ALLEN & OVERY

Covid-19 coronavirus - advice for the U.S. hospitality industry

April 2020

The Covid-19 crisis continues to impact the US hospitality industry in dramatic ways. Shelter-in-place orders and non-essential business closures are in effect across the US (and around the globe), domestic and international travel have been severely reduced, US hotels are facing a projected 50.6% decline in revenue per available room in 2020[1] and US restaurants experienced an estimated 47% decline in sales from March 1 to March 22, 2020[2]. We have received numerous questions from our clients in food, beverage, restaurant, restaurant technology, and other hospitality businesses on the federal response to Covid-19, as well as their contractual rights and loss mitigation strategies. This Alert synthesizes our answers to those questions in order to assist owners and operators of US hospitality companies in responding to this evolving Covid-19 crisis.

Specifically, this Alert discusses:

(1) potential sources of federal relief available to such owners and operators;

(2) US employment law considerations;

(3) US tax law considerations;

(4) force majeure, material adverse effect, and other affirmative defenses for nonperformance;

(5) credit facility and liquidity-related issues;

(6) landlord and tenant considerations; and

(7) business interruption insurance coverage.

in each case with special focus on issues germane to the hospitality industry.

Note that while the analyses set forth herein are limited to the laws of the United States and the State of New York, Allen & Overy is one of a small number of truly global elite law firms, with 44 offices in 31 countries, and is uniquely positioned to provide tailored multijurisdictional advice across all Covid-19-related legal issues.

Should you have any questions on, or need any assistance in connection with, this Covid-19 outbreak, please do not hesitate to contact us.

1. Available federal relief

For any given hospitality sector business, its workforce represents both its most important asset and one of its largest line items. As shelter-in-place and non-essential business closure orders go into effect across the nation, hospitality businesses – whether remaining operational (i.e., restaurants converting to take-out and delivery-only models) or temporarily pausing operations – are struggling to make payroll and stay current on their other obligations.

Enter: the Coronavirus Aid, Relief, and Economic Security Act (the **CARES Act**), which signed into law on March 27, 2020. The CARES Act expands relief options available to US small businesses through the Small Business Administration (the **SBA**), including the creation of a new class of Section 7(a) lending, the Paycheck Protection Loan Program, and an expansion of the existing Economic Injury Disaster Loan Program. The CARES Act also provides for a loan and loan guarantee program intended to help distressed businesses that do not qualify for small business relief, including a program specifically designed for mid-sized businesses with between 500 and 10,000 employees. Bear in mind that much of the funding appropriated by the CARES Act remains subject to clarifying regulation and administrative guidance. We will continue to closely monitor developments in CARES-act related funding programs, and will provide updated guidance as and when we can.

US hospitality businesses, depending on their size, may be eligible for one or more of such relief programs. As noted below, these programs are being offered on a largely first-come, first served basis.

1.1 Paycheck Protection Loan Program.

If it satisfies the requirements set forth below, a US hospitality business may be eligible to receive a short-term loan intended to cover payroll and certain operating expenses under the Paycheck Protection Loan Program (a **PPP Loan**).

(a) **Qualifying Borrowers**. Any business concern[3] will be eligible to apply for a PPP Loan if such entity (1) has fewer than 500 employees and (2) was in operation and had either employees (for whom it paid wages and payroll taxes) or a paid independent contractor on February 15, 2020. Individuals operating as sole proprietorships, independent contractors or self-employed individuals are also eligible to apply for a PPP Loan. With regards to aggregate employees, there is an express exception for certain US hospitality concerns, specifically those business concerns assigned an North American Industry Classification System (**NAICS**) code beginning with 72 (a **Food/Accommodation Entity**).[4] A Food/Accommodation Entity will be eligible to apply for a PPP Loan so long as such entity has no more than 500 employees per physical location. Further, while the SBA's employee affiliation rules (which require aggregation of the borrower's employees as well as those of its ultimate equityholder(s) and all sister company affiliates) apply to PPP Loans, the CARES Act provides an exception for Food/Accomodation Entities that have no more than 500 employees in the aggregate.

Private equity sponsors with multiple Food/Accommodation Entity portfolio companies may therefore be able to seek separate PPP Loans for each such Food/Accommodation entity (to the extent each meets the eligibility requirements described herein). Similarly, to the extent that a hospitality group has established separate Food/Accommodation Entities for each of its physical locations, each such Food/Accommodation Entity with fewer than 500 employees at its given physical location may be eligible to apply for its own PPP Loan. This affiliation waiver, however, will not provide a similar benefit to any Food Accommodation Entity that directly owns and operates its different physical locations (though such an entity will still be eligible to apply for a single PPP Loan so long as it has no more than 500 employees at any such location).

