Direct Agreements in Hotel Financings: Key Considerations

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The purpose of this agreement is to clearly set out the relationship between these three stakeholders and how the financing agreements between the financiers and the hotel owner and hotel management agreements between the hotel owner and the hotel operator will fit together. This requirement often emanates from both the hotel operator and the financiers as it is in their common interest to reach a clear agreed position.

There will often be some conflicting provisions between the hotel management agreement and the financing agreements and part of the job of the direct agreement is to iron out any such conflicts. Although united by the common purpose of operating the hotel efficiently, the three key stakeholders tend to have differing priorities. The priorities of the operator would be to protect (i) its right to operate the hotel for the anticipated term, (ii) its autonomy as regards operational matters, (iii) its revenue and (iv) its brand and intellectual property. The owner will want the hotel to be a success and will want to support the operator and financiers in reaching agreement, as this will be critical to the success of the project. The financiers usually understand the position of the operator and the owner, but have their own requirements as regards the extent of security and operational control required in respect of the particular project. Notwithstanding the potential for conflict between these stakeholders, there is one key factor which unites them and that is the desire for the hotel project to be completed and for the hotel to operate smoothly and profitably.

In this article we will comment upon four key areas which are significant for the stakeholders to consider, which are usually covered in a direct agreement. These are:

- bank accounts;
- non disturbance of the operator;
- insurance requirements and application of insurance proceeds; and
- termination.

Bank accounts

Hotel projects usually involve a number of bank accounts, with payments moving between them as agreed under the hotel management agreement and facility agreement. The typical structure is that hotel revenue is paid into the hotel operating account and applied towards hotel operating costs. Any profit is subject to various deductions, such as management fees payable to the operator and/or a contribution towards a maintenance and repair fund, after which the remaining balance is paid to the owner, as the owner’s return.

In some cases, the financing agreements and the hotel management agreement are not implemented at the same time, so the parties need to review the existing contractual framework as regards bank accounts, payments and cashflows and then amend that framework as necessary to reflect how these matters will operate in practice.

From the operator’s perspective, the priority is to ensure that they have control over, and access to, the hotel operating revenues and an ability to carry out their role as hotel manager, which will usually include managing the income and operating costs of the hotel, for the duration of the term of the hotel management agreement. The operator will be less concerned with the owner's return.

By contrast, the owner's priority will be to ensure that the operator is able to operate the hotel efficiently and that there are no unnecessary hurdles to payment to the owner (or its nominated account) of the owner's return.

The financiers will want to have as much visibility as possible over the hotel operations and cashflow and will often want to see all hotel project accounts held with one of the financiers. The financiers would usually appreciate that the operator needs a high level of autonomy in terms of operating income and expenses and may allow this, provided that they have visibility over operations and control as regards the accounts, other than the accounts required for operating the hotel.

In some hotel projects, the direct agreement will provide that there should be a hotel operating budget prepared periodically and agreed between the parties and allowing for matters within the budget to be automatically permitted, whereas deviations require special approval. Whether this is required or advisable will depend on a case by case assessment of the project. Where the budget formulation and approval process is contemplated, the timelines to agree the budget and a fallback position to resolve any disagreement, for example by referring the matter to an expert, are advisable.

Related to accounts are the financiers' right to set off amounts due to them from the owner against credit balances on accounts in the name of the owner. This is relevant because in many cases, certain operating accounts will be held in the name of the owner, but would be under the sole control of the operator. For this reason, some operators require that the "operating" accounts (ie which relate strictly to hotel revenue and expenses and other deductions under the hotel management) are kept outside the security structure and the only obligation on the operator is to pay the owner's return to such account as is required by the financiers. Alternatively, where the accounts must be held with one of the financiers, the operator may require that the financiers' right of set off cannot be exercised against the operating accounts. This is because the operator will have committed to running the hotel, including dealing with many third parties, in reliance upon amounts in those accounts and the operator would not want to be left in a position where the funds on which it relied have been unilaterally withdrawn by the financiers.

