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What Now?

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

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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.

COVID-19 Update: Banking Agencies Issue Temporary Deferral of Appraisals and Evaluations for Real Estate Transactions

April 27, 2020 | Issue No. 11

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On April 14, 2020, the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation issued an interim final rule to temporarily defer real estate appraisals and evaluations under interagency appraisal rules.[1] The interim final rule provides a 120-day deferral of appraisal and evaluation requirements for all transactions secured by commercial or residential real estate during the COVID-19 pandemic (which for purposes of the interim final rule extends to December 31, 2020, unless extended by the federal banking agencies), other than transactions for acquisition, development, and construction of real estate. It does not revise any of the existing appraisal exceptions or any other requirements with respect to the performance of evaluations. Under the interim final rule, regulated institutions may close a real estate loan without a contemporaneous appraisal or evaluation, subject to the requirement that they obtain appraisals or evaluations within a grace period of 120 days after the closing of the transaction. Notwithstanding the interim final rule, the federal banking agencies expect institutions to use best efforts and available information to develop a credible, well-informed estimate of the collateral value of the subject property before the loan closing, and otherwise underwrite loans consistent with the principles contained in interagency standards. The deferral will expire on December 31, 2020, unless extended by the federal banking agencies.

In conjunction with the interim final rule, the federal banking agencies, together with the National Credit Union Administration and the Consumer Financial Protection Bureau, issued an interagency statement that outlines existing flexibilities in industry appraisal standards and federal appraisal regulations.[2] It also summarizes temporary changes to Fannie Mae and Freddie Mac appraisal standards that can assist lenders in light of the COVID-19 pandemic.

COVID-19 Update: Temporary Ban on Eviction of Commercial Leases

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The *Coronavirus Act 2020*, which received Royal Assent on 25 March 2020, has introduced a temporary ban on eviction of commercial property tenants with respect to non-payment. The legislation was announced on 23 March and passed through parliament in two days, as part of the rollout of numerous emergency measures to address immediate economic effects resulting from this pandemic. The mandate is simple and serves to be temporary and overarching as an emergency measure and, for this same reason, it doesn't provide much detail nor address the surrounding issues and consequences.

The legislation

Section 82 of the *Coronavirus Act 2020* simply provides that:

'A right of re-entry or forfeiture, under a relevant business tenancy, for non-payment of rent, may not be enforced, by action or otherwise, during the relevant period.'

Breaking it down:

- relevant business tenancy refers to all business tenancies within Part 2 of the Landlord and Tenant Act 1954, which effectively covers most tenancies, including headleases. There are exceptions, which include licence to occupy, tenancy at will, tenancies not exceeding 6 months and certain farm business tenancies;
- relevant period is 26 March 2020 to 30 June 2020, which may be extended;
- the right of re-entry/forfeiture ban only applies to non-payment default. There are no restrictions on landlords exercising right of forfeiture for other types of default, although we query how practical this will be in the current circumstances;
- "rent" is defined as "any sum a tenant is liable to pay under a relevant business tenancy" so any non-payment of any other amounts such as tenant contributions, service charges, etc. will be subject to the same rule (*i.e.*, no eviction if any of these amounts are unpaid); and
- note that there is no requirement for justification for the non-payment – that is, whether the tenant remains financially able to pay the rent is not relevant. Landlords simply cannot forfeit the lease for this default during this period.

Implications

The legislation simply provides that any action of forfeiture may not occur during the period up to 30 June 2020 (this date may be revised) if the grounds for forfeiture is due to non-payment under the terms of the relevant lease. It is silent with respect to the rights of the tenant and the landlord post this period.

Non-payment of rent by tenants will still constitute a breach of the lease, and although landlords are unable to forfeit a lease during this period, it does not mean that the landlord cannot take other actions with respect to a payment default. For example, landlords will continue to be able to exercise other rights available to it under the relevant lease, such as drawing down on the rent deposit (to the extent this is available), serving a statutory demand on the tenant which, upon the 21-day expiry, will provide grounds for winding up petition, or enforcing any rental guarantees, as applicable.