(b) **PPP Loan Size**. The maximum amount of any PPP Loan is the lesser of (x) $10 million and (y) the sum of (i) 250% of the borrower's average monthly payroll costs (measured over the one-year period prior to the loan funding date) and (ii) the outstanding amount of any EID Loan (as defined below) made between January 31, 2020 and the date the PPP Loan is made available to such borrower.

"Payroll costs" are defined as the sum of such borrower's salary, wage, commission and other compensation, payment of cash tip or equivalent, payment for vacation, parental, family, medical or sick leave, allowance for dismissal or separation, payment required for the provisions of group health care benefits, including insurance premiums, payment of any retirement benefit, or payment of state or local tax assessed on the compensation of employees. Payroll costs shall not include the prorated portion of any compensation in excess of $100,000 per year paid to a given person, compensation of any employee whose principal place of residence is outside of the US, certain payroll taxes (including FICA and income tax withholding), and certain payments for family and sick leave for which a tax credit is available under Section 7001 or Section 7003 of the FFCRA (as defined below).

(c) **Qualifying Uses/Loan Forgiveness**. PPP Loans are intended to cover the cost of maintaining payroll costs, rent and mortgage expenses for the 8-week period following loan funding (the **PPP Covered Period**). To that end, the sum of the following payments made with PPP Loan proceeds during the PPP Covered Period will be forgiven at the end of the PPP Covered Period: (i) payroll costs, (ii) interest payments on mortgage obligations existing prior to February 15, 2020 (but not on any prepayment or payment of principal), (iii) rent payments pursuant to leases in existence prior to February 15, 2020, and (iv) certain utility payments, including electricity, gas, water, transportation, and phone and internet access for service incurred in the ordinary course of business prior to February 15, 2020. The CARES Act permits certain other uses of proceeds, but such uses will not be eligible for loan forgiveness.

The amount otherwise forgiven will be reduced proportionally by any reduction in the number of employees retained by the borrower as compared to the prior year. There is a further dollar-for-dollar reduction in loan forgiveness equal to the reduction of salary/wages of any employee (making less than $100,000 per year) in excess of 25% of such employees salary/wages for the most recent full quarter during which the employee was employed prior to the PPP Covered Period. A borrower, however, will not be penalized by these reductions for termination of an employee and/or reduction of an employee's salary (in excess of 25%) made between February 15, 2020 and April 26, 2020, as long as the employee is rehired and/or the salary is restored by June 30, 2020. Forgiven amounts will not constitute cancellation of indebtedness income for US federal tax purposes.

(d) **PPP Loan Terms**. Based on the latest guidance received from the SBA, if and to the extent that a PPP Loan has a remaining balance after the forgiveness described above, it will have a maturity of 2 years and an interest rate of 0.5% per annum. The SBA PPP Loans are non-recourse to the borrower and not subject to the credit elsewhere, personal guaranty, collateral, and guaranty and annual fee requirements typical of SBA Section 7(a) loans. PPP Loan lenders must defer payments under the PPP Loan for at least six months (and up to one year) from loan funding, and there shall be no prepayment penalties. The SBA will guarantee 100% of PPP Loans through December 31, 2020, which guarantees will thereafter be reduced to 75% for loans exceeding $150,000 or 85% for loans less than $150,000.

(e) **Timeline, Application Process**. The PPP Loans are administered through the SBA Section 7(a) Program, but applications should be made directly to participating lenders, not the SBA. Loan applications will be processed beginning on April 3, 2020, and will be available until June 30, 2020. **Note**: PPP Loans will be processed on a first-come, first-served basis and, unsurprisingly, SBA lenders have already reported substantial demand for these new loans. We understand from SBA

lenders that there is very strong interest in these PPP Loans. US federal officials have also indicated that they will seek further appropriations for this program if and when needed.

Interested US hospitality companies eager to move as quickly as possible on PPP Loans can consider this Sample PPP Loan Application.

1.2 Economic Injury Disaster Loan Program

In lieu of (or in addition to) a PPP Loan, a US hospitality business may be eligible to receive a grant (an **EID Grant**) and a longer-term loan under the SBA's Economic Injury Disaster Loan Program (an **EID Loan**).

(a) **Qualifying Entities**. Any business concern with not more than 500 employees located in a declared disaster area (which, as of March 13, 2020, include all states, tribes, territories and the District of Columbia) is eligible to apply for an EID Loan and an EID Grant as an advance thereon. Note: this replaces the typical annual receipts threshold for determining whether a given Food/Accomodation Entity is a "small business concern" until December 31, 2020.

