

Bankruptcy: Offensive Weapon or Bad Faith Filing?

Even though occupancies, ADR and RevPAR are declining or stagnant in the hotel industry, we don't hear much about bankruptcy filings. That's probably because, many years ago, lenders required more equity in hotel deals.

Still, in the aftermath of Sept. 11, 2001, and with an overbuilt industry and a soft economy, many hoteliers are probably contemplating filing for bankruptcy to avoid foreclosure and to renegotiate management deals or mortgages.

Such a filing is a way to save one's financial estate from the crush of too much debt. It also is a legitimate method to avoid foreclosure and restructure debt or management pacts. Unfortunately, some debtors distort the Bankruptcy Code and use bankruptcy to avoid obligations that do not directly benefit their estates.

For instance, a Federal district court affirmed a decision dismissing a chapter 11 case in which a solvent debtor/upscale hotel owner sought to avoid an unrecorded operating lease/management contract without demonstrating benefit to the bankruptcy estate.

The purpose of the filing was to stave off foreclosure of a hotel on which the debtor/owner had failed to make a balloon payment on a promissory note held by an over-secured mortgage lender. The debtor/owner alleged that due to unfavorable terms of an unrecorded operating lease/management contract with

the debtor/owner's motion to avoid the contract by noting that avoiding it would only benefit the debtor and its equity holders, not the debtor's bankruptcy estate.

Also, the lessee/operator of this allegedly burdensome operating lease/management contract sought dismissal of the case, showing it did not want its lease/management contract terminated. The court granted that motion, ruling that the petition had been filed in bad faith for the sole purpose of resolving a contractual dispute between the debtor/owner and lessee/hotel operator. Otherwise, there would have been no reason to file the bankruptcy.

Despite the debtor/owner's appeal of the ruling to the district court, that court affirmed the bankruptcy court for the same reason, saying a solvent debtor should not be permitted to avoid a transfer of property to the detriment of its sole remaining creditor for purposes unrelated to the debtor's bankruptcy reorganization.

As a hotel operator, you will want to check and double-check that the commercial lease/management contract is properly recorded; failing to do so could result in termination of the contract. And even if it is recorded, a solvent debtor will have a difficult time avoiding the lease/management contract, especially if it is the only party

that would otherwise stand to gain from such avoidance. More importantly, the courts will follow the literal terms of Section 544 of the Bankruptcy Code when an insolvent debtor seeks to avoid an unrecorded lease/management contract. Finally, upon discovery of an unrecorded lease,



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the operator, it was unable to refinance the loan or sell the hotel. The debtor/owner was solvent, however, and had no creditors other than the lender and the operator/lessee.

During proceedings, equity holders of the debtor bought the mortgage lender's claim. The debtor/owner argued that because the operator/lessee had failed to file its interest in the operating contract in the appropriate jurisdiction, the debtor/owner was entitled to avoid the contract. The Bankruptcy Court acknowledged that generally, an unrecorded operating lease/management contract was avoidable under Section 544. Nevertheless, the court de-

termined the lessee/operator should immediately file it, even though other issues requiring avoidance may arise under Sections 547 and 548 of the Bankruptcy Code.

Depending on whether the party is the lessee/operator or lessor/owner, bankruptcy can be used as an offensive tool when disputes arise and parties are unable to resolve their differences.

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