

## PRYOR CASHMAN - HOSPITALITY INDUSTRY ALERT

### **COVID-19 Pushes Hospitality Industry to the Edge: Key Considerations for Stakeholders**

As reports of confirmed Coronavirus cases increase, travel bans and mass quarantines go into effect, and citizens across the globe avoid all nonessential travel, the hotel industry is being hard hit. Without exaggeration, owners, managers, and brands that were already struggling, and even those that were not, may face existential decisions. To aid in addressing the myriad of issues, we have compiled a series of key points that any stakeholder should consider in navigating and evaluating the difficult decisions that lie ahead.

#### **Cost Cutting: Can Vendor Contracts Be Modified, Suspended or Terminated?**

Hotels are being inundated with guests and conference organizers, canceling upcoming events and reservations. As the number of guests and events evaporate, owners and managers may find themselves seeking to cut costs dramatically by canceling or modifying contractual obligations. Contractual provisions to consider include:

- **Force Majeure:** The starting point is to review force majeure clauses, which are designed to address circumstances outside the control of the parties – such as natural disasters, terrorism, or potentially even pandemics – and may allow a party (or both parties) to suspend or terminate performance under the contract. Contracts often define what constitutes a force majeure event, and hotel owners and operators should review their contracts to determine whether their performance or that of their counterparty, may be excused. Generally, if a force majeure clause includes a certain event (such as a pandemic), the contract allocates the risk of the event to the party who is the beneficiary of the obligation. Generally, if an event is not listed, the party obligated to perform is not excused from fulfilling its obligations.
- **Limitations on Liability:** Contracts often contain provisions limiting the damages available upon a breach. It is critical to be aware of the presence of any such provisions, which may take the form of liquidated damages or prohibiting the recovery of consequential damages, as they could limit or define the scope of recovery or of liability.
- **Indemnification:** Hotel owners and operators should also give consideration to risk-shifting clauses including indemnifications.
- **Dispute Resolution:** Owners and operators should also be mindful of the contract's dispute resolution and choice of law provisions. Some jurisdictions, such as California, have statutory force majeure-like protections that apply even if a contract contains no express provision.

### **What About Temporarily or Permanently Reducing the Hotel Workforce?**

As hotel revenues decrease, hotel operators may be forced to consider staffing reductions as a way to reduce expenses. This course of action may implicate various hotel agreements, including the applicable management agreement or franchise agreement, and may implicate Collective Bargaining Agreements (“CBA”) and require compliance with the federal Worker Adjustment and Retraining Notification (“WARN”) Act. A number of issues should be considered, including:

- **The “Employer”:** A threshold issue will be to determine precisely which entity is the “employer” under the applicable management or franchise agreement, as that will dictate who has the power to hire and terminate employees.
- **Severance Obligations:** Hotel employees, particularly when unionized, are often entitled to severance payments calculated based on their time of service. CBAs generally provide a formula, though in practice unions seek to impose additional and higher severance obligations than those contractually called for by the CBA. Owners and operators should carefully review the CBAs and seek the advice of counsel to accurately assess their likely severance obligations, and whether the unique circumstances may enable negotiations to reduce this burden.
- **Withdrawal Liability:** In addition, hotel owners and operators must consider whether any reductions will trigger withdrawal liability. If a layoff qualifies as a “mass layoff” under the WARN Act (generally, a layoff of 50 employees who make up at least 33% of active employees or 500 employees at a single site of employment during any 30 day period), the employer is required to provide at least 60 days’ notice to workers through the workers’ union. If a workers’ union does not exist, notice must be given to the workers themselves, as well to local government officials. Importantly, unforeseeable business circumstances or a natural disaster – which may include a pandemic – may provide exceptions to/reductions of the 60-day notice period.

### **What Happens if Operating Revenues Become Insufficient to Fund Operations?**

A sudden drop in revenue will also present a variety of challenges to the relationship between the hotel owner and the brand. While owners will remain focused on the financial viability of the hotel, brands may become concerned with being unable to pay third party vendors and employees. This conflict may force managers to make the unusual decision of whether or not to come out of pocket to pay for owner expenses. Brands will also be concerned with the potential reputational impact of a hotel closure. Given this possible divergence of interests, stakeholders should carefully review the applicable agreement for the following:

- **Obligations to Fund Operations/Keep the Hotel Open:** Hotel agreements often obligate owners to fund operations even if operating revenue is insufficient. Typically, such agreements also contain provisions requiring the owner to keep the hotel open during the term of the agreement. Owners and operators should identify any such provisions, and consider whether owner obligations are contingent or whether a force majeure clause or other contractual mitigating factors excuse such obligations. This will also present serious

practical questions to managers: Does the manager “front” money to pay third party vendors and employees?; If so, how will they be paid back?; If the owner fails to fund operations, should the brand default or terminate the contract? There are sure to be dozens more questions surrounding this issue.