(b) **Permitted Uses**. EID Loan proceeds are to be used by borrowers to cover payroll obligations and other working capital needs or normal business operating expenses. One notable usage permitted for EID Loans (but not for PPP Loans) is meeting the borrowers' increased costs due to supply chain interruption.

(c) **EID Loan Terms**. Terms and conditions of EID Loans vary. EID Loan amounts are based on actual harm suffered, up to a maximum amount of $2 million. EID Loans can feature up to 30-year terms, and interest rates may not exceed 3.75% per annum for small businesses or 2.75% per annum fixed for nonprofit organizations. The CARES Act eliminated the need for personal guarantees for EID Loans up to $200,000, but for any loan in excess of that amount, each principal owning in excess of 20% of the borrower's equity must provide a personal guarantee. The CARES Act also waived the credit elsewhere requirement and the requirement that the borrower be in business for the 1-year period before the applicable disaster (so long as the borrower was in business prior to January 31, 2020). Borrowers must provide collateral for all EDI Loans over $25,000.

(d) **EID Grants**. Borrowers that self-certify as eligible can apply for an EID Advance (and **EID Grant**) in an amount up to $10,000, to be provided within 3 days after receipt of such borrowers applications. These advances can be applied to any of the allowable purposes described above. If an applicant receives an EID Grant and is subsequently denied an EID Loan, such applicant need not repay the EID Grant.

(e) **Interplay with PPP Loans**. The CARES Act allows a borrower who has already or is in the process of applying for an EID Loan to apply for a PPP Loan if it will not duplicate the borrower's use of the EID Loan. Further, if a borrower received a EID Loan related to Covid-19 between January 31, 2020 and the date at which the PPP Loans become available to such borrower, then the borrower may refinance that EID Loan into the PPP Loan for loan forgiveness purposes, it being understood that any portions of such EID Loan that do not meet the loan forgiveness requirements outlined above will remain a loan (but subject to the terms of the PPP Loan). If the borrower took out a PPP Loan and took advantage of an EID Grant, the amount of such EID Grant would be subtracted from the amount forgiven in respect of the PPP Loan.

(f) **Application, Timing**. EID Loans are available now, and interested companies can access the streamlined EID Loan for Covid-19 relief here. The relaxed eligibility requirements for these EID Loans will be available until December 31, 2020.

1.3 Coronavirus Economic Stabilization Act Program

In addition to the PPP Loan and the expansion of the EID Loan Program, the CARES Act also provides for $454 billion in financing to banks and other lenders that make direct loans or guaranties to certain eligible business impacted by Covid-19 (including the hospitality industry) (the **CESA (b)(4) Program**). As the CARES Act authorizes, but does not fully establish, the CESA (b)(4) Program, the precise mechanics of applying for relief under the CESA (b)(4) Program remain to be determined.

(a) **Eligible Businesses**. A business concern is eligible to participate in the CESA (b)(4) Program if it (i) is created and organized in the US and has significant operations and a majority of its employees located in the US, and (ii) has incurred losses as a result of Covid-19.

(b) **Terms, Restrictions**. The Secretary of the Treasury is given broad discretion over the form and terms of the loans provided under the CESA (b)(4) Program, but applicable requirements under Section 13(3) of the Federal Reserve Act related to collateralization, taxpayer protection and borrower solvency will still apply to each such loan. The following restrictions apply to borrowers that receive direct loans under the CESA (b)(4) Program (note: these would not apply to other forms of aid, including secondary purchases, syndicated loans and other securities or capital markets transactions):

- the borrower may not pay dividends or other capital distributions while loan is outstanding and for 12 months thereafter;
- the borrower may not repurchase listed stock of the borrower or any parent company while a loan is outstanding and for 12 months thereafter, except as required by contracts in effect on the date of the enactment of the CARES Act; and
- the borrower must agree to the following employee compensation caps for a period ending 12 months after the loan is repaid (where compensation includes salary, stock and bonuses): (i) any officer or employee whose 2019 annual compensation exceeded $425,000 cannot receive compensation in excess of their 2019 compensation in any consecutive 12-month period or severance pay in excess or twice their 2019 compensation, and (ii) any officer or employee whose 2019 annual compensation exceeded $3 million cannot receive total compensation in excess of an amount equal to $3 million plus 50% of the excess over $3 million.