The tenant's liability to pay rent remains. The legislation also provides in section 82(2) that: *"During the relevant period, no conduct by or on behalf of a landlord, other than giving an express waiver in writing, is to be regarded as waiving a right of re-entry or forfeiture, under a relevant business tenancy, for non-payment of rent."* Therefore, unless the landlord has waived its forfeiture rights in writing, once the relevant period expires, the landlord may forfeit the lease straight away (subject to complying with any applicable notice provisions in the lease) unless this breach is cured.

In practice, a tenant who is struggling financially to meet the rent may not simply stop paying rent and ride out the non-forfeiture period, as this is simply a temporary measure and the ban on forfeiture will lift eventually and the fact that other remedies remain at the landlord's disposal. Furthermore, non-payment breach (even not enforced in this period) will give rise to additional rights/liabilities depending on the terms of the lease (for example, any interest) and so it will be prudent to regularise any variation/agreement with respect to rent rather than simply stop paying. However, with this legislation in place, it places a ceiling as to the enforcement actions landlords may take. What this is likely to result in is tenants approaching landlords to negotiate rent reductions or other variations to the lease during the duration of the lock-down period. For landlords, it is important to make sure that any variation or suspension of rights/liabilities are documented properly. In addition, where properties are leveraged and subject to financial covenants, suffice to say reduced rental collections will have an impact on compliance with financial covenants or potentially debt service, which may affect compliance with the debt facility.

COVID-19 Update: Revisiting Pre-Negotiation Agreements in the Era of COVID-19

April 27, 2020 | Issue No. 11

By **Michael S. Anglin**
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While the ramifications of the COVID-19 pandemic for real estate lenders and borrowers will unfold over time, at this point we know that lenders and borrowers will be communicating frequently and extensively regarding potential loan modifications and other accommodations. Lenders are well advised to insist on a pre-negotiation agreement, often referred to as a "PNA," as a prerequisite to these communications.

A PNA is an agreement between a borrower and a lender intended to permit the lender to communicate with the borrower regarding a possible loan modification, waiver or other accommodations without prejudicing the lender's ability to enforce the loan documents. The primary purpose of the agreement is to preserve the status quo over the course of negotiations and to prevent the borrower from using the negotiations as a basis for opposing any pending or potential enforcement efforts by the lender, or as a basis for bringing lender liability claims against the lender, by asserting that over the course of negotiations the lender committed to modify the loan documents, that correspondence exchanged during the negotiations itself constituted a loan modification, that the borrower justifiably relied on statements of the lender in forgoing refinancing opportunities and in incurring transaction costs, etc. Even if a borrower is ultimately unable to prevail on these claims, their potential use in opposing a lender's motion for summary judgment and thereby prolonging an enforcement proceeding and increasing the borrower's leverage should be of concern to the lender. The lender will typically require parties that entered into guaranties with respect to the loan to join in the PNA in order to prevent the guarantors from making similar claims, and to prevent the guarantors from asserting that the PNA itself precluded certain defenses and thereby increased the guarantors' risk and raising so-called "surety defenses" on that basis.

It is advisable to enter into a PNA as soon as the lender anticipates negotiations with the borrower. In normal times, this would mean when a default occurs, when the borrower approaches the lender with a request to discuss a modification or waiver, or when a default is reasonably anticipated (*e.g.*, when the lender has reason to believe that the borrower will be unable to refinance or satisfy the conditions to the exercise of an extension option on an approaching maturity date or to satisfy any other requirements under the loan documents, such as making a scheduled amortization payment or continuing to pay monthly debt service). Under current circumstances, the universe of loans for which these events can be anticipated has dramatically expanded.

