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Hotel Bankruptcies: Introduction to Critical Issues

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The global COVID-19 pandemic has devastated the hospitality industry. Hotel occupancy rates have fallen greatly in many markets, with employee layoffs and property closures affecting even the largest and otherwise best performing hotels. It is uncertain when the industry will recover. Many hotel properties will require a chapter 11 bankruptcy case to successfully reorganize their debt obligations and operations and preserve the value of the business.

Hotel properties present a unique set of issues in bankruptcy. Owners, investors, lenders, and professionals in the hospitality industry should carefully consider the benefits and challenges associated with a chapter 11 case. Some of the principal strategic issues are:

1. **Lender Negotiations and Forbearance Agreements.** As a hotel business encounters financial distress, the best approach is often to proactively engage with its lender and—especially in light of the COVID-19 pandemic—be transparent about the financial challenges confronting the business. In these times, lenders are frequently willing to provide amendments to loan documents or otherwise forbear from starting foreclosure proceedings based on COVID-related defaults. The lender may impose additional financial reporting requirements and fees in connection with any forbearance agreement. Forbearance agreements with senior lenders can also assist a hotel borrower in maintaining control over an upcoming financial restructuring, especially where the hotel has additional layers of junior or mezzanine financing. The hotel borrower should seek to effectively use any time afforded under a forbearance agreement to evaluate its options, negotiate with its creditors, and, if necessary, prepare for a chapter 11 case.

2. **Management in Chapter 11.** Directors and officers remain in place and continue to manage the debtor in chapter 11. In this way, chapter 11 is different from other types of insolvency proceedings, in which existing management is removed in favor of a trustee or receiver. The directors and officers of a business in chapter 11 continue to owe fiduciary duties to the company and are required to make business decisions that are in the best interests of the estate. In planning for a chapter 11 case, a company should consider retaining a financial advisor or chief restructuring officer with experience navigating the complicated and specialized legal and business challenges associated with operating a chapter 11 debtor.

3. **Liquidity and Financing Needs.** The COVID-19 pandemic has strained the liquidity of hotels throughout the country and created tremendous uncertainty when it comes to financial projections. For many hotels, it is unclear when—and in what form—they will be able to reopen. Nevertheless, a comprehensive understanding of the business's liquidity

position and projected cash needs over the upcoming quarter will be critical in planning any chapter 11 case. The Bankruptcy Court, the hotel's lender, and other parties will expect to see a 13-week cash flow budget for the property. The budget will be critical in evaluating whether the hotel debtor will be able to use any cash generated by the business that is the lender's collateral, as well as whether any additional financing—referred to as debtor-in-possession or "DIP" financing—may be necessary during the chapter 11 case. If the lender has a security interest in the cash proceeds of the business, the debtor will be required to obtain either the lender's consent or a Bankruptcy Court order approving the use of such cash.

4. **Single Asset Real Estate.** A potential hotel debtor should carefully consider the applicability of the single asset real estate or "SARE" provisions of the Bankruptcy Code. These provisions streamline the ability of secured lenders to obtain relief from the Bankruptcy Code's automatic stay and foreclose on the property unless the debtor meets certain expedited timing requirements in the chapter 11 case. Accordingly, if a hotel debtor does fall within the SARE rules, its options in a restructuring may prove limited. However, courts will often decline to apply the SARE provisions where a hotel debtor can demonstrate that it provides substantial goods and services to guests and customers beyond simply renting rooms.

5. **Valuation in Bankruptcy.** The valuation of the hotel will be critically important in any chapter 11 case. For example, establishing a value for the hotel in excess of the amount of the secured debt may allow the debtor to utilize cash generated from operations without the lender's consent. The hotel debtor will also have to establish the value of the hotel in order to confirm a plan of reorganization. The Bankruptcy Court will consider all of the typical measures of hotel financial performance as well as generally-accepted valuation methodologies, such as RevPar, DCF, and comparable sales. Expert testimony regarding valuation may be necessary in contested cases. Given that the financial performance of hotels during the COVID-19 pandemic has suffered tremendously, a hotel debtor may face substantial challenges on the valuation question. Yet even if proving valuation is difficult, chapter 11 may provide the "breathing spell" necessary for a hotel business to stave off its creditors until the hospitality market sufficiently recovers.

6. **Guarantees of Hotel Debt.** Hotel debt obligations are often guaranteed by the hotel's owners or sponsors under so-called non-recourse carve-out or "bad boy" guarantees. These guarantees allow a lender to recover against the guarantor under limited circumstances, often including the bankruptcy of the hotel debtor. Bad boy guarantees are generally enforceable against the guarantor even if the lender is prevented from collecting against the hotel debtor during the bankruptcy case. The existence and scope of any bad boy guarantees will be a critically important strategic issue in the chapter 11 planning process.

7. **Franchise Agreements in Bankruptcy.** A hotel's franchise agreement is often one of its most valuable assets. The Bankruptcy Code's automatic stay prevents the franchisor from terminating the franchise agreement based on the hotel debtor's bankruptcy case. Under the Bankruptcy Code, the debtor has the ability to assume or reject "executory contracts," including franchise agreements. If the debtor elects to assume the franchise agreement, keeping the franchise agreement in place, the hotel must cure any defaults, including payment defaults, that might exist under the agreement.

8. **Route to Exit Bankruptcy.** Chapter 11 cases are generally faster and more cost-effective if the debtor has a game plan for how it will exit the bankruptcy case before the bankruptcy petition is even filed. There are two ways for an operating business to exit chapter 11. The first option is for the debtor to confirm a chapter 11 plan of reorganization. Under this approach, the existing owners generally remain as the owners and operators of the post-reorganization business, with a court-approved restructuring of the various liabilities of the company. The second way for the business to exit chapter 11 is through a sale of substantially all assets under section 363 of the Bankruptcy Code. In a section 363 sale, the debtor seeks out a buyer for the business, with the transaction approved by the Bankruptcy Court. Section 363 sales for businesses of any material size are almost always subject to an overbid and auction process. An existing secured lender to the hotel debtor will have an option to "credit bid" its secured claim in any sale process.

All of the parties involved in a potential hotel chapter 11 case should carefully consider the issues outlined in this article. A comprehensive understanding of the risks and benefits of a chapter 11 case early in the process can often aid in achieving the best outcome.

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