WORKOUT INCENTIVES AND DISINCENTIVES, AND ISSUES, PARTICULARLY WITH RESPECT TO HOTELS

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I. GENERAL FACTORS AFFECTING THE CHOICES OF TRYING A WORKOUT BEFORE SEEKING BANKRUPTCY OR FORECLOSURE

There are many economic factors that generally affect the desirability of workouts, as opposed to foreclosures or bankruptcy proceedings. For example:

(a) The principals of the Debtor may be subject to personal guaranties, or recourse carve-outs, particularly ones that are triggered by any efforts they make to place the Debtor in bankruptcy, i.e. the so-called "bad boy" provisions of the loan documents. Such provisions may pit the principals' interests against those of the other members of other persons and entities having ownership interests in the Debtor, but may make those principals very amenable to acquiescing to the lender's demands.

(b) Principals who also own or control related entities that in turn own or control separate properties, and the respective mortgagees of those entities, will be concerned about having good properties thrown into a single bankruptcy proceeding, along with the bad ones, in a substantive consolidation. See In re General Growth Properties, Inc., 409 B.R. 43, 2009 Bankr. LEXIS 2127, 62 Collier Bankr. Cas. 2d (MB) 279, 51 Bankr. Ct. Dec. 280 (BK S.D.N.Y., 2009). Such relationships among different properties, which may have different investors, may create even more conflicts of interest.

(c) Workouts and bankruptcy proceedings can address unsecured trade creditors, whereas foreclosures cannot. On the other hand, foreclosures and bankruptcies can wipe-out junior liens, whereas workouts cannot. Bankruptcy also provides a dispute resolution mechanism, particularly in instances in which cooperation is necessary, but cannot be obtained, to keep the business in operation.

(d) What funds, if any, are available, from any source, and when, to fund a workout or bankruptcy, including trade creditors who now demand to be paid upon delivery and employees? The automatic stay in bankruptcy enables to Debtor, at least for a time, to divert available funds from the secured creditors and prepetition debts to pay such operating expenses.

(e) Under 11 U.S.C. §1146, state and local stamp and similar taxes are avoided for a transfer made pursuant to a plan of reorganization that has been confirmed. See Fla. Dep't of Revenue v.

Piccadilly Cafeterias, Inc., 128 S. Ct. 2326, 171 L. Ed. 2d 203 (2008). That tax savings often creates an asset that can encourage a workout implemented through a friendly bankruptcy.

(f) Instead of blaming the economy or the approved business plan for the failure, the lender may have no confidence in the Debtor, in the Debtor's willingness or ability to make the requisite changes, and the Debtor's likely cooperation. The lender may also feel that it can find a turn-around specialist who brings a new perspective, can make the unpopular changes, or otherwise can do a better job. In that case, a foreclosure or bankruptcy may be the only way to try to get the Debtor to step aside. On the other hand, the Debtor may be willing to pay down the loan or devote special expertise and work to try to rectify the situation.

(g) Any weaknesses in the lender's position, such as

(1) whether the lender is susceptible to being accused of acting in bad faith or lender liability;

(2) whether the lender is susceptible, in bankruptcy, to equitable subordination (11 U.S.C. §510), voidable preferences (11 U.S.C. §547, fraudulent transfers and obligation (11 U.S.C. §548), or a cramdown (11 U.S.C. §1129); but see In re General Growth Properties, supra; In re: Adelphia Communications Corp., 365 B.R. 24, 2007 Bankr. LEXIS 1942 (BK S.D.N.Y., 2007); and In re: Lois/USA, Inc., 264 B.R. 69, 2001 Bankr. LEXIS 747 (BK S.D.N.Y., 2001); or

(3) whether the lender has the requisite documents to establish its standing and power to foreclose. See Kemberling v. Ocwen, 2009 U.S. Dist. LEXIS 116674 (Nev., 2009); Blau v. America's Servicing Company, et. al., 2009 U.S. Dist. LEXIS 90632 (Ariz., 2009); and In re: Wilhelm, 407 B.R. 392, 2009 Bankr. LEXIS 1857, 69 U.C.C. Rep. Serv. 2d (Callaghan) 582 (BK ID., 2009); and whether the lender has made the requisite recordations and filings to support its claims to priority, such as UCC continuation statements.

