KING & SPALDING

CRISIS PRACTICE
Coronavirus

FINANCIAL SERVICES INDUSTRY

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Cancellations, Quarantines and Closings - Coronavirus Considerations for Hospitality Lenders

Due to the novel coronavirus outbreak, the hospitality industry is potentially facing its worst crisis since the September 11, 2001 terrorist attacks. In response to the continuing outbreak, major companies have announced plans to restrict nonessential travel for employees and trade conferences. Moreover, annual events such as South by Southwest, the largest film, music and tech festival of its kind in the world, have been canceled in response to governmental efforts to contain the virus. The International Air Transport Association estimates that global air travel may lose between $63 billion and $113 billion due to reduced demand.[1] According to Morningstar,[2] travel demand through 2020 is expected to decrease by 5 percent in North America, 10 percent in Europe, and 25 percent in the rest of the world compared to last year. Moody's Analytics indicates that the U.S. hotel industry could see a 50 percent drop in foreign visitors because of the coronavirus.[3]

For at least the near-term, the hospitality industry will continue to be uniquely impacted by this crisis and lenders and borrowers in this space should take several factors into account in navigating a rapidly evolving landscape. As hotel reservations and conferences continue to be cancelled, hospitality lenders should consider the following as they dust off their loan agreements to assess their options:

1. *Hotel Management Agreements and Related Loan Covenants:* Hotel management agreements typically provide for performance tests for the hotel manager. If these performance hurdles are not met, the owner typically has a right to terminate the hotel manager. The loan agreement, in turn, will require lender approval for any termination of the hotel management agreement, and may give the lender the right, either before or after an event of default by the borrower under the loan agreement, to exercise such termination right. If terminated, the lender typically has the right to approve the replacement hotel manager or even to appoint the replacement hotel manager. However, in the context of the coronavirus,

poor financial performance of the hotel as a result of the virus may be excused as the hotel management agreement will typically contain provisions making the manager's performance tests subject to, among other things, force majeure. In addition to any casualty or taking, storm, earthquake, flood or other act of God, labor, transport or other disruptions, the typical force majeure definition will also include epidemics, and depending on the level of detail in the definition, quarantine restrictions or other public health restrictions or advisories. Hotel management agreements will also often require the hotel owner, i.e., the borrower, to renovate the hotel pursuant to a property improvement plan (PIP) agreed with the hotel manager to keep with a hotel brand's standards. If such PIP is not timely implemented by the owner, the hotel manager may usually terminate the hotel management agreement, which in turn would typically constitute an event of default under the borrower's loan agreement. Again, the hotel management agreement will typically provide that the implementation of the PIP will be subject to force majeure, so to the extent renovation works will be impacted by the coronavirus (e.g., workers are sick, materials cannot be obtained due to shortages or supply chains are disrupted due to quarantines), force majeure may apply.

2. *Financial Covenants:* Hotel loan agreements typically contain financial covenants such as DSCR (debt service coverage ratio), which measures the ratio of net operating income to debt service, and debt yield covenants, which test net operating income as a percentage of the outstanding loan amount. It is safe to assume that, at least in the short term, the novel coronavirus outbreak will severely impact the ability of some hospitality borrowers to generate net operating income at levels anticipated when these loan agreements were signed. Depending on the loan documents, financial covenant breaches may give the lender the right to trap or sweep excess cash from the property. Where the documents provide for a cash trap, excess cash would at least initially be held as additional collateral for the loan but may be swept and applied to repayment of the loan if the breach is not remedied by a specified future test date. Documents may also provide for an immediate cash sweep with cash being applied to repayment when the breach occurs (if such breach is not cured within a short period by paying down the loan or providing additional collateral). Determining how to address breaches of financial covenants in these circumstances may depend, in part, on the borrower's history of operations prior to the current pandemic as well as the potential likelihood that the property will revert to pre-outbreak operational levels in the coming months. For example, in some circumstances the lender may decide to make any excess cash that would otherwise be trapped or swept available to the borrower in future months to pay for operating expenses to offset weaker performance.

3. *Budget Approval:* Hotel loan agreements of newer vintage often give the lender approval rights over the borrower's budget only after an event of default or financial covenant breach resulting in a cash trap/sweep has occurred. Where the lender has approval rights, the lender and borrower will have to work closely together on the budget which will likely need to be adjusted in light of lower operating income and potentially higher operational expenses triggered by the coronavirus (additional cleaning, disinfection, security or other expenses).

4. *Events of Default:* Loan documents of an older vintage may provide that breaches of financial covenants constitute events of default. Additionally, the failure to make payments under the loan when due will always result in an event of default. While case law is generally favorable toward the right of lenders to exercise remedies, particularly with respect to payment defaults, lenders will need to consider both whether it is desirable to declare a borrower in default and what remedies should be sought in light of the likely negative impact of the virus on foreclosure proceeds as well as any impact the coronavirus may continue to have on the property post foreclosure (and, should the lender decide to credit bid and take control of the property, its or a third party manager's ability to improve performance vis a vis the borrower's and existing manager's ability to do so). If a borrower is likely to recover from the current drop-off in bookings, a lender may consider a forbearance agreement modifying the cure rights of a borrower to address setbacks that would not have been anticipated prior to the novel coronavirus outbreak. Alternatively, if a hotel was

already showing signs of distress prior to the outbreak, the current downturn may accelerate the decision to foreclose on a property.

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[1] https://www.nbcnews.com/business/business-news/empty-sidewalks-deserted-hotels-coronavirus-slamming-tourism-industry-n1147061
[2] https://www.nbcnews.com/business/business-news/empty-sidewalks-deserted-hotels-coronavirus-slamming-tourism-industry-n1147061.
[3] https://therealdeal.com/2020/03/03/us-hotels-brace-for-coronavirus-impact/