(c) **Mid-Sized Business Loan Program**. As part of the CESA (b)(4) Program, the US government will seek to establish a loan program specifically targeting mid-sized businesses (including nonprofits) with between 500 and 10,000 employees. The CARES Act requires that any such loans to mid-sized borrowers would feature annualized interest rates no higher than 2% per annum, and that for the first six months of financing under the program, no principal or interest would be due. The CARES Act would also require that any borrower applying for a direct loan under this program would be required to make the following good faith certifications:

- the loan is necessary for ongoing operations of the borrower;
- any proceeds will be used to retain at least 90% of the borrower's workforce until September 30, 2020;

- the borrower intends to restore not less than 90% of its workforce that existed on February 1, 2020, no later than four months after the declared public health emergency in respect of Covid-19 is terminated;

- the borrower is domiciled in the US, with significant operations and employees in the US;

- the borrower is not in bankruptcy;

- the borrower will not pay dividends with respect to common stock, or buy-back shares during the term of the loan;

- the borrower will not outsource or offshore jobs for the term of the loan and two years after completing repayment;

- the borrower will not abrogate existing collective bargaining agreements during the term of the loan and two years after completing repayment; and

- the borrower will remain neutral in any union organizing effort for the term of the loan.

We will be closely monitoring developments with the CESA (b)(4) program, including the mid-sized business component thereof. As and when further information becomes available, we will provide updated guidance. Keep in touch with us to stay apprised of the latest developments.

1.4 Main Street Lending Program

On March 23, 2020, the Federal Reserve stated that it "expects to announce soon the establishment of a Main Street Lending Program to support lending to eligible small-and-medium sized businesses, complementing efforts by the SBA." The CARES Act clarifies that its provisions for assistance to midsize businesses as part of the Coronavirus Stabilization Act of 2020 would be in addition to (and would not limit) the Main Street Lending Program. We expect that the program, when established, will include detailed eligibility requirements and have numerous "strings attached," consistent with existing Small Business Administration programs and programs authorized by the CARES Act.

We will be closely monitoring developments with the Main Street Lending Program, including the mid-sized business component thereof. As and when further information becomes available, we will provide updated guidance. Keep in touch with us to stay apprised of the latest developments.

2. US employment law considerations

Hospitality businesses considering layoffs or across-the-board wage reductions in response to Covid-19 should consult first consult with counsel to understand all of their contractual and statutory obligations with respect to any such action. Where a hospitality business is retaining its workforce, it should consider the expansion of paid sick leave and FMLA under the Families First Coronavirus Response Act (the **FFCRA**), which was signed into law on March 18, 2020.

Among other things, FFCRA offers all US businesses with fewer than 500 employees offsetting tax credits to provide employees with paid leave, either for the employee's own health needs or to care for family members. The legislation will enable employers to keep their employees on their payrolls, while at the same time ensuring that employees are not forced to choose between their paychecks and the public health

measures needed to combat the virus. Note that FFCRA does not alter an employer's obligations with respect to applicable state and local laws, which may be more generous than the FFCRA.

Generally speaking, where a US hospitality business has more than 50 but less than 500 employees, it is a "covered employer" for the purposes of the FFCRA and must provide:

(a) to all employees: (i) 2 weeks (up to 80 hours) of paid sick leave at the employee's regular rate of pay where the employee is unable to work because the employee is quarantined (pursuant to federal, state, or local government order or advice of a health care provider), and/or experiencing Covid-19 symptoms and seeking a medical diagnosis; or (ii) 2 weeks (up to 80 hours) of paid sick leave at two-thirds the employee's regular rate of pay because the employee is unable to work because of a bona fide need to care for an individual subject to quarantine (pursuant to federal, state, or local government order or advice of a health care provider), or care for a child (under 18 years of age) whose school or child care provider is closed or unavailable for reasons related to Covid-19, and/or the employee is experiencing a substantially similar condition as specified by the Secretary of Health and Human Services, in consultation with the Secretaries of the Treasury and Labor; and

(b) to employees that it has employed for at least 30 days up to an additional 10 weeks of paid expanded family and medical leave at two-thirds the employee's regular rate of pay where an employee is unable to work due to a bona fide need for leave to care for a child whose school or child care provider is closed or unavailable for reasons related to Covid-19.

The FFCRA specifies that the emergency leave described therein is in addition to any leave the employer already offers their employees. Employees may use their two week emergency paid sick leave during the first two unpaid weeks of FMLA leave, before paid FMLA leave begins. FFCRA also prohibits covered employers from changing their paid leave policies to avoid compliance.

The employer-paid sick leave liability is capped at $5,100 for full-rate sick pay and $2,000 for two-thirds sick pay.

3. Us tax considerations

US hospitality companies should also take note of the following tax provisions of the FFCRA and the CARES Act.

