

Ten Things You Want to Know About Non Disturbance Agreements

2007-12-20

Non disturbance agreements or NDAs govern the relationship between a hotel owner, hotel operator and financier.

In the situation where a hotel owner defaults under its loan agreement, the financier has a right to take control of the operation of the hotel as a result of that default. The contractual relationships between the owner and the operator are generally not enforceable against the hotel owner's financier.

From a hotel operator's perspective, a non disturbance agreement is an important document because it provides the hotel operator a direct contractual relationship with the hotel owner's financier. This relationship can then facilitate the operator obtaining the financier's agreement to give the operator tenure.

There is also an argument that a non disturbance agreement can be beneficial to an owner's financier because, where an event of default occurs, the financier is able to take control of the hotel in an orderly fashion.

Based on our experiences throughout Asia Pacific in the last 12 months, we make the following observations on non disturbance agreements.

1. Valuing the operator

The operator's desire to require a non disturbance agreement has increased dramatically. Up until recently, it has been easier to persuade operators that a non disturbance agreement with the owner's financier is not required to be entered into if no financial guarantees were being provided by the operator and the hotel was not a "key" hotel from the operator's perspective, that is if only the operator's fees were at stake. The current trend seems to be that operators are taking firm positions on requiring non disturbance agreements. In our view, the main reason for the change in the operator's position is due to the change in the nature of operating companies. Operating companies, traditionally valued by property ownership and management contracts, are now having their value almost solely derived from management contracts. As a result, tenure is more important for operators, and non disturbance agreements are therefore increasingly more important for operators.

2. Financiers need to catch up with the trend

It appears that more and more financiers are offering to lend to hotel owners, and this has meant that the owners have more options when choosing a financier to borrow from. Therefore, there is a tendency for the owner to choose its financier based on competitive pricing rather than the financier's experience in lending to a hotel owner. We have seen an increase in the number of financiers with little or no experience in hotel management agreements that are providing finance to hotel owners. These financiers are in many instances being advised by advisers with little or no experience in hotel management agreements. This has meant that financiers and their advisers have had little or no experience in negotiating non disturbance agreements.

Financiers will need to catch up with the trend and understand the dynamics of hotel operations to remain competitive in this space.

3. Major financial institution as financier

Despite the strong trend towards operators requiring non disturbance agreements from financiers some hotel operators may still be willing to contemplate carve outs requirement, albeit in very limited circumstances. One such carve out is where the financier is a major financial institution and the loan to valuation ratio is below a certain predetermined level. The logic behind this carve out is the assumption that such institution will put in place prudential safe guards which would mitigate the risk of default by the owner.

4. Opposite positions

The positions adopted by the operator and financier are increasingly becoming diametrically opposed. One circumstance that illustrates this well is where an operator is making a financial contribution and is a quasi lender itself. If the value of the owner and its hotel at the point in time when an event of default occurs under its loan agreement is less than the combined value of the two loans, who gets priority?

This leads to difficult negotiations. Often the financier is asked to make significant concessions to the operator. While ultimately the financier retains its rights as secured lender, it must recognize the financial commitment made by the operator and, for example, agree to honor the terms of the management agreement if it enforces its security. Appropriate recognition should be given to the benefit operators provide pre and post enforcement by the financier.

5. Terms of non disturbance agreements

The different positions being taken by the parties are making it increasingly difficult for financiers and operators to agree the terms of non disturbance agreements. Financiers are seeking a position where the operator cannot terminate the management contract on the basis that the owner is insolvent. However, financiers are also taking the position that they will not be responsible for the owner's financial obligations to the operator prior to the time the business is taken over by the financiers, and are seeking to have discretion as to which of those obligations they will comply with. Further, financiers are requesting

that they have the ability to terminate the hotel management agreement in the event of sale without having to pay any termination payment, despite the terms of the hotel management agreement.

6. Timing

Operators are imposing absolute obligations on owners to ensure their financier enters into a non disturbance agreement before owners have determined who their financier will be. This is particularly the case in new build situations because the hotel management agreement is typically entered into prior to a financier being determined. In these circumstances, owners need to be sure they do not place themselves in the disadvantageous position of having a contractual obligation to the operator to enter into a non disturbance agreement, usually in the form attached to the hotel management agreement, before choosing a financier.

7. Looking ahead - Sale of hotel

Attention should be given to any obligations an owner may have to obtain a non disturbance agreement from a financier even if the owner has sufficient funds and does not need a financier.

In our view, such owners pay insufficient regard to the fact that if they decide to sell the hotel, any potential purchaser that needs to borrow money must have its financier agree to enter into the non disturbance agreement. The tougher the non disturbance agreement, the harder it is for prospective purchasers to comply with this requirement.

The obligation on a potential purchaser to have its financier enter into a non disturbance agreement may affect the owner's ability to sell the hotel or the sale price.

8. Understand how the financier operates

Owners, when seeking to secure finance for hotels, should take a more holistic view of a financier's responsiveness to issues raised.

When an owner seeks proposals from financial institutions, it should provide a copy of the non disturbance agreement and determine the bank's response to the non disturbance agreement.

In some instances, finalization of the non disturbance agreement can be a condition precedent to finalization of the hotel management agreement. Therefore, if the negotiation of the non disturbance agreement is protracted, this can have repercussions by delaying the execution of the hotel management agreement.

Owners should understand the internal decision making process of the financier (particularly a bank) and the implications on closing contractual arrangements. Right from the outset, a clear understanding as to the decision making process of the financier is important. If a problem arises in negotiating the non disturbance agreement, owners should ensure it is brought to the attention of the key decision maker rather than any subordinates. Also, owners should avoid situations where they think they've struck a deal only to find out that the deal is subject to the bank's credit committee approval.

9. Operators should not be viewed as financiers

Owners need to better understand operator sensitivities in contractual arrangements when operators are asked to lend together with third party financiers. The more an owner seeks operator financial contributions, the greater tension between the interests of the financier and the operator.

In our view, ideally the operator is treated as a pure service provider and is not required to make financial contributions, even on a stand aside basis. In practice, this may not always be feasible.

Rather than penalizing the operator financially for under performance, look at ways to terminate the relationship if a particular operator is not the right one for the property.

10. Build an ongoing relationship

Everyone has a role in building a good ongoing relationship. For owners, it may make sense to continue to work with the same financier for future hotel projects. Operators could also assist in identifying financiers that are competitive but also sensitive to issues surrounding non disturbance agreements including those set out in this article. Finally, like all other industries, lending in this area is getting more and more competitive. Any savvy financier should consider how it may be able to position itself taking into account the dynamics that exist in hotel operations.

www.bakernet.com

(C)2007 Baker & McKenzie All rights reserved.

Disclaimer

This publication has been prepared for the general information of clients and professional associates of Baker & McKenzie. You should not rely on the contents. It is not legal advice and should not be regarded as a substitute for legal advice. To the fullest extent allowed by law, Baker & McKenzie excludes all liability (whether arising in contract, for negligence or otherwise) in respect of all and each part of this document, including without limitation, any errors or omissions.

Baker & McKenzie International is a Swiss Verein with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a 'partner' means a person who is a partner, or equivalent, in such a law firm. Similarly, reference to an 'office' means an office of any such law firm.

This article comes from Hotel News Resource

<http://www.hotelnewsresource.com>

The URL for this story is:

<http://www.hotelnewsresource.com/article30565.html>

© 1998 - 2008 Nevistas and the author.

Brought to you by Hotel News Resource

Distribute your news on our Network

See what all the buzz is about at:

http://www.hotelnewsresource.com/Info-news_account_info.html