

Newsletter

Hospitality & Mixed-Use Leader - When the Owner Checks Out: Hotel Manager Issues in Bankruptcy

4/9/2009

Given the impact of the current economic turmoil in the hospitality industry, hotel managers need to be aware of the potential issues impacting their continued operation of the hotel and right to payments in the event the owner files a petition for bankruptcy protection.

One of the manager's primary concerns will be the impact of bankruptcy on the existing management agreement and its ability to be paid. If the debtor rejects the management agreement, the manager is no longer obligated to perform and may assert a general unsecured claim in the case for its "rejection damages." If the management agreement is assumed by the debtor, the manager should be paid for its post-petition fees pursuant to the terms of the agreement and will be entitled to an immediate cure of all existing defaults. The timing of that assumption or rejection of the management agreement depends on the type of bankruptcy case. The parties may also want to consider accelerating or delaying that decision for various reasons depending on the relationship of the parties or the status of the case. Whether the management agreement is assumed or rejected, the manager should be entitled to an administrative claim for those management services rendered to the debtor on a post-petition basis. These administrative claims have priority over all general unsecured claims arising prior to the case. If the owner does not maintain those payments on a current basis, the manager will have the right to enforce that default and terminate the contract.

Additionally, managers must consider the possibility that pre-petition management fees and other payments made under the management agreement might be challenged as preferences. Generally speaking, a preference lawsuit is based on a claim asserted by a debtor or trustee in a Chapter 7 or 11 bankruptcy case against a creditor to recover payments made within 90 days prior to the filing of the case. These are statutory claims on behalf of the bankruptcy estate, which are intended to create a more equitable distribution to all creditors. If one creditor was favored and received a significant pay down of a debt immediately prior to the filing of the case, then this recovery is necessary to return those assets to the bankruptcy estate and assure that each party receives their pro rata share.

By definition, a preference is a transfer to a creditor on an antecedent debt within the 90 days prior to the petition (one year for transfers to insiders of the debtor). Insiders are typically officers, directors, owners, general partners or related parties defined under the bankruptcy code. If the manager is a separate and unrelated person or entity, the extended preference period should not apply. Not all transfers in this period are recoverable as there are many defenses. The primary defense is referred to as the "ordinary course of business" defense. As long as the creditor was paid in the ordinary course of business (either pursuant to the contract terms of the parties or the customary terms of the industry), then the creditor should be able to defend the claims and retain the payments. A defense also exists for contemporaneous exchanges (i.e., simultaneous payment for goods or services) and offsets can exist if new value was transferred to the debtor during that time period following the alleged preferential transfer.

With that background, the best approach for the hotel manager is to assure that any payments to them are made strictly in compliance with the terms of the hotel management agreement as and when due. If payments become delinquent, then any late payments received by the manager will potentially lose the ordinary course of business protection. This doesn't mean that a creditor such as the hotel manager shouldn't accept late payments. The manager just needs to be aware that those funds, or a portion of them, may be subject to recovery by the bankruptcy estate.

There are many other bankruptcy issues a hotel manager may want to consider in anticipation of a bankruptcy filing. In particular, the manager should carefully assess its obligations and potential liability with respect to continued operation of the hotel in a distressed situation. Under the applicable agreements, the manager may have to consider the impact of not funding certain hotel operating expenses like employee payroll and other related obligations to maintain compliance with an existing franchise agreement. Please contact us for additional information on these and other topics.

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