In particular cases, some of the above factors may be more important than the ones discussed below. Many of the above factors are to be addressed in the program itself, including by other speakers. This paper is designed to focus upon many of the factors that often particularly affect efforts at hotel workouts.

Workout negotiations occur in the context of what other types of remedies and defenses are available to the parties, particularly those under the federal Bankruptcy Code, 11 USC §101, et. seq. [All references herein to the "Bankruptcy Code" shall be to 11 USC §101, et. seq.] Thus, the following frequently relates to the Bankruptcy Code.

II. ADDITIONAL GENERAL FACTORS THAT OFTEN HAVE PARTICULAR AFFECTS UPON WORKOUTS OF HOTELS

In addition to the foregoing factors, the decision of the parties whether to try workout negotiations, rather than to proceed to foreclosure and/or bankruptcy, often involve the following practical problems and legal issues, particularly with respect to hotels:

A. <u>As a Practical Matter, Does the Lender Have to Provide More Funding - The Lender's Continuing to Fund May be the Best Way to Maximize Its Total Final Return</u>. The question here is whether the lender would be "putting good money after bad" or is stuck in a situation of being "in for a penny, in for a dollar".

With most real estate construction loans, if the building is still under construction at the time of the Debtor's default, then, if the lender stops funding (1) there will be large shut-down and re-start-up costs; and (2) there will still be certain fixed costs, such as for a minimum level of utilities services and maintenance, real estate taxes, and security, as well as the increased costs of insuring a vacant building. Moreover, if finishing construction is the best way to limit losses, the Debtor may be the best person to undertake that work. On the other hand, since a hotel has a particular and costly design, the ability to alter it for a potentially higher and better use becomes more difficult as construction proceeds.

With most real estate interim or permanent loans, if the building is in operation at the time of the Debtor's default, then, if the lender doesn't fund operating losses (1) there will still be certain fixed costs, such as for a minimum level of utilities services and maintenance, real estate taxes, and security, as well as the increased costs of insuring a vacant building, but with less and less income coming in to help pay those costs; and (2) key employees will likely become more and more concerned about their job security and potential for advancement and begin to leave.

In such cases, the lender should perform a relative cost/benefit analysis of whether to fund or to continue funding, as the case may be. As discussed above, this relates to whether the principals or related assets are subject to liability that the lender can realize. In relation to the foregoing, the lender needs to consider the time-is-money benefits of a quick and friendly sale to a third party, even at a large loss.

Moreover, for the following reasons, the nature of the hotel business may make it particularly important for the lender to keep funding the construction loan and/or to provide the funds necessary to keep the hotel operating:

1. Hotels are somewhat unique in that they (1) are usually managed by a separate manager (which may be an affiliate of the Debtor, an independent professional hotel management company, or a

brand or flag hotel chain), who is usually given, in the form of a hotel management agreement (a "Manager", and a "Hotel Management Agreement", respectively), a great deal of authority in operating the hotel; and (2) may be subject to a franchise agreement with a brand or flag hotel chain, which sets extensive operating standards. In either case, the hotel will also probably be subject to a subordination, non-disturbance and attornment agreement by and among the Debtor, the management company and the hotel chain (an "SNDA"). Such agreements are generally far more detailed than the usual office building, apartment complex, or shopping center management agreements. For example: The hotel manager or brand or flag franchisor may have start dates, revenue minimums and operating requirements that, if not satisfied, allow it to terminate the agreement. Termination of a valuable brand may be very damaging to a struggling hotel, and getting a replacement brand for a failed hotel may be very difficult and expensive.

2. The major part of the hotel's revenue comes from advanced bookings of conferences, hotel rooms, and meeting rooms, all for relatively short periods of usage. If word of the hotel's difficulties gets out, such customers will likely become concerned about the continued ability of the hotel to operate or to do so at the contemplated quality. Those bookings may be cancelled and future bookings may not occur. The hotel's forfeiture of the customers' deposits as to such cancellations of the then existing bookings is unlikely to make up for the losses even as to just them. The value of the hotel as just real estate could decline quickly if it is not a going concern.

