Responding to a Cash Flow Crisis for a Hospitality Business to Survive the COVID-19 Crisis

Part II: Minimizing Cash Outflow

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"Cash flow is the lifeblood of a business." The COVID-19 crisis has been a brutal reminder to the hospitality industry of this maxim. This is the second of a pair of articles discussing a two-part strategy for improving a hospitality business' cash flow to survive this crisis. The first article explores the first part: **replacing lost cash inflow**. This article explores the second: **minimizing cash outflow**.

When I was a high school freshman I took a first aid class in which the we were taught four basic lifesaving steps. [1] Two of these were aimed at minimizing loss of blood: stop the bleeding, and dress and bandage all wounds. The first of these steps had to be completed before the second. I am reminded of these steps in considering how a distressed hospitality business should minimize its cash outflow.

Stop The Bleeding: Cut all Unnecessary Expenditures

The first step in this strategy must be to stop all unnecessary expenditures. Sadly, for many hospitality businesses, the largest of these is payroll. By design, the Paycheck Protection Program under the Coronavirus Aid, Relief, and Economic Security Act of 2020 (the "CARES Act") should make it easier for most hospitality businesses to keep some essential employees for a period of eight weeks. However, as of this writing it has been nearly ten weeks since the President declared COVID-19 a national emergency and, especially for the hospitality industry, it will be many more weeks before the crisis is over. Thousands of hospitality workers have already been furloughed and laid off. Others fortunate enough to keep their jobs are facing pay cuts. If your hospitality

[1] The four steps, in order, were (1) open the airway and restore breathing, (2) stop the bleeding, (3) treat for shock and (4) dress and bandage all wounds.

business intends to lay off or furlough workers or implement pay cuts, I urge you to consult with an employment attorney before doing so.

Other expenditures that may be reduced involve contracts with suppliers and service providers. All of these should be reviewed, starting with contracts for non-essential goods and services. If any non-essential contracts can be terminated without liability, this should be done immediately.

Dress and Bandage all Wounds: Restructuring Debts and Obligations under Existing Contracts

After eliminating unnecessary expenses, a hospitality business will still have several contractual relationships that will be a continued source of cash outflow. The business should seek relief from each of these parties to reduce and/or postpone its financial obligations. For some of these parties, the possibility of the business closing and depriving them of future revenues will be enough to motivate concessions. Others will be in a position to demand concessions from the hospitality business in return.

The second lifeblood-saving step I mentioned above is to dress and bandage *all* wounds, and a distressed business should seek cashflow relief from all of its creditors and potential creditors. However, some wounds are bigger than others. A distressed business will need to strategize and prioritize before approaching these other parties. For each, factors to consider include the following:

- Has any owner of the business executed a personal guaranty in favor of this party?
- Is the business' debt to this party secured by real estate or any other assets owned by the business?
- Will defaulting under the business' contract with this party cause the business to cross-default under another contract (e.g. by breaching a representation and warranty in a loan agreement)?
- If the other party is a provider of goods or services, is continued receipt of these critical to the survival of the business?
- Does a default under the business' contract with a party trigger additional obligations (such as payment of a penalty or a default rate of interest), or give the other party remedies (such as a right to seize property)?

It is critical that a distressed business review all of its contracts with creditors and potential creditors to make these assessments and develop a strategy for approaching each.

For each category of creditors and potential creditors discussed below, a distressed hospitality business will have different opportunities to reduce its outflow of cash, and will likely be asked to make different concessions in exchange for that relief.

Secured Lenders

For many hospitality businesses, the sucking chest wound—its largest creditor with the most leverage—is a senior lender. This is usually a bank whose debt is secured by the businesses' most valuable assets, usually including any real estate, often including vehicles, equipment and other "hard assets" and sometimes including intangibles such as accounts receivable. The secured lender may or may not receive the largest monthly payments from the business. Either way, it likely has more bargaining power than most or all of the business' other creditors because it can foreclose on the business' most critical assets in the event of default. Nevertheless, a lender whose debt is secured, for example, by a blanket lien on all of the assets of a hotel will know that its collateral will have more value as a going concern than as a closed business. The COVID-19 crisis has suddenly forced thousands of hospitality business owners to default on their loans. To avoid foreclosure or liquidation, a business owner in this position will need to restructure this primary debt.

