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Hotels and COVID-19

The ongoing COVID-19 pandemic has affected all areas of the economy, and the hospitality industry was one of the first to see significant and material economic issues. Hotel owners and operators are specifically facing declining occupancy, loan obligations, staffing issues and other concerns. There are several key issues to be aware of while navigating these unprecedented events.

Operating the Hotel

Although many jurisdictions have active shelter-in-place orders, or have otherwise required non-essential businesses to close, hotels have been excluded from a vast majority of these orders. While being considered an essential business, and therefore having the option to remain open, is a good thing, many hotels have been faced with such low occupancy numbers that closing remains a consideration. However, before making the decision to close, franchise agreements, loan documents, large-scale corporate booking contracts and local law should be reviewed to determine whether closing the hotel will result in defaults or violations that will continue to affect the property long after the industry has begun to recover.

Many franchise agreements and loan documents include requirements that the hotel continue to operate as a hospitality property at all times and may or may not include force majeure exceptions that would cover a global pandemic. Additionally, in some jurisdictions, a closing of the hotel will invalidate hotel permits, liquor licenses, or other applicable permits. This would result in a requirement to obtain such permits again before the hotel can reopen.

Hotel owners may also be considering alternate uses of the property to maximize income for the duration of the pandemic. These alternate uses may include hospital overflow, healthcare worker housing, quarantine housing and other atypical uses. Once again, a review of the applicable franchise documents, loan documents, insurance policies and local zoning, and use regulations

should be performed prior to entering into any agreements for such alternate uses of the property.

While other factors may ultimately override these considerations, a thorough analysis of the consequences of closing a hotel or pursuing novel income streams is the prudent course of action, and will inform how such decisions are implemented to minimize negative consequences.

Avoiding Recourse

For any hospitality property with a non-recourse loan, a critically important consideration for its owners is oftentimes to ensure that they do not trigger personal recourse to their own assets. The ultimate analysis of recourse liability must be done on a case-by-case basis, as all loan documents are different. However, the following actions are likely to trigger recourse liability if not done in accordance the loan documents:

- Admitting an inability to pay debts as they become due, even to an entity's own lender, will typically trigger recourse liability, sometimes in the full amount of the loan. Making such an admission, especially in writing, should only be done with careful consideration and ideally after entering into a pre-negotiation agreement ("PNA") with the lender. See below for more information in that regard.
- A borrower directly obtaining additional financing, including paycheck protection program ("PPP") loans, without the approval of the lender is likely to result in recourse liability. Whether such liability is recourse for the full amount of the loan, or only for losses, will depend on the exact language in the applicable loan documents.
- For hotels with commercial leases in place (in contrast to standard room rental agreements), agreeing to any rent concessions, amendments, or other forbearance agreements with such tenants without the approval of the lender is likely to trigger recourse. Many loan documents define prohibited transfers in such a way as to make these actions a full recourse event.

Working with the Franchisor

Many of the largest franchisors, Marriot and Hyatt among them, moved swiftly to address the COVID-19 pandemic. Common concessions have been permitting franchisors to use Furniture, Fixtures, & Equipment (“FF&E”) funds to pay operating expenses (if the franchisor had any FF&E reserve requirements to begin with and subject to lender approval), deferring PIP and other brand initiatives until 2021, and delaying brand audits. Many franchisors have also indicated a willingness to discuss hotel closures and other measures on a case-by-case basis. Hotel owners should reach out to their franchisor if they haven’t heard from them on the above matters and to discuss any actions they are considering to address the current economic climate.

Negotiating with the Lender or Servicer

In addition to avoiding recourse, there are many other considerations when dealing with the lender or servicer. The first question likely to arise is whether or not to make the monthly payment. For many hotel owners, that will not be an option. For others, using cash on hand or injecting capital to make such payments may be feasible. While this analysis should be done on a case-by-case basis, and there are risks in not making such a payment, we note that many owners simply cannot make their payments, and as a result, short-term forbearances from lenders are expected to be the norm for properties that were in good standing prior to the COVID-19 pandemic. In such circumstances, injecting equity may be unnecessary and cash on hand or in reserves may be better utilized in other manners. Under no circumstances, however, should distributions be made to owners or investors if the entity is not making monthly loan payments.

If a payment is not made, the next decision will be whether and how to alert the lender or servicer. Generally speaking, proactive communication with the lender or servicer will be key in the long run. However, lenders and servicers are dealing with an unprecedented volume of forbearance requests and other notices, and as such, the most effective communication at this stage will likely be a phone call with an existing lender contact, if such a

contact exists. If such a contact does not exist, or when following up after such a phone call, a notice letter may be appropriate. The notice letter should be limited to a short, matter-of-fact statement that a monthly payment will not be made due to the COVID-19 pandemic. Caution must be used to avoid admitting an inability to make payments since, as discussed above, doing so may trigger personal recourse.