3. The major aspect of a hotel is generally not its position as a major piece of real estate, but as an on-going business. That business cannot function unless the trade creditors and the employees are paid on an on-going basis. Thus, even if the Debtor files for bankruptcy, as long as the hotel remains open for business, that will require that such payments be made on a priority basis as administrative expenses. 11 U.S.C. §§ 503 and 507.

B. <u>Relative Expense - Bankruptcy Proceedings Necessarily Add a Lot of People and Formalities, and, Are, Therefore, Usually Very Expensive Compared to Negotiating a Workout</u>. Bankruptcy proceedings call for more parties, such as the U.S. Trustee and a creditors' committee. The secured creditors, the creditors' committee, and at least some of the unsecured creditors individually will have separate counsel whose fees are paid out of the bankruptcy estate, and some will have to retain separate expert witnesses, whose fees may also be paid out of the assets of the estate. Moreover, those attorneys and experts will probably be spending a great deal of billable time preparing pleadings and attending court hearings. Even the U.S. Trustee is entitled to a fee. Fears of establishing precedent and the fee reimbursement provisions may encourage litigation that may be compromised quickly in a non-bankruptcy situation. The Borrower also generally has to pay retention bonuses to keep key staff. Moreover, such allowed payments to attorneys and to the U.S. Trustee, perhaps to some of the experts, and as retention bonuses will be made, off-the top, as administrative expenses, as the bankruptcy case progresses, thereby draining substantial funds out of the bankruptcy estate on a continuing basis. 11 U.S.C. §§503 and 507. A hotel adds additional parties in interest - the Manager and/or the franchisor, perhaps a union, and perhaps the federal Pension Benefit Guaranty Corporation - and thus additional potential issues.

C. Relative Time-Frames - The Lender May Find Workout Negotiations Faster than a Foreclosure or Bankruptcy. As stated above, timing can be critical, especially with respect to the construction or operation of a hotel. A commercial foreclosure, even in a state allowing a non-judicial power of sale, can easily take at least thirty days, assuming that the Debtor does not file for bankruptcy. Even a friendly bankruptcy proceeding can easily take at least six months. The two most likely sources of authority, to try to speed-up a bankruptcy proceeding, are the "single asset real estate" and the "small business case" provisions; however, they will probably not be applicable to most hotel cases.

1. Single Asset Real Estate Cases Exception.

11 USC §101 defines "single asset real estate" as follows:

> (51B) The term "single asset real estate" means real property constituting 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.

Subject to certain qualifications, 11 USC §362(d) provides for expedited procedures benefiting secured lenders in a single asset real estate case.

However, in In re: Club Gulf Partners, L.P., 2007 Bankr. LEXIS 1225, 47 Bankr. Ct. Dec. 229 (BK E.D. TX, Sherman Div., 2007), the Court interpreted and applied the definition of "single asset real estate" as follows:

> 7. Other courts similarly focused on whether the real estate is used in the operation of a business or whether it is simply held for income. In *Centofante v. CBJ Dev. Inc. (In re CBJ Dev., Inc.),* 202 B.R. 467 (9th Cir. B.A.P. 1996), the court examined whether the debtor is conducting "substantial other business activity" on the property, and held that a hotel is not single asset real estate because the gift shop, restaurant, and bar constitute significant other business. The court drew a distinction between a hotel and an apartment house:

> [T]he operation of the average hotel requires daily maid service, linen service, and many other services not provided by an apartment building owner. The maintenance services provided by an apartment or office building are minimal and primarily limited to common areas. . . . [T]he operation of a full service hotel is more than the mere operation of property. . . . [T]he operation of the Hotel requires substantially more day to day activity than does the operation of an apartment complex. Accordingly, the operation of the Hotel is sufficiently active in nature to constitute a business other than the mere operation of property. We conclude that the Hotel is not "single asset real estate."