For the owner of a distressed hotel, restructuring debt secured by the real estate is likely to require a multi-step process. If the business has defaulted on any of its loan obligations by missing payments or otherwise, the first major step will be to negotiate a forbearance agreement with the lender holding the mortgage. This is a contract under which the lender agrees to forbear from exercising its right to foreclose on the hotel, and often suspend or reduce the requirement for future mortgage payments, for some period of time while the borrower's business stabilizes. The lender will do this in exchange for concessions from the borrower, in addition to an obligation to complete suspended mortgage payments later. In today's crisis, concessions for forbearance are likely to include some form of cash as additional security for the lender. The borrower may be required to maintain a debt service reserve account. If such an account was already required, its mandatory balance may be increased. The lender may require existing and/or new equity investors to make capital contributions to fill this account. Meanwhile, the hotel's operating account may have to become a lockbox account that is held and controlled by the lender, with conditions to withdrawals by the borrower. Some lenders have already required borrowers in forbearance to apply to the U.S. Small Business Administration for forgivable debt under the CARES Act. If the loan is a commercial mortgaged-back securities (CMBS) loan, the borrower will also be required to pay fees associated with the loan being in in "special servicing" following a default.

Before negotiating a forbearance agreement, many lenders require a borrower to sign a pre-negotiation letter ("PNL"). A PNL is usually limited to procedural requirements to accommodate negotiation of a forbearance agreement. In response to the volume of requests for forbearance during the COVID-19 crisis, some lenders are demanding that PNLs include substantive, cash-related requirements such as an expanded debt service reserve, which normally await the forbearance agreement.

The initial period under a forbearance agreement will be measured in months—not years. In the likely event that the borrower is still in default at the end of the forbearance period, it may be extended. After some period of time, if the market stabilizes, the lender may be willing to negotiate a restructured loan that rolls up the outstanding amounts due under the original loan and makes them payable over a new schedule. The term of this loan may be short, to allow the market to further stabilize before the lender considers a longer-term commitment. In addition to the concessions required by the forbearance agreement, the restructured loan may require additional forms of security, such as cross-collateralization of other properties owned by the borrower and its affiliates, or a guaranty executed by an upstream entity or individual. Throughout this process, the lender will require the borrower to develop and follow a legitimate business plan for recovery.

In the forbearance agreement, the lender may also be willing to provide cashflow relief by suspending or reducing any requirement under the loan for the borrower to maintain a capital reserve. This is a bank account into which a business is often required to deposit some percentage of its monthly revenue or profit to fund future capital improvement (e.g. replacing a leaky roof) or to fund operations in the event of a financial crisis. The lender may allow the borrower to shift deposits from this reserve to the debt service reserve to make it easier to satisfy that new or expanded requirement. The forbearance agreement will also need to waive "covenant defaults," such as failures of the borrower to maintain a minimum debt service coverage ratio during the forbearance period. Finally, if one or more owners of the borrower have already executed personal guarantees of the loan, they will want the forbearance agreement to extend to the guaranty.

Mezzanine Lenders

In an ordinary economy, mezzanine lenders would have less motivation to work with a distressed borrower to restructure debt. For these lenders, mezzanine debt is a "loan to own," and default an opportunity to seize ownership. As of this writing, because of COVID-19's unprecedented impact on hospitality industries, fewer mezzanine lenders have been eager to acquire ownership of hospitality businesses. This may change when the pandemic subsides. In the meantime, many mezzanine lenders have been cooperating with senior lenders to explore workout strategies for hospitality businesses in default.

Landlords

For owners of most restaurants and many other hospitality businesses that lease their places of business, landlords will be in position to offer significant relief. Commercial landlords should be willing to cooperate with their tenants to help them survive the COVID-19 crisis. If a tenant survives, it will again be a source of steady lease payments for years. If the tenant closes, the landlord will likely be left with an empty storefront that produces nothing except property tax liability. Even in ordinary times it can take a year or longer for a landlord to fill a vacant commercial space. A COVID-19-driven recession will only extend this.

If a business has defaulted on lease payments, remedies available to the landlord usually include termination, eviction and seizure of a security deposit. Additional remedies may include penalties, a default rate of interest and/or forfeit of any discount to rent the landlord had extended. The landlord may even have a right to enter the premises and seize and sell the business' personal property. For a business in default under its lease, the primary objective in negotiation with the landlord should be to obtain an agreement to forbear from exercising these remedies. Whether or not the tenant is in default, another objective should be to negotiate a temporary reduction in rent. A landlord may also be willing to permanently write off some or all past-due rent.

