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

## Part I: Replacing Cash Inflow

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"Cash is king, especially in a time of crisis." This is a phrase we have been hearing a lot during the COVID-19 crisis. "Cash," of course, means cash flow. By one definition, "cash flow" is "the money that is moving (flowing) in and out of your business" from month-to-month. "Profit is an accounting concept, while cash is the amount in the checking account. You can have assets, like accounts receivable, but if you can't collect payments, you won't have cash" and won't be able to pay your business' bills as they come due. Most businesses that fail do so because of lack of cash flow.

It goes without saying that the ordinary and preferred source of cash flow is revenue. The COVID-19 crisis has dramatically reduced the revenue of nearly all hospitality businesses. For many hotels, restaurants and clubs, it has shut off revenue altogether.

Some large businesses (Apple Inc. reportedly being one) are lucky enough to have significant cash reserves on which they can fall back to pay operating expenses during the crisis. However, most businesses in the hospitality industry do not have that luxury. To survive this crisis, many will need to pursue a two-part strategy of **replacing cash inflow** while **minimizing cash outflow**.

This article provides an overview of options some businesses have to replace cash inflow by taking on new debt and/or new equity investment. A second article will explore options for minimizing cash outflow by restructuring existing debts while cutting or postponing unnecessary expenses. Although the articles explore these two steps in this order, a business should pursue them simultaneously.

### Replacing Cash Inflow

Perhaps you are a hotel owner and have responded to low occupancy by making rooms available to healthcare workers responding to the COVID-19 crisis or their patients. Or maybe you are a restaurant owner and replaced some of your ordinary revenue with a take-out and delivery business. Well done. However, if yours is like most struggling hospitality businesses, this will not be enough. To pay debt service and rent, make payroll and cover other operating expenses, you will still need additional cash. This is going to have to come from new debt and/or new equity investment.

**New Debt**

If your business has an open line of credit from before the crisis with funds still available, you are better off than most. Now is the time to consider tapping that credit line. Of course, before doing so, it is important to understand what that tap will require of you and your business beyond paying the money back with interest. Most significantly, if you have personally guaranteed your business' line of credit, you should be very careful before drawing on it.

Most hospitality businesses did not go into the COVID-19 crisis with significant open lines of credit. In theory, a hospitality business should be able to obtain a new loan if it owns valuable real estate or other hard assets that are unencumbered by existing debt. However, during the crisis, even most hospitality businesses in that position will not be able to obtain new loans from ordinary sources. Since the crisis began, most lenders have not been taking the risk of extending ordinary new credit to hospitality businesses.

With the Coronavirus Aid, Relief, and Economic Security Act of 2020 (the "CARES Act"), Congress has partially filled this gap by causing the federal treasury to assume much of this risk through a number of programs.

For a small business (with 500 or fewer employees) that is able to retain some employees, the CARES Act's Paycheck Protection Program (PPP) provides for loans guaranteed by the U.S. Small Business Administration (SBA) for up to 2.5 times the business' monthly payroll expenses (capping the measure of any individual employee's compensation at an annual rate of $100,000). Most or all of the amount borrowed under this program is subject to forgiveness if primarily used to pay employees and secondarily for other specified categories of expenses. Any amount that is not forgivable accrues interest at a rate of 1% and matures in two years. There is no collateral or personal guaranty required for a PPP loan. As of this writing, Congress has made two rounds of funding for PPP loans, with some speculation about a third. There is reportedly still a backlog of PPP applications pending review. However, the latest report is that new applications have fallen, with 40% of the second round of funding still available.

The CARES Act has also supplemented a previously existing Economic Injury Disaster Loan (EIDL) program for SBA to lend directly to small businesses, with smaller amounts of these loans also being forgivable if used to fund payroll. The EIDL interest rate for most small businesses is 3.75%, with longer terms before the loans mature. Like PPP loans, EIDLs do not require collateral or any personal guaranty. Unfortunately, EIDL applications have faced a larger backlog and, as of this writing, SBA is placing new limits on the amounts of such loans and blocking most new EIDL applications. This may change if Congress appropriates a third round of funding.

If a small business meets the criteria for either or both of the EIDL and PPP loans, it has nothing to lose from applying for them and would be well advised to do so. This does not mean that a small business should proceed without caution. First and foremost, it is essential that a business not make any misrepresentation in its application for either program. This week, two business owners were arrested for allegedly conspiring to seek forgivable SBA loans based on a representation that the business employed dozens of people, when in fact it employed none. Second, if you expect portions of your loans to be forgiven, it is essential that you document use of the proceeds for the relevant purposes. As of this writing, to be eligible for forgiveness, 75% of PPP loan proceeds must be used to fund payroll costs (including certain employee benefits). The remaining 25% may be forgiven if used for other specified costs, including payment of rent, mortgage interest and utilities. An EIDL may be forgiven at a rate of $1,000 per employee up to a maximum of $10,000 forgiven.

The CARES Act includes provisions for credit relief for larger businesses as well. The Act authorizes the Treasury Department to make up to $500 billion in loans, guarantees and other investments in support of eligible businesses and state and local governments, while funding up to an additional $454 billion for loans, guaranties, and other credit facilities extended by the Federal Reserve to support such businesses and governments. These loans also come with significant requirements, including with respect to the retention of employees.

As a last resort for debt financing, a distressed business could look to mezzanine debt. This form of debt is usually extended by a lender that has also issued senior debt secured by the business' assets. However, mezzanine debt can also be extended by a non-traditional lender with cash reserves that is looking for growth opportunity in a distressed market. The name "mezzanine debt" derives from it being a "middle layer," within the order of priority of payments from operation of a business, which sits between secured debt and equity. One of its advantages is that it may available even if a business has run out of assets with which to secure senior debt. Another is that it does not require dilution of the current owners' equity interest in a business, as would issuance of new equity. However, with each of those advantages comes a trade-off. Because mezzanine debt is not directly secured by a business' assets, it is extended at a higher interest rate, often over 12% per year. Moreover, this debt is not completely unsecured. The owners of the borrower are required to pledge warrants to the mezzanine lender, which give the lender the right to purchase their business if the borrower defaults on its loan, with the outstanding loan balance being a credit against the purchase price. These tradeoffs make mezzanine financing a "loan-to-own" strategy for lenders, and a risky option for business owners.

**New Equity Investment**

During the COVID-19 crisis, some businesses will look to new equity investments as an additional source of liquidity. The manager of a business may have a right to make a capital call on its owners, requiring each to contribute capital in proportion to his or her percentage of ownership. Another option is to look for a new equity investor. Because the business is in distress, a new equity investor is likely to demand a preferred position—i.e. the right to be paid from the business' operations before the existing owners receive any distribution. A new investor would be just as likely (or more so in this crisis) to demand that his or her investment be treated as mezzanine debt and backed by warrants.

During a more conventional time, a branded hotel or restaurant in financial distress might look to its brand company for financial relief in the form of key money. The trade-off would be an extension of the term of the franchise or management agreement, possibly with an increase in fees payable to the brand company. However, the COVID-19 crisis has put financial strain on brand companies as well, making it much more difficult to extend key money than it was just before the crisis.

## Conclusion

For most businesses in the hospitality industry, the best strategy for replacing incoming cash lost to the COVID-19 crisis is likely to see what government-backed credit facilities it can use before looking to risker sources of debt or equity financing.

A second article in this series will explore the equally important second part of the two-part strategy for a distressed hospitality business to improve its cash flow: minimizing cash outflow by restructuring existing debts while cutting or postponing unnecessary expenses.

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


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