Id. at 472. See also *In re Whispering Pines Estate, Inc.,* 341 B.R. 134, 135 (Bankr. D.N.H. 2006)(apart from bar, restaurant, gift shop, and tour revenues, the services provided by a hotel are "reason enough to remove the hotel from the definition of [§ 101(51B)]"); *Philmont Development,* 181 B.R. at 224 (holding that "the phrase 'single-asset real estate' was intended in the statute to encompass an apartment building, office building, or strip-mall shopping center 'owned by an entity whose sole purpose was to operate that real estate with monies generated by the real estate.'").

* * *

12. In particular, the Court interprets the definition according to an active-versus-passive criterion that inquires into the nature of revenue generation on and by the property, that is, whether the revenue is the product of entrepreneurial, active labor and effort--and thus is not single asset real estate--or is simply and passively received as investment income by the debtor as the property's owner--and thus is single asset real estate. Real property that, for the generation of revenues, requires the active, day-to-day employment of workers and managers other than or additional to the principals of the debtor, and that would not generate substantial revenue without such labor and efforts, should not be regarded as single asset real estate. See *CBJ Development,* 202 B.R. at 471 ("courts consider . . . whether the debtor has employees other than its principals").

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This is the heart of the definition. In order to be single asset real estate, the revenues received by the owner must be passive in nature; the owner must not be conducting any active business, other than merely "operating the real property and activities incidental thereto." Under the prior jurisprudence, those passive types of activities are the mere receipt of rent and truly incidental activities such as arranging for maintenance or perhaps some marketing activity, or in the Fifth Circuit's memorable phrase, "mowing the grass and waiting for the market to turn." *Humble Place,* 936 F.2d at 818. In contrast, a variety of business ventures that own a tract of improved real estate on which active entrepreneurship is underway -- such as the golf course of the Debtor -- should fall outside the ambit of the § 101(51B) definition.

Applying the Definition in the Present Case

15. In the case at bar, the Debtor owns real estate but also operates a variety of revenue-producing activities on it. It employs third-party employees, without whom little or nothing of a revenue-producing nature would happen

on the land; and it enjoys revenues from a variety of commercial activities on the property, including selling memberships, charging fees or prices for access to the public golf course; use of a golf cart; use of the driving range; use of the tennis courts; merchandise in its pro shop; food and beverages (beer, wine, and nonalcoholic) in the restaurant in its clubhouse; and use of the clubhouse for special events.

16. Because its business activities are variegated and multiple and are dependent on the entrepreneurial efforts and ongoing hard work of its principals and its other employees, and because it does not simply lease its property to tenants as the owner of true single asset real estate such as an apartment house does, the Debtor's golf course does not fall within the scope of the definition of "single asset real estate" in Code § 101(51B), and the Debtor is therefore not subject to Code § 362(d)(3). . . .

However, regardless of the structure of the Hotel Management Agreement, the Debtor generally has an active role in the operation of the hotel. See, for example, Rabkin & Johnson, 26-22 Current Legal Forms with Tax Analysis Form 22.100 (the employees work for the owner, not for the manager). Thus, the lender secured by a hotel is not likely to get any speed-up, in bankruptcy, under the single asset real estate statute.

2. Small Business Cases Exception.

Various Sections of the Bankruptcy Code are designed to provide accelerated and streamlined treatment of "small business cases". See, for example, the reporting requirements of §308, §1116, and the Debtor's exclusive period for filing a plan of reorganization under §1121.

11 USC §101 defines a "small business case" as follows:

(51C) The term "small business case" means a case filed under chapter 11 of this title in which the debtor is a small business debtor.

(51D) The term "small business debtor"--

(A) subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition or the date of the order for relief in an amount not more than $ 2,343,300 (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) [11 USCS § 1102(a)(1)] a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and

> (B) does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $ 2,343,300 (excluding debt owed to 1 or more affiliates or insiders).

Because of the size of the $2,343,300 dollar cap in relation to the value of most hotels, the small business case statutes are also not likely to be available to speed-up a hotel bankruptcy proceeding.

D. <u>Bankruptcy Gives the Debtor Flexibility to Keep or Reject Executory Contracts, But Not Necessarily to Force Changes to the Terms Thereof; a Workout Provides the Possibility of Getting Such Charges in the Give-and-Take of Negotiations</u>.