From the lender's perspective, a PNA should at a minimum include those provisions necessary to preserve the status quo during the course of negotiations. These typically include agreements to the effect that (i) negotiations, which should be defined broadly to include all discussions, meetings, conferences, correspondence, e-mails, exchange of term sheets and draft documents and all other communications, are non-binding unless and until a binding written agreement has been executed and delivered, (ii) either party has the right to, at any time, terminate discussions in its sole discretion, for any or no reason, (iii) the borrower has no right to rely on the negotiations resulting in a settlement and should not forgo refinancing opportunities, and (iv) the PNA does not constitute an agreement on the lender's part to forbear from exercising its rights and remedies under the loan documents during the course of the negotiations. While an agreement to forbear is sometimes entered into in connection with workout discussions, that is usually documented under a separate forbearance agreement that is negotiated and entered into subsequent to the PNA. A forbearance is often more complicated than a PNA and involves more negotiation. Entering into a PNA prior to the negotiation of a forbearance agreement gives those negotiations the protection of the PNA and permits concurrent discussion of both forbearance and ultimate settlement terms. To reiterate, a PNA simply preserves the status quo as to discussions between the borrower and lender and provides that the discussions themselves are not binding. A PNA is *not* a forbearance, and the lender retains the right to commence, continue, discontinue, pursue or otherwise exercise its remedies notwithstanding the existence of the PNA. Typically, however, a lender would not be aggressively pursuing its remedies when a PNA has been entered into.

In a syndicated loan, the PNA is entered into by the administrative agent and covers any discussions between the borrower and the administrative agent, as well as any discussions between the borrower and other lenders in the syndicate. While the co-lenders are named and all provisions are also for their benefit and protection, the co-lenders, however, will usually not be signatories to a PNA and will rely on the ability of the administrative agent to protect their interests. In addition, to preserve the unity of the lending group, a PNA covering a syndicated loan will typically provide that the borrower may discuss the loan only with the administrative agent. Where a property is financed by both mortgage and mezzanine loans, the mortgage lender and the mezzanine lender should each enter into a separate PNA with its respective borrower. The holder of any preferred equity should also consider entering into a PNA in order to protect its interests over the course of workout discussions.

The lender will typically want the PNA to cover past as well as future discussions. While technically this goes beyond preserving the status quo as of the date that the PNA is entered into, a lender might find it unacceptable for a borrower to preserve its right to make claims on the basis of an initial conversation that it had with the borrower before the PNA was prepared and entered into. It is advisable for lenders to make every effort to defer these conversations until the PNA is entered into. Beyond the sanitizing of such past discussions, PNAs will sometimes include some or all of the following, which are advantageous to the lender: (i) a ratification of the existing loan documents, (ii) a statement of the outstanding amount of the debt, (iii) an acknowledgement that the lender has performed all of its obligations under the loan documents, (iv) where the loan is in default, an acknowledgement of the default and a waiver of defenses, (v) a release of claims against the lender, and (vi) an agreement that authorizes the lender to discuss the loan and the property with other parties providing debt and equity financing to the property and other creditors. Inclusion of the above can be helpful to the lender both in pursuing an enforcement proceeding and in protecting itself from lender liability claims. Whether and the extent to which the above are included are typically determined by negotiations between the lender and borrower, and their inclusion or exclusion ultimately depends upon the particular circumstances and the relationship and relative bargaining power.

PNAs are widely required by real estate lenders as a matter of policy, and borrowers have come to understand and accept that they are necessary for lenders to obtain in order to discuss loan modifications and waivers and that there is no stigma attached to them. While the circumstances brought about by the pandemic are extremely unfortunate, and while neither borrowers nor lenders are responsible for the economic hardships that it is inflicting, PNAs are both appropriate and necessary to facilitate the discussions that will be required to mitigate the pandemic’s consequences.

A Closer Look at REMICs at the Time of COVID-19

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Our Tax Group colleagues recently wrote an exceptional article, titled "Securitization Guidance on Coronavirus-Related Forbearances." It examines the Internal Revenue Service's helpful revenue procedure that permits loans that are subject to certain forbearances and related modifications as a result of the COVID-19 pandemic to be contributed to, and held in, real estate mortgage investment conduits (REMICs) and grantor trusts without jeopardizing these vehicles' U.S. tax status. You can access it **here** in our *BrassTax* newsletter. Also take a look at our Tax Group's **REMIC flow chart** and **article**, "Unrecorded Mortgages Pose Unique Issues for REMICs."

