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Lessons from the Marketplace:

Evolution of Developer Financing in Fee-Based Service Arrangements

BY MARK I. SANDERS AND J. MATTHEW FLOWER

As many throughout the industry know, developers' ability to finance consumer notes was heavily impacted by the global economic downturn. This environmental change then challenged the survivors to create innovative, new strategies that adapted to this new marketplace.

One such strategy that has been successfully implemented by some national and international developers is the offering of their services to smaller, regional or single-site timeshare developers in "fee-based-service" or "fee-for-service" arrangements. In these type of arrangements, larger national and international timeshare developers ("FBS Providers") provide sales and marketing services, management services, and loan origination and servicing to smaller, regional, or single-site timeshare developers ("FBS Developers") —in exchange for the payment of fees.

The fee-based-service arrangement offers advantages for both FBS Providers and FBS Developers. FBS Providers are able to generate fee-based income without incurring the traditional costs and risks of acquiring and developing real estate; FBS Developers are able to leverage the size, infrastructure, and experience of the FBS Providers. In many of these arrangements, the resort being developed by the FBS Developer will also be sold as a part of a vacation club or plan of the FBS Provider, significantly increasing the marketability of the FBS Developer's timeshare interests. In addition, having an FBS Provider in a deal can give comfort to a lender who is financing the development of an FBS Developer's resort. In many instances, a lender may only be willing to finance certain projects if that Provider is involved.

Who's Playing

There are usually multiple parties to whom an FBS Developer will owe significant payment obligations in a fee-based-service arrangement. Generally, these parties are all vying for a finite amount of collateral to secure such obligations.

Fee-based-service arrangements can easily become complicated and expensive if there is a lack of awareness of the respective parties' collateral expectations until the late stages of negotiation and documentation. Two simple ways to avoid these issues are by (1) including all parties in early stage negotiations; and (2) considering the benefits of the fee-based-service arrangement (versus more traditional timeshare development).

While fee-based-service arrangements come in a variety of different shapes and sizes, such arrangements generally include the following:

- The acquisition by the FBS Developer of inventory (whether by construction of a new resort or the purchase of all or part of an existing resort);
- The creation by the FBS Developer of a timeshare regime within the resort;
- The inclusion of the resort within the FBS Provider's vacation club or plan;
- The management of the resort by the FBS Provider;
- The sales and marketing of the timeshare interests within the resort by the FBS Provider; and
- The loan underwriting and origination by the FBS Provider, with respect to the FBS Developer's seller-financed timeshare consumer notes.

There are also a number of parties involved in a fee-based-service arrangement beyond just the FBS Developer and the FBS Provider. In most cases, as in traditional resort development financing, there will be financing to the FBS Developer to provide funding for the acquisition or construction of the resort—as well as receivables financing, so the FBS Developer may monetize its seller-financed timeshare consumer notes originated from sales of timeshare interests at the resort. The acquisition/construction loan and the receivables loan may be provided by the same lender or by different lenders. In connection with the receivables loan, there is also typically a custodian that holds the collateral files related to the pledged timeshare loans, a loan servicer (which may or may not be the FBS Provider), a back-up loan servicer that will step in immediately upon a default by the loan servicer, and one or more banks that provide lockbox account services for the remittance of payments on the timeshare loans.

Rules of the Game

During the life of a fee-based-service arrangement, an FBS Developer will owe payment obligations to all of these third parties. It is the cash from the payments on the FBS Developer's timeshare loans that is used to pay these obligations. With respect to each—the FBS Provider, the acquisition/construction loan lender, and the receivables loan lender—the payment obligations will be significant, and these parties will likely want collateral to secure the payment of the obligations owed to them.

In a traditional resort development financing arrangement, a single-site developer gives the acquisition/construction loan lender a blanket mortgage, encumbering all of the real property purchased with the acquisition/construction loan. The acquisition/construction loan lender also typically requires a security interest in all of the other assets of the developer, including any proceeds from sales of timeshare interests, rights under the management agreement and other contracts, and any developer rights under the timeshare program and owner association governing documents. In addition, the acquisition/construction lender may also receive a guaranty from the owners of the developer entity—in which these owners promise to pay the obligations of the developer under the acquisition/construction loan in the event of a default by the developer.

