PUBLICATION

Hotel Owner Not Liable for Value Loss After Rebranding

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A Texas hotel owner secured non-recourse financing of a Holiday Inn® hotel in Kansas City. The financing carried the typical "bad-boy" carve-outs which allow the lender recourse against the borrower for certain acts or omissions, including the concept of "waste" of the collateral. The mortgage documents were silent as to what the waste concept was intended to cover. The conventional interpretation involves intentional or grossly negligent destruction, loss or removal of tangible assets. In this case, the owner was faced with a product improvement plan (PIP) of $1.8 million from its franchisor to renew its Holiday Inn franchise, and elected instead to allow its Holiday Inn franchise to expire. The owner chose to rebrand as a Clarion® Hotel, which required a PIP of about $370,000. However, the owner informed the lender that the Holiday Inn franchise was not offered for renewal, citing a letter from the franchisor stating that the franchisor's intent was not to renew the franchise. The testimony of the franchisor revealed that the letter was sent to comply with the Missouri Franchise Relationship Law (MO. Rev. Stat. § 407.405) which requires 90 days' prior notice of non-renewal. The owner tapped the FFE Reserve for the costs of the Clarion PIP.

The hotel suffered a business decline after the rebranding. Rate and occupancy dropped, and the owner eventually was unable to meet debt service. The lender foreclosed on the hotel and sought damages for its loss of value, which an appraiser pegged at $3.85 million. The appellate court dismissed the lender's theory of waste because that concept is predicated on the impact of borrower actions on existing, not future, assets. The loan documents required the borrower to maintain the existing franchise but were silent on the issue of renewal. The original franchise ran until its intended expiration and was not renewed. *Interestingly, the court leaves open the important question of whether the borrower would be subject to full recourse under the waste carve-out in the mortgage if it causes asset value loss by failing to maintain the specified franchise.*

The lender's theory of fraud and material misrepresentation as a cause of its value loss in the hotel was also rejected by the appellate and trial courts. There was no testimony to the effect that, even if the borrower paid for the PIP, there was no certainty that Holiday Inn franchise would have been renewed. But, the appellate court found that the FFE Reserve disbursement to pay the Clarion PIP was obtained by material misrepresentation, so the owner was obligated to repay the withdrawn $370,000. The finding of owner liability also shifted the attorneys' fees burden, so the owner also became liable to pay the lender's legal fees, to the tune of over $450,000.

While the owner escaped liability for millions in value losses, the case demonstrates the importance of specific undertakings by lenders and borrowers about hotel franchises that form part of the collateral for the loan. If a loan spans the expiration of the existing franchise, what are the franchisee's obligations to make good faith efforts to renew? Is the lender's FFE Reserve balance available for performing a renewal or conversion PIP? The opinion leaves to another case the question of whether an owner's discretionary decisions that cause loss of a valuable brand franchise give the lender personal recourse against the owner for lost value of the hotel assets under the "waste" concept. The hindsight calculus is curious – instead of paying $1.8 million and the renewal fee on the original franchise, the owner rebranded, paid a franchise fee to the second franchisor, lost its equity in a $6 million property to foreclosure, and paid over $800,000 to the lender on a supposedly non-recourse loan. Under most franchise agreements, the owner would owe the second franchisor liquidated damages, too. Ouch!