In these initial communications with the lender, there are certain common requests that should be considered:

- deferral of monthly payments – many lenders and servicers are agreeing to three-month deferrals (note, however, an initial request of 6 to 12 months is not unreasonable);
- waiver of additional deposits into FF&E or PIP reserves;
- using funds on deposit in existing reserves, particularly FF&E or PIP reserves, for other purposes, including (1) funding of tax and insurance reserves, (2) application to debt service payments and (3) using such amounts for basic operating costs;
- requests to permit the closing of the hotel, or if applicable, using the hotel for alternative purposes;
- requests for rent concessions to commercial tenants, if required by the loan documents; and
- requests for lender's consent to obtain a PPP loan (see below).

Once these requests have been made, it is likely that the lender or servicer will ask to enter into a PNA before granting or further considering such requests. In their basic form, PNAs protect the borrower and the lender by providing that statements and information disclosed during negotiations cannot be used against the other party. While there is generally little room for negotiating a PNA, an experienced attorney should review the PNA to ensure it covers standard matters.

If the loan is a CMBS loan, any request for concessions from a master servicer can potentially result in a transfer to special servicing. Typically, such a transfer would be necessary to obtain

concessions, as master servicers generally have limited ability to provide such relief. However, many master servicers appear to have been granted expanded powers in these unprecedented circumstances. Since a transfer to special servicing will result in additional fees, it would appear that the current best practice is to avoid such a transfer if possible, understanding that it will be more important to make the necessary requests. Avoiding special servicing may not be possible for every property, but it is something to be considered when developing a plan to deal with the COVID-19 pandemic.

PPP Loans

By far the most popular source of short-term financing for hotel property owners during the COVID-19 pandemic are Small Business Administration (“SBA”) loans. While multiple types of SBA loans were established or funded through the CARES Act, the most desirable is the Paycheck Protection Program (“PPP”). Its popularity stems from the fact that under certain circumstances the loan is forgivable and, even if not forgiven, becomes a two-year loan with a 1.0% interest rate.

While there are a bevy of requirements to be eligible for these loans, there are particular challenges for hospitality properties. First, the maximum loan amount of a PPP loan is up to 2.5 times *the monthly payroll of the PPP borrower*, capped at \$10 million. Many hotel owners have no employees, and therefore will not qualify for PPP loans. In many cases, the employees of the hotel will be employed by a property manager, or if the property is subject to an owner-operator arrangement pursuant to a master lease, the operating company. Those entities may qualify for a PPP loan, assuming they meet the other requirements; however, those entities would not be permitted to use such a loan to pay the debts of the hotel owner.

A similar result can be expected if an upper-tier entity, managing member or other affiliate of the hotel owner seeks to obtain a PPP loan. Such an entity would be able to obtain a PPP loan based on its own payroll, and the proceeds of the loan could be used for such payroll expenses and the other permitted obligations of that entity, but not the direct obligations of the property owner.

In addition to the issues posed above, general eligibility for PPP loans requires an entity have, together with its affiliates, less than 500 employees, or otherwise qualify based on industry-specific size standards established by the North American Industry Classification System ("NAICS"). For example, a Nonresidential Property Manager (NAICS Code 531312) would qualify even though they have more than 500 employees if they have less than \$8 million in average annual revenue for the past 3 years. The SBA rules for defining affiliates are also complicated and fact specific, but are generally quite expansive; however, the CARES Act provides an exception for hospitality properties and restaurants (any organization with an NAICS Classification code starting with 72). These entities are eligible so long as they have no more than 500 employees at any one location, and they are also exempted from the complex affiliation rules.

Although PPP loans are forgivable under certain circumstances, such forgiveness is not automatic. In order to be fully forgiven (1) the PPP loan must be used for payroll costs, mortgage interest payments (but not principal), rent payments, utility payments, interest payments on other debt obligations or refinancing EIDL loans taken out earlier in 2020, and must be used within 8 weeks of obtaining the loan, (2) 75% of the PPP loan proceeds must be used for payroll expenses, and (3) the PPP borrower must maintain the same full-time employment and compensation levels as measured on June 30th compared to pre-February 15th levels. Failure to comply with clause (3) will result in a pro rata reduction in forgivable amounts. Hotels in particular may struggle to expend 75% of an obtained PPP loan on payroll costs, particularly as they will be competing with expanded unemployment benefits. Front-line hotel workers may, understandably, be reluctant to return to work under those conditions.

Due to these issues, we understand that lobbying efforts on behalf of the hospitality industry are ongoing to better equip the PPP program (or to introduce a new program) to more readily suit the needs of hotel owners and operators. However, as of April 15, 2020, no such changes have been announced.

In summary, there are many issues facing hotel owners in the current economic climate, and the situation is rapidly evolving. It is important to address these issues in a systematic and thoughtful way in order come out of the other side in the best possible situation. For more information, please contact [Geoff White](#), [Josh Brock](#), or any attorney in Frost Brown Todd's [Financial Services](#) or [Franchise & Hospitality](#) industry teams.

To provide guidance and support to clients as this global public-health crisis unfolds, Frost Brown Todd has created a [Coronavirus Response Team](#). Our attorneys are on hand to answer your questions and provide guidance on how to proactively prepare for and manage any coronavirus-related threats to your business operations and workforce.

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