CADWALADER

Empty Rooms — COVID-19's Impact on the Hospitality Industry

April 27, 2020 | Issue No. 11

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The ongoing COVID-19 pandemic has had an unprecedented impact on all sectors of the U.S. economy in a remarkably short period of time, but one of the largest and earliest impacts has been on the hospitality industry. According to STR, in February, the month immediately prior to the impact of COVID-19-related restrictions, average hotel occupancy was 62.2%, a year-over-year increase of 0.2%, average daily rates were up 1.4% from the prior year and revenue per available room (or, RevPAR), was up by 1.7%. Travel restrictions, shelter-in-place orders, closure of non-essential business and other restrictions on gatherings and social distancing guidelines instituted through the month of March have brought hotel occupancy and revenues to a halt, causing an almost immediate and material economic decline. In the first two weeks of March alone, RevPAR dropped nationally by 32.5%, with declines in excess of 50% in markets in New York and California. In addition, occupancy was down by 24.4% nationally and over close to 50% in the New York and California markets. As of April 8, according to STR, 8 out of 10 hotel rooms across the United States are empty. As a result, hotel owners and operators are facing cash flow issues, employment-related concerns and, in many cases, difficulty with respect to their loan obligations.

To Close or Not to Close, That Is the Question

Given the steep decline in occupancy and demand for hotel services, many hotel owners and operators are faced with the difficult decision of whether to remain in operation during the ongoing pandemic. In most jurisdictions, a hotel is considered an essential business and is therefore not subject to mandatory closure, but instead are faced with an economic decision and, in many cases a contractual one, as to whether it is advisable to remain open. Hotel owners must consider their franchise and management contracts, ground leases, loan documents, employment contracts and any long-term booking contracts before making the difficult decision to close their doors. A closure for an extended period of time may result in a default under any of these contracts.

Most loan documents will contain an operating covenant that requires the property to continue operating as a hotel or in the same manner as it was operating at the time the loan was made. Failure to do so will trigger an event of default under the loan. Therefore, prior to any shutdown of the hotel, hotel owners will need to seek a temporary waiver of this covenant from their lenders. Similarly, franchise agreements will typically require the hotel owner to continue to operate the hotel other than in limited circumstances such as a casualty. Any shutdown of the hotel will likely require a furlough or other change in employment status for employees at the property. State law, employment contracts, collective bargaining agreements and statutes such as the WARN Act and ERISA will be implicated in any such shutdown and may result in substantial cost to the hotel owner. Additionally, many hotels have hospitality and liquor licenses and, in some cases, casino licenses, which may be invalidated by an extended closure or a change in use.

Another alternative for hotel owners in certain jurisdictions may be a temporary use of the hotel as housing for medical professionals, or in some instances, hotels as temporary medical facilities. In addition to restrictions on a hotel closure pursuant to the aforementioned underlying contracts, loan documents will have restrictions on alternative uses and should be consulted. Additionally, the contract with the agencies that may be looking to use the property for an alternative use will need to be reviewed carefully with respect to responsibilities for restoring the property at the end of the alternative use, as well as for indemnities for any losses incurred by the owner as a result of damages, injuries or other issues at the property during the time of use. Lenders should be third-party beneficiaries of such agreements and receive the benefit of such indemnities as well. Lastly, the property insurance policies with respect to the property should be reviewed to confirm that the alternative use does not invalidate existing coverage and that any additional coverage that may be needed is provided as a condition to the contract specifying the alternative use.

Loan documents, franchise agreements and other contracts may provide relief from operating covenants or use requirements in the event of force majeure. These clauses may or may not be drafted narrowly enough to cover a pandemic and this will almost certainly be a fact-specific issue in each situation that will need to be considered and reviewed.

Navigating Loan Documents – Negotiating a Forbearance or Modification

As the COVID-19 pandemic continues across the country and the world and keeps many in their homes, commercial real estate loans secured by hospitality properties are particularly susceptible to stress and a need for forbearance or restructuring. In order to protect all parties, the borrower, lender and guarantor should enter into a pre-negotiation letter prior to engaging in forbearance and similar discussions. This will allow the parties to explore potential solutions in a non-binding manner. While every loan, property and situation are different, there are several common requests facing borrowers and lenders with respect to loans on hospitality properties that were operating prior to the COVID-19 pandemic in order to address cash flow concerns.

The first request from many borrowers is short-term deferral of monthly interest payments. Of note, this is not typically granted in the form of a waiver of the payment of debt service, but a deferral of the payment to a later date. Another common request is a waiver or short-term deferral of deposits into the FF&E reserve, particularly if the hotel is not open and the ability to use existing FF&E reserves for other purposes such as operating expenses and payment of debt service (if not otherwise waived). In considering this request, lenders should make sure that the brand or flag has also agreed to waive such deposits and that the franchise agreement either permits the redirection of such funds or the brand has agreed to such clause as well. As noted above, a request for a temporary waiver of the operating covenants and/or a change to an alternative use is also a typical part of a forbearance request. To the extent that the property is subject to a ground lease, the borrower may also be seeking a modification or deferral of ground rent under their ground lease. A modification of the ground lease will also typically require the consent of the lender.

A careful review of the non-recourse carve outs and events that may trigger the non-recourse carve outs is also prudent for both the borrower and lender. To the extent that the property has substantial commercial tenants, such as in a resort property or one where there is a large ground floor retail component in an urban setting, the property owner may be negotiating rent modifications with their commercial tenants as well. Agreeing to a reduction in such rents, particularly for a major tenant, may conflict with the transfer provisions in the loan documents and trigger a recourse carve out, resulting in liability to the guarantor. Consequently, both parties should ensure that the lenders are a party to and consent to any material lease modifications. Borrowers who are looking to avail themselves of short-term financing through the Small Business Administration Payroll Protection Program (the “PPP”) will also need the consent of the lenders in order to avoid violating restrictions on permitted indebtedness that would trigger recourse liability. While there are other considerations related to the PPP and hotel owners, any application must be submitted with the consent of the lenders.

What Is Next?

By most industry accounts, the next few months look to be challenging for the hotel industry. As hotels struggle with occupancy and employment issues, many are likely to have difficulty making debt service payments and to seek relief from lenders and servicers on their loans. Borrowers, lenders and servicers will need to continue to work on solutions to the unique challenges facing the hospitality industry as a result of the COVID-19 pandemic. With preparation and thoughtful solutions to complicated problems, as the spread of the pandemic slows and travel restrictions begin to lift, a previously thriving hotel industry and its lenders will be able to come out of the other side of this ready to face a population very much in need of travel again.