The Debtor, obviously, wants to keep executory contracts that are beneficial to the Debtor or otherwise valuable to sell, and to reject executory contracts that are burdensome to the Debtor. This is particularly important with respect to a Hotel Management Agreement, which may have a term from 20 to over 50 years, sometimes with extension options, and generally gives the Manager the right to be paid "off-the-top". The respective rights and obligations under a Hotel Management Agreement can vary substantially, based in part upon the relative bargaining strengths of the parties, and customs, at the time the agreement was entered into. The Hotel Management Agreement may be may be with a value-enhancing manager or brand, and/or may provide the Debtor (but not the Manager) with broad rights to terminate the agreement, to control the operation of the hotel, to control the charges required the Debtor thereunder (such as for repairs and replacements), and/or to control the amounts or types of advertising or other attention the Debtor receives thereunder. On the other hand, it may give the Manager or the franchisor broad rights, from the Debtor's perspective, to pay little attention to the particular hotel rather than its other operations, to collect excessive fees, to be indemnified for its acts or omissions, to restrict assignments, to terminate the agreement, to receive termination fees if the Debtor terminates, or to lower the quality of the brand or flag assigned to the hotel.

11 U.S.C. § 365 (executory contracts and unexpired leases) gives the Debtor broad powers to take advantage of those benefits or overcome those detriments. Specifically, the Debtor can reject the contract or lease under 11 U.S.C. § 365, and even limit its damages for such rejection under 11 U.S.C. § 502 with respect to employment contracts and unexpired leases of real property under which the Debtor is the tenant. Alternatively, if the Debtor wants to assume and assign the contract or lease for a profit, the Debtor can even modify that contract or lease to permit that assignment, especially if the restriction being modified is deemed to be an anti-assignment or a <u>de facto</u> anti-assignment provision. The only exceptions to that right to modify are for (1) many of the provisions of "shopping center" leases; and (2) provisions that are a "material and bargained-for element" of

the contract or lease which is "economically significant" to the other party. In re Fleming Companies, Inc., 499 F.3d 300, 2007 U.S. App. LEXIS 19927, Bankr. L. Rep. (CCH) p. 80,996, 48 Bankr. Ct. Dec. 188 (3rd Cir., 2007).

However, 11 U.S.C. §1113 imposes certain procedural and substantive limitations upon the Debtor's ability to reject a collective bargaining agreement. The Wages, Worker Adjustment and Retaining Act, 29 U.S.C. §2101, etc. applies with respect to employee wages and benefits and rights to notice. Furthermore, ERISA and IRS rules generally apply with respect to the protections of pensions.

With respect to hotels, if the retail portions of the hotel are bound together as a separate condominium unit or parcel, that unit or parcel may be deemed to be a "shopping center".

III. SOME OF THE LEGALESE TO CONSIDER IN NEGOTIATING WORKOUT AGREEMENTS

(a) Whether to have a separate, up-front pre-negotiation agreement to try to avoid any waivers by the lender in engaging in negotiations, including that the lender has no fiduciary duties.

(b) Whether the Debtor admits default and liability for a specified amount owed, waives all defenses that shall have arisen after the date of the loan documents, and waives all other weaknesses in the lender's position. Specific waivers vs. general waivers.

(c) Whether the Debtor stipulates to the dollar amount of the fair market value of the collateral, i.e. that the loan is "underwater".

(d) Whether the Debtor places, in escrow, an executed and notarized deed, along with the other standard closing documents and instructions, including notices to tenants and consents to transfers of liquor licenses and permits and approvals that do not run with the land. Whether the grantee of that deed records a lis pendens with respect thereto.

(e) Whether particular key principals or employees of the Debtor will agree to stay on at the request of the lender, despite a foreclosure or bankruptcy; and, if so, under what terms and conditions.

(f) Whether the Debtor should up-date its representations and warranties, especially with respect to environmental assurances.

(g) Whether the Debtor shows that it is not insolvent or acting under duress.

(h) Whether the Debtor should have a continuing obligation, personally guaranteed by its principals, with respect to the transfer of licenses, permits and contracts.

(i) Reinstatement of lender’s concessions if the deed-in-lieu or other transfer is voided by a bankruptcy court.