Hey, Ground Lessor, I've Got a Mortgage: The Significance of Proper Notice

April 27, 2020 | Issue No. 11

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The primary concern for the holder of any mortgage is ensuring the priority and perfection of its lien. When the collateral is a ground leasehold mortgage, this concern is significantly heightened. A ground lease is a lease of the land, generally for an extended term (we often see terms extending up to 99 years). The tenant under a ground lease can usually mortgage its leasehold interest in the land pursuant to an express right contained in the ground lease. The ground lease will, however, almost always require notice to the landlord and, in some cases, specific provisions which are required to be included in the mortgage. For a ground lease to be financeable, it must contain detailed protections in favor of the mortgagee or lender such as notice and cure rights which require the landlord under the ground lease to notify the lender of any default and give the lender a period of time to cure such default. There are numerous other protections required for the lease to be financeable, but of paramount importance is that the financing be permitted. In many cases, a pre-condition to such financing being permitted is that a notice be given to the landlord. In addition, a landlord obviously cannot give notices to a mortgagee it is unaware of, and a mortgagee's cure rights in the event of a tenant default are only meaningful if such mortgagee receives notice of same. As mentioned, ground leases often provide that a mortgage on the tenant's leasehold interest will not be recognized at all by the landlord unless and until the landlord receives notice of such mortgagee or lender. Other protections contingent on notice include preventing the landlord from terminating or materially amending a ground lease without first notifying the recognized mortgagee.

In general, the law is pretty strict with respect to notices. If a document specifies the manner, language, timing and/or method of delivery, then to be effective, such notice must strictly comply. There is case law which holds, in certain cases, that if a party received a notice but it did not strictly comply with notice provisions, such notice is still effective. These cases are not in the majority and many times are very fact-dependent. Consequently, in practice, no one would intentionally take the chance of disregarding specific notice requirements. The general rule of thumb is that a notice will not be effective unless and until provided in strict accordance with the notice provisions of the ground lease. If the ground lease requires that a duplicate original of the mortgage be delivered to the landlord, an executed original must be sent to the landlord, in addition to the original being recorded. If such mortgage must be received by the landlord within ten days after its execution, the mortgage should be sent immediately after the closing of the loan to ensure that it is received within the stated timeframe. Ground leases often require notice by personal delivery or delivery by a reputable, national overnight delivery service. While today's most common and efficient way to send a notice may be via FedEx, if FedEx delivery was not contemplated pursuant to the terms of a ground lease executed decades ago, notice is not effective if sent that way. It is also prudent to review all related lease documents, including estoppels, to ensure that notices are being sent to the correct address. If a party's address has changed over time, but such change in address has not been reflected in either an amendment to the ground lease or changed in strict compliance with the notice provisions of the ground lease (*e.g.*, a notice provision may simply require that a notice be given in the manner required by the notice provision to change one's address for purposes of future notices), notice should be sent to all addresses, even if the sender knows that the original notice address is no longer valid. If its notice provision provides that a notice is not effective until delivery, and notice is sent to the wrong address, the notice will not be effective.

It's imperative as part of the closing of the loan to send notice of the mortgage to the landlord as may be required pursuant to the terms of the ground lease. While most people generally don't give much thought to notices, ensuring notice is delivered timely, in the correct fashion, and to the correct address is necessary in order for the lender to receive any mortgagee protections it may be entitled to pursuant to the ground lease. Further, effective notice is especially important with respect to time periods that start running based on receipt. Consider, for example, if the documents provide that the lender cannot foreclose on the leasehold estate without first giving the landlord the opportunity to cure the tenant's default, and that the landlord has thirty days after receipt of notice of such default to exercise its right to cure. If notice is not properly given to the landlord, this thirty-day time period cannot begin to run, and the lender ultimately cannot foreclose. The law with respect to notice provisions can be draconian, and complying with notice provisions is a simple, vital, and requisite way to protect a lender's interest in a leasehold estate.