



Negotiating Lender Approval Rights over Service Agreements for Hospitality and Other Properties



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Standard loan documentation for most commercial property classes typically includes lender approval rights over major commercial leases (subject to negotiated thresholds) and property management agreements.

Complex operating properties such as hotels, casinos, resorts and senior living facilities require extensive contractual relationships for services and goods that are important to the operation and financial success of these properties. These agreements may address somewhat standard services such as laundry service and waste removal for a domestic, city-center hotel but also may extend to somewhat exotic (but equally critical) services such as import services and water desalination plant operations for a more remote destination resort. Agreements that are essential for the operation of these properties often include employment and union contracts, intellectual property and other licenses, online travel agency agreements, sports book and other gaming agreements, and contracts for headliner acts and other entertainment as well as major service contracts.

Lender's Concerns

A lender's diligence and underwriting typically will focus on the impact of major contracts on property cash flow and valuation. These contracts not only may represent significant expenses but, in the case of contracts with online travel agencies or entertainers, they may also provide significant revenue sources. Major contracts frequently cover services and amenities such as spa services and golf course maintenance that affect the property's value. A lender's concern that its real estate collateral becomes unduly burdened by costly service contracts that cannot be unwound easily must be balanced against the need for services and supplies that are essential to a property's continued operation and profitability.

Borrower's Concerns

In many ways, the interests of the property owner/operator and those of its lender are aligned with respect to major contracts. The property owner is concerned primarily with entering into agreements with suppliers and service providers that

provide goods and services necessary for, and/or that enhance, the operations and revenue of its property on the best possible terms. However, the property owner and its property manager also need sufficient latitude to operate the property effectively, which may require making contract decisions quickly in order to obtain the best terms or the services of a contract party in high demand. In addition to its lender's requirements, the property owner and its manager must ensure compliance with standards imposed by franchisors, regulators and other third parties through service and supply contracts. Contracts satisfying the goals of all interested parties for an operating property such as a destination resort are not easily negotiated. For example, the lender's desire for relatively conservative contract terms with maximum flexibility may conflict with the terms necessary to secure licensing with a celebrity chef necessary to satisfy a franchise agreement standard for a flagged resort hotel. The owner/operator of a complex property will be focused on financing terms that allow it to act quickly and exercise its business judgement as to terms that are best for the operation and profitability of its property.

Loan Document Requirements

Lenders regularly seek to regulate the agreements to which its collateral property and borrower may become subject by imposing seemingly objective limitations on contract terms that do not require lender approval. Loan documents commonly require lender approval of service and supply contracts that (a) exceed a specified term, (b) cannot be terminated on limited prior written notice without payment of a penalty exceeding a specified amount, (c) require payments exceeding a specified amount, and/or (d) are not subordinate by their terms to a financing secured by the related property or equity interests in the property. This can be a rational approach for both the property owner/operator and the lender depending on the type of property involved. For a property requiring specialized services, such as operating a waste treatment plant or providing skilled nursing personnel, a term of only one or two years and the right to terminate the agreement on 30 days' notice with only a limited penalty may not be possible to obtain. A simple dollar threshold, such as all contracts providing for payments in excess of \$1 million, may not adequately address contracts requiring variable payments based on use, consumption or a percentage of related revenue. Requiring a service contract to include subordination language so that it may be terminated by a foreclosing lender may not correspond to the market standard or may be a concept that is completely unfamiliar to the supplier or service provider, depending on the jurisdiction and sophistication of the parties involved.

Further Considerations

When negotiating loan document provisions for service and supply contracts, the property owner/operator will want to involve its property management personnel familiar with the property's day-to-day operations to confirm that the criteria being imposed make sense in the context of the full range of such agreements necessary for the operation of the property, allow for sufficient latitude to negotiate the best terms for these agreements and can be understood and complied with by personnel regularly handling contracting for the property. A lender will want to candidly assess its likely servicing capabilities, considering whether its servicer will be equipped to evaluate the terms and provisions of contracts requiring lender approval and the volume of such contract reviews and approvals that its servicer

can handle on a timely basis. Although borrowers frequently negotiate “deemed approval” language providing that a contract requiring lender approval is deemed approved under the loan documents if the lender or its servicer fails to reject or approve a contract submitted in the manner required under the loan documents within a specified time period, neither the lender nor the property owner should rely on this as a substitute for carefully considered approval parameters. Once those general parameters have been established in the course of negotiations, the parties and their counsel should ensure that they are sufficiently detailed to provide clarity for ongoing servicing and compliance. For example: (i) the loan document provisions describing contracts requiring lender approval should be clear about the various types of agreements that may have different approval criteria so that a definition intended to capture only property management agreements for the comprehensive management of the overall property is not so broad as to overlap with another defined term intended to capture contracts for more limited services at the property; (ii) limitations on the term of contracts not requiring approval should be clear as to whether the threshold term includes extension options; and (iii) any dollar threshold should be clear as to its application to variable payments and whether the amount applies to a 12-month period, the entire contract term or another time period.

Conclusion

Loan document provisions for lender approval of service and supply contracts for complex properties rarely receive the level of attention during negotiations that other major loan document provisions (such as those regulating transfers or leasing) typically receive. However, these provisions may produce uncertainty and unintended results for both parties, if not given adequate attention prior to closing.