None of these concessions from a landlord will be free. There are a number of concessions that a tenant can offer in exchange for them. If the landlord has agreed to defer rent during a relief period, these concessions will begin with a requirement for the tenant to repay the deferred rent (in addition to its then-current rent) on a schedule beginning at the end of that period. The term of the lease may be extended to accommodate this schedule. A tenant might also extend to the landlord a right to percentage rent (or an increase in any existing percentage rent) in addition to the base rent. (Percentage rent is an amount equal an agreed-upon percentage of any profit earned by the tenant from its business operated in the leased premises.) For additional security, the landlord may demand an increase in its security deposit or a guaranty of the tenant's obligations by one or more owners of the business.

Before and during negotiations with its landlord, a distressed business should be mindful of rights and obligations of third parties that may exist under the lease and/or other instruments. For example, one or more owners of the business may have already executed guaranties in favor of the landlord. If the lease is a sublease, the fee owner of the property will have rights under the primary lease. A lender to the landlord may have rights under an instrument assigning rents or a subordination, non-disturbance and attornment agreement (SNDA). Finally, a lender to the tenant may be entitled to notice of any default by the tenant under the lease, remedies if the default has caused the tenant to breach any covenants under its loan documents, and consent to any restructuring of the lease.

Management Companies

If a hotel or other hospitality business is operated by a management company pursuant to a management agreement with the business' owner, there are several modifications to which the parties can agree to improve the owner's cashflow during the crisis. These modifications can be documented in a side letter agreement or amendment to the management agreement.

To begin, the owner should seek to temporarily suspend or reduce cash reserve requirements that often appear in management agreements. Most hotel management agreements with brand-affiliated management companies, as well as some with independent ones, require a hotel to maintain a reserve for repair and replacement of fixtures, furniture and equipment (FF&E), into which a specified percentage of the hotel's revenue is deposited each month. This requirement can be temporarily suspended or reduced. In exchange, the parties can agree to accelerate these contributions after a specified relief period to restore the reserve. Most hotel management agreements also include a requirement for the hotel to maintain a minimum working capital balance in its operating account. This requirement can also be temporarily reduced to make more cash available to pay debt service and other expenses.

Hotel management agreements with brand-affiliated companies invariably require the owner to comply with brand standards that include periodic renovations of the hotel. (Franchise agreements include the same requirement.) A brand company may agree to temporarily suspend these. This March, Marriott International CEO Arne Sorenson advised hotel owners that Marriott was "deferring required funding of FF&E reserves for six months," while also "delaying all regular cycle renovations that are due in 2020 by one year[.]"

A management company may also be persuaded to temporarily reduce its monthly management fees by a flat amount or a percentage of the business' revenue, in return for an opportunity to recoup lost fees (and possibly additional amounts) later, either through accelerated base fees or an opportunity (or increase in any existing opportunity) to earn profit-based incentive fees later.

Many hotel management agreements include performance tests, under which the owner is given the right to terminate the agreement early if the hotel fails to meet certain performance standards. Some others include performance guaranties by the hotel management company. Even in the likely event that force majeure language within such provisions makes them inapplicable during the COVID-19 crisis, an owner seeking the above concessions can expect the management company to demand suspension of the performance test and performance guaranty in exchange, perhaps for a timeframe that extends well beyond the crisis.

As with leases, parties restructuring a hospitality management agreement should be attentive to any rights of third parties under the agreement and other instruments. The owner's lender may have rights under an SNDA or a collateral assignment of the management agreement. A loan document may give the lender a right of approval over any amendment to the management agreement. If the business is located in a mixed use development, the owners of adjoining properties may have rights under other instruments that could affect a restructuring of the management agreement.

Franchisors

A franchisor may be another source of relief to a distressed hospitality business. In the interest of preserving the business as a future source of fees and representation of the brand, the franchisor may be willing to temporarily suspend some of the franchise fees. For a business that ordinarily performs well, this is likely to be a better option for the franchisor than an unsecured claim in the franchisee's bankruptcy, costly development of replacement property in its market and potential entry into that market by a competitor during this process. In the same way as a brand-affiliated management company, a franchisor can also provide relief in the form of suspending any requirement to make contributions to an FF&E reserve and agreeing to postpone any required improvement of the property.