Non disturbance of the operator

As noted above, the stakeholders usually agree that they will all be best served by a well run hotel, operated by the operator with minimal interference from the owner or financiers. The operator is, after all, the best placed stakeholder to make the relevant operational decisions and would usually have been selected based on its track record and experience. In light of this, the operator will seek assurances from the financiers that the operator will be left to run the hotel operations in accordance with the hotel management agreement and, to the extent possible, the hotel management agreement will be respected by the financiers and their representatives, delegates and successors. In the UAE, this latter point requires careful consideration because of the lack of self help enforcement remedies under UAE law. In most cases, the financiers will see the land on which the hotel is based as their core collateral and will take a mortgage over that site. If there were an event of default under the finance agreements and the financiers were to enforce their security, this mortgage would be executed through the relevant execution court, culminating in an auction of the property. Currently, contracts such as hotel management agreements will not automatically follow the land to the ultimate buyer, binding that buyer to comply with their terms. As such, the type of non disturbance clause seen in the UAE may be lighter in this respect than the equivalent clause in some other jurisdictions.

Insurance requirements and application of proceeds

In most transactions, the operator will have insurance requirements placed on the owner under the hotel management agreement, sometimes with the operator arranging the necessary insurances at the owner's cost. Similarly, the financing agreements will include insurance obligations on the owner and also provisions setting out the way in which insurance proceeds are to be applied (such as to replace or repair a damaged asset or in certain circumstances to mandatorily prepay the financing). Any mismatch in these requirements needs to be carefully considered and the documents drafted, or amended if they are already in place, to reflect the commercial agreement between the stakeholders on these matters. Of particular importance are the obligation to apply proceeds paid on total loss of the property itself to reduce the financing amount (on the basis that the main asset has been destroyed) and the ability of the operator to have visibility and comfort as regards application of certain operations related insurance proceeds. For example third party liability insurance should be applied to pay the injured third party and insurance proceeds paid in respect of a damaged lift ought to be applied to repair the lift. There is no 'one size fits all' approach to these matters, as they will depend on the insurance policies in question and the provisions of the hotel management agreement and financing agreement. They are, however, important to understand and agree at an early stage in negotiations.

Termination

Another area which unites the stakeholders is the desire to agree the manner in which the hotel management agreement may be terminated. The financiers want to have visibility on the occurrence of any potential termination event under the management agreement, usually with a right (but not an obligation) to remedy the underlying breach. This is because, in some cases, the financiers would want to protect the hotel management agreement and the services provided thereunder, even if this is at their cost for a certain period. This would usually be because either the owner is not in a position to remedy the breach, or requires financier assistance to do so and the financiers feel their overall position is best served through continuation of the hotel management agreement. From the operator's perspective, agreeing to such a termination process is beneficial, in the sense that a breach could be remedied not only by the owner, but (at the financiers' option) by the financiers as well. The downside from the operator's perspective is that the financiers' requirements may extend the timeframe and process to terminate, when compared with the operator's rights under the hotel management agreement.

On the flip side, the financiers would usually agree to notify the operator of the occurrence of an event of default or enforcement event under the financing agreements. This would simply put the operator on notice as regards the owner's position, allowing the operator to begin contingency planning. This notification would not usually give the operator any new rights, so this is more an information sharing obligation to reflect the good faith of the parties.

Concluding remarks

As can be seen from the above, the interplay between operator, owner and financiers can be very varied and depends on the operational arrangements in place in respect of the hotel project in question. The one key theme in hotel financings is that clarity in requirements and expectations of these stakeholders is vital in helping them to quickly and efficiently find contractual solutions to manage the relationship between them, while allowing the hotel to operate smoothly.

Should you have any queries concerning direct agreements or hotel financings, please feel free to contact the author of this article or any other member of the Banking & Finance team at Al Tamimi & Company.