by criminal sanction. Secondly, they may be valuable assets in their own right. Premises licences, in particular, can add significant value to property values.

It is important to be aware of the effect of insolvency on those permissions. Many of the permissions will lapse upon certain insolvency events, with premises licences and gambling licences falling into that category. There is then a limited window available to the officeholder within which to reinstate the licence (by transferring it to an appropriate solvent vehicle). Where a licence is lost it may not be possible to obtain a new licence on the same terms (or in some cases at all). Thus, it is vital to be aware of this.

Administrators therefore need to be aware of their responsibilities. Preparation is vital, as some of the time periods available for reinstatement of a licence are short. In a hotel group situation, each separate premises will have separate licences, so this may be a time consuming process, but it must be done carefully.

If trading the premises, the administrators should ensure there are licences in place and consider what the requirements of the licences and legislative scheme are. For example, many licences will have detailed conditions attached to them and failure to comply with them may amount to a criminal offence. In addition, where sales of alcohol are concerned each licence will have an individual named on the licence fulfilling the role of 'designated premises supervisor'. Without a named 'DPS' who is responsible for particular premises, alcohol sales will be unlawful. In addition, if the terms of licences are not being adhered to then this may put the licences in jeopardy of enforcement action, possibly with a view to revocation in the case of serious breaches. An officeholder is unlikely to obtain proper recovery in monetary terms for a hotel site with potential enforcement issues hanging over it.

There may also be other regulatory requirements which the officeholder should ensure that he or she is aware of and able to comply with as failure to do so may result in criminal liability. Again by way of example, there is a wealth of regulation around food safety which includes requirements to keep certain records in relation to food handling. Similarly, there may be agreements in place for maintaining or servicing particular plant, machinery or equipment which are vital to the hotel's operations. Again, a failure to keep these arrangements in place may have significant adverse consequences.

### OTHER CONSIDERATIONS

On appointment, an officeholder will need to give consideration to issues such as staffing, and whether any redundancies will be needed, or whether jobs can be preserved via a sale of the business as a going concern. Any break-up sale will also need to factor in division of central office staff or any staff employed to service a number of individual hotels.

Finally, the officeholder should also check all supplier contracts: is there provision for termination by suppliers on the appointment of an insolvency officeholder? There may be an immediate need for cash, as suppliers may demand payment of arrears before they will supply further. Fundamentally, the question will be is there a source of cash funding? ■