Brand standards and more general operating requirements are a subject that, in time, most hospitality franchisors will need to address with most of their franchisees before the end of the COVID-19 crisis. For example, a franchise agreement for a hotel is likely to include the basic requirement that the owner continue to operate the property as a hotel throughout the term. The pandemic has forced many hotel owners to close their hotels. Some are making alternate uses of their properties, such as leasing them to municipal agencies and hospitals to house healthcare workers and patients. Will any such closure or alternate use be treated as a default under a franchise agreement? Brand standards required under a hotel franchise agreement may include operation of a swimming pool, a bar and a full-service restaurant in the hotel. During the pandemic, hotel owners have been compelled by law to close these facilities. Will any of these closures be treated as defaults? Most hotel owners have been left without answers to the questions for very practical reasons: Many of the brands' corporate and regional employees who would answer these questions have been furloughed from their jobs. Meanwhile, so many hotel owners are now faced with these situations that it would be impossible for brands' relationship managers to have spoken with them all by now. Some brands have made some general announcements regarding some brand standards. (Mr. Sorenson's statement above is an example.) Most are still in the process of determining how to respond to the unprecedented impact of this pandemic on the ability of hotels worldwide to comply with brand standards, and in many instances to continue operating at all.

Any branded hospitality business in workout discussions with its franchisor (or brand-affiliated management company) should not await systemwide guidance from the brand before addressing these issues. In the same agreement in which the business owner seeks relief from fees and reserve requirements, it should also seek a commitment from the brand not to treat as defaults any earlier closure or reduction in services necessitated by the crisis.

Vendors and Service Providers

Vendors and service providers with whom a hospitality business will continue to work after cutting unnecessary expenses are another group that can provide cashflow relief. Many of these companies will stand to gain from continued, long-term relationships with the hospitality business and should be willing to accept reduced prices and fees during the crisis. However, this should only be done after a conversation, followed by some written communication documenting the concession.

Especially if the hospitality business has a pending contract with the vendor or service provider, this conversation should not begin with the business owner stating flat-out that he or she expects the vendor or service provider to accept lower or delayed payments. That could be interpreted as an anticipatory breach of the contract, exposing the hospitality business to liability. Under the Uniform Commercial Code, such a statement could entitle a seller to suspend a shipments of goods and demand a pre-payment from the hospitality business as a condition to completing the shipment.

Finally, if a hospitality business owes payments to multiple vendors and service providers and cannot afford to complete them all, it should prioritize those vendors and service providers that are essential to its business. If the hospitality business files bankruptcy within ninety days after making any such payments (or one year afterward for payments to creditors related closely enough to the business to be "insiders"), this may result in preference liability to the recipients of these payments. (They may be compelled to return the payments to the bankruptcy estate.) This can be avoided by paying for the goods or services in advance or at the same time that the goods or services are provided.

Taxing Authorities

A final source of cashflow relief to a distressed hospitality business are federal and state taxing authorities. The CARES Act provides for almost $600 billion in tax cuts. These include changes to payroll taxes and the rules for net operating losses, as well as employee retention credits and credits for paid sick leave for employees necessitated by the crisis. The statute also extended deadlines for filing tax returns for 2019 and quarterly estimated tax payments for 2020. Several states are also offering tax relief during the crisis. A hospitality business would do well to consult with its tax advisor to take advantage of these savings.

Concluding Thoughts

A comprehensive restructuring strategy such as the one summarized here, or even a partial one focused on only one or two of the above creditor relationships, cannot be accomplished well without competent professional advice. Existing contracts need to be reviewed, risks and options discussed, and new contracts negotiated. Especially during a time of crisis, a small business owner may assume that he or she has no bargaining power when presented a document by a larger business such as a bank, a commercial landlord, or a hospitality brand company. This assumption is rarely accurate. My own experience and accounts I have heard from other attorneys confirm that creditors are willing to negotiate with struggling hospitality businesses and make some compromises to restructure their agreements for their mutual benefit. For a small business venturing into this process, much opportunity for relief can be lost simply because no one asks for it. Still, an ambitious business owner venturing into this process is unlikely in the end to get nearly everything he or she wants from the business' creditors. Before venturing into this process, I encourage any business owner to obtain the right advice and representation, to be willing to ask for concessions not initially offered, and to be flexible and amenable to compromise. This approach can mean the difference between the life or death of a hospitality business during this crisis.

Please let us know if Lannan Legal PLLC may assist your hospitality business with negotiation of transactions to restore vital cash flow during the COVID-19 crisis.

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