- **Performance Test Obligations:** Management agreements also generally include a performance test, which (typically) measures the annual performance of the hotel against (i) a competitive set of similarly situated hotels and/or (ii) the hotel’s annual budget. Ordinarily, when the performance test is not met, the hotel owner is entitled to terminate the operator, subject to the operator making a cure payment. First, force majeure events will often serve as exceptions to the performance test. Second, while the performance test may not be an immediate concern given that most such tests are not evaluated until the end of the calendar year and are frequently two-year tests, the duration and extent of the impact of the Coronavirus remains unknown. Owners and operators should carefully monitor the hotel’s results against the performance metrics and evaluate their rights with respect to the same.
- **Insurance:** Hotel agreements often require the owner to maintain various forms of insurance, and owners and operators should consider the applicability of business interruption insurance. While this type of insurance typically requires some physical damage, there may be arguments that contamination of a physical premises triggers coverage. However, owners and operators should consider (a) the business/practical/public relations implications of a public filing, providing that a particular premises is , in fact, contaminated, and (b) whether a public filing (for publicly traded companies) or other disclosure is required.
- **Bankruptcy:** Owners may have to give serious consideration to their options under bankruptcy law in an effort to stave off the potential loss of their property.

### **What about the Lender?**

Decreased revenue may also impact compliance with loan documents. In assessing a lender/borrower rights and obligations, careful attention should be paid to the following provisions:

- **Material Adverse Change (MAC) and Material Adverse Event (MAE) clauses:** These clauses allow a lender to declare a default or cease funding a loan or line of credit upon a material adverse change in the financial condition of the borrower or upon the occurrence of a material adverse event. Precisely what constitutes a MAC or a MAE often is the subject of litigation – particularly as to what is determined to be “material.” Parties should review their loan documents to determine whether they contain specific definitions of, or exclusions from, MAC or MAE.
- **Debt Service Coverage Ratio (DSCR):** Lenders typically require borrowers to maintain a prescribed debt service coverage ratio to demonstrate a continued ability to repay a loan. DSCR is calculated by taking the property’s net annual operating income (gross income less operating expenses) and dividing it by the property’s annual debt payments (interest

and amortization of principal). The greater the ratio, the greater the ability of a property to support its existing debt and the more secure the lender's position. DSCR covenants vary from lender to lender, from borrower to borrower, and from loan to loan. A drop in revenue will lead to a decline in DSCR, leading to covenant defaults.

- **Loan to Value Ratio (LTV):** LTV is the ratio of the principal amount of a loan to the value of the collateral for the loan. Like DSCR, LTV measures the amount of risk a lender is willing to assume; the lower the LTV, the lower potential the lender will suffer a loss. Many hotels are valued on a multiple or other calculation predicated on revenue or earnings. As revenue and earnings drop, so will the value of the business – leading to LTV covenant defaults.
- **Force Majeure:** Parties should review the force majeure provisions of their loan documents to determine the circumstances under which the parties have agreed performance may be suspended. Where loan documents are silent, it will be an issue for the court as to whether performance can be excused based on the extent to which the parties could have anticipated the occurrence of a particular event.

Lenders may declare defaults requiring owners/borrowers to infuse cash, pay down loan balances, provide credit enhancements, and/or make other financial concessions or accommodations in order to bring ratios back into compliance (or “in balance”) and/or avoid a default.

### **Conclusion**

The hotel industry is one of the earliest and hardest hit industries impacted by the Coronavirus. Owners and operators must consider a wide variety of legal and business issues as they navigate and mitigate the risks associated with this black swan event. Management agreements, franchise agreements, loan agreements, collective bargaining agreements, and insurance policies are just some of the considerations.

Pryor Cashman's Hotel + Hospitality Group provides meticulous personal attention with the added strength and support of a full-service firm. We are advisors who help clients define key business goals, develop strategies to optimize value and assemble teams to get deals done. Representing owners, operators, private equity firms, lenders and family offices in the U.S. and abroad, our seasoned hospitality litigators are on the cutting edge of the industry's most impactful issues. So, whether your company is bracing for coronavirus-related damage, or has already sustained it, please contact [Todd Soloway](#) or your [Pryor Cashman](#) attorney. We're here to help.