3.1 FFCRA

(a) FMLA and Paid Sick Leave Tax Credits

In connection with the FMLA leave and paid sick leave required under the FFCRA, the FFCRA provides for a series of refundable tax credits, which may offset the cost of providing paid emergency leave. These may tax credits be used against employer-side Federal Insurance Contribution Act contributions, to which several caps and restrictions apply.

In response to expected cash flow concerns with employers bearing the up-front costs of paid sick and FMLA leave, the CARES Act amended the FFCRA to (i) allow employers to request an advance of the anticipated tax-credits and (ii) provide penalty relief for employers who do notdeposit employer-side Social Security taxes in anticipation of receiving the tax credit.

3.2 CARES Act

(a) Employee Retention Credit

Eligible employers are allowed a refundable payroll tax credit equal to 50% of qualified wages paid to certain employees from March 13, 2020 to December 31, 2020, up to $10,000 per employee.

This credit is <u>not</u> available to any employer that takes out a PPP Loan.

An employer is an "eligible employer" for any calendar quarter (i) during which its operations were fully or partially suspended due to orders from a governmental authority relating to COVID-19; or (ii) during the period beginning with the first calendar quarter in 2020 for which the employer's gross receipts declined by more than 50% measured on a year-over-year basis and ending with the 2020 calendar quarter following the calendar quarter for which such eligible employer's gross receipts exceed 80% of gross receipts measured on a year-over-year basis.

"Qualified wages" includes wages and compensation, including health benefits and, (i) with respect to eligible employers that, on average, employed more than 100 full-time employees during 2019, only includes wages paid to employees not providing services due to the circumstances described above (i.e. wages paid to a furloughed employee); and (ii) with respect to employers that, on average, employed 100 or fewer full-time employees during 2019, includes all wages paid to employees during the time periods described above, regardless of whether the employees are furloughed or actively working.

(b) Delay of Payment of Employer Payroll Taxes

Employers and self-employed individuals may postpone the employer portion of certain payroll taxes otherwise due between the date the CARES Act was enacted and January 1, 2021. Deferred payments are due in two equal installments, with 50% of the deferred amount due December 31, 2021 and the remaining 50% due December 31, 2022.

Employers may <u>not</u> take advantage of this deferral if they take advantage of the PPP Loan forgiveness under the CARES Act.

(c) Modification of Net Operating Loss (NOL) Rules

The 2017 Tax Cuts and Jobs Act (**TCJA**) limited NOLs arising after 2017 to 80% of taxable income and eliminated the ability to carryback NOLs to prior taxable years. The CARES Act temporarily modifies this provision for taxable years beginning before January 1, 2021 by delaying the 80% limitation for 2020 and prior taxable years and allowing corporate NOLs from 2018, 2019 and 2020 to be carried back for up to five years. This allows corporations to carryback NOLs to taxable years for which the corporate tax rate was 35%, as compared with the current corporate tax rate of 21%.

The CARES Act does <u>not</u> permit a taxpayer to use NOL carrybacks to offset the repatriation tax under Section 965 of the US Internal Revenue Code of 1986. However, the CARES Act allows a taxpayer to elect to exclude any taxable year to which Section 965 applies from its NOL carryback.

The CARES Act also relaxes certain taxable income limitations on the use of corporate NOLs that would otherwise apply for taxable years beginning in 2021 and provides special carryback rules for real estate investment trusts and life insurance companies.

(d) **Acceleration of Corporate Alternative Minimum Tax (AMT) Credits**

The TCJA repealed the corporate alternative minimum tax and allowed corporations to recover certain AMT taxes paid as a refundable credit against their regular tax liability, but only over a four-year period beginning in 2018. The CARES Act accelerates the refund timeline by allowing corporate taxpayers to claim the full refund over 2018 and 2019, or if the taxpayer elects, entirely in 2018.

(e) **Relaxation of Business Interest Deductions**

The TCJA generally limited the amount of business interest allowed as a deduction to 30% of adjusted taxable income (**ATI**). The CARES Act increases this limitation to 50% of ATI for 2019 and 2020, except for taxpayers that elect out of this increase. Taxpayers may elect to use their 2019 ATI in calculating their 2020 deductible interest expense. Note that special rules apply to partnerships.

4. Force majeure and mae clauses

As the Covid-19 crisis rages on and US hospitality businesses and their suppliers, service providers, and customers all grapple with their contractual obligations to one another, US hospitality businesses will increasingly find themselves asking whether they or their counterparty may terminate a contract (or at least have their nonperformance excused) due to a force majeure event or a material adverse effect. These provisions cut both ways, and US hospitality businesses will need to understand how to both argue for these provisions (when canceling and renegotiating supplier and service provider agreements) as well as defend against them (when seeking to retain key customer contracts and maximizing future cash flow).

4.1 Force