In addition, when a receivables loan is made to a developer, the receivables loan lender is customarily given a security interest in all of the timeshare loans against which it would make advances and is also given certain other collateral, which may include reserve accounts, assignments of rights under developer contracts, and guaranties made by the owners of the developer entity. Between the acquisition/construction loan lender and the receivables loan lender, the universe of available developer collateral is typically accounted for under traditional resort development financing arrangements.

Many lenders initially approach these deals thinking in terms of more traditional

> **This type of model has ushered in a new resort finance paradigm...**

resort development financing and want the same type of "all asset" collateral that they have traditionally received. The problem with this approach is that it generally leaves no collateral by which an FBS Provider may secure the substantial payment obligations owed to it from the FBS Developer. If fee-based-service arrangements are not structured properly, the FBS Provider can incur significant payment risk for the "turn-key" services being provided to an FBS Developer. Accordingly, an FBS Provider will want some security to ensure that the FBS Developer's payment obligations will be paid—especially given that such turn-key services are the lifeblood of the fee-based-service arrangement and, ultimately, the engine that drives the repayment of acquisition/construction loans and receivables loans.

Lenders, however, are sometimes caught off-guard when an FBS Provider requests collateral to secure an FBS Developer's payment obligations, since they view this Provider as just another unsecured service provider to the developer without the need for security. In many fee-based-service arrangements, the lender may not become aware that the FBS Provider expects to receive collateral until well into the documentation process, sometimes even after the lender's credit committee has approved the loan transaction. The results can be costly. Both time and money are lost if negotiations stall between lenders and FBS Providers or if a lender has to seek further credit committee approval for a revised loan collateral structure.

How to Win

Fortunately, such circumstances may be mitigated with some planning and consideration of the advantages to all parties of these service arrangements.

FBS Providers and FBS Developers should ensure that these providers are involved in the early stages of all financing discussions and negotiations. The best practice is to have all financing-related letters of intent, commitments, or similar proposals include as detailed of a description as possible of the collateral that will be available for each party (including the FBS Provider). It is also important at the outset to have a clear understanding of respective collateral positions and expectations among the applicable lenders, FBS Developer, and FBS Provider.

In addition, if you keep the benefits of the fee-based-service transaction in mind while negotiating relative collateral positions, each party will be able to recognize the value of compromise when it comes to sharing a finite amount of collateral. In fee-based-service financing arrangements, lenders typically get the benefits of traditional resort development financing of a smaller, single-site, or regional developer (i.e., individual guaranties and more lender-friendly covenants) *and* the benefits of traditional resort development financing of a larger developer (i.e., the experience, infrastructure, brand recognition, dependability, and financial resources of a national or international developer).

Also, some early fee-based-service arrangements have involved the acquisition of distressed properties at much more favorable purchase prices when compared to the resort project acquisition process. This has resulted in acquisition lender over-collateralization—to a greater extent than in traditional resort development financing arrangements—creating i.e., the potential for the acquisition loan to be paid down at a faster pace relative to a project's sales cycle. In addition, fee-based-service arrangements give FBS Providers the potential to generate significant fee income without the attendant risks typically associated with real estate acquisition, while also lessening their need to find independent sources of liquidity. Finally, FBS Developers have the benefit of leveraging an FBS Provider's experience and infrastructure—thereby viewed in the eyes of the lender as part of the FBS Provider's system in many respects, which results in financing to the FBS Developer that it otherwise might not receive.

Early stage collateral discussions among the participants in fee-based-service financing arrangements, coupled with a practical recognition by participants of their inherent advantages, should serve to streamline the negotiation and documentation of these kinds of transactions. With a greater efficiency in the negotiation and documentation process, the costs to all participants (particularly for FBS Developers and FBS Providers) should diminish and offer a viable business model. And this type of model has ushered in a new resort finance paradigm that should continue to be embraced by lenders, FBS Developers, and FBS Providers well into the future. ■

Mark I. Sanders is a partner and J. Matthew Flower is a senior associate in Taylor English's Corporate & Business; Resort, Hotel & Hospitality; and Real Estate, Lending & Finance practice groups. Their respective e-mails are ***msanders@taylorenglish.com*** *and* ***mflower@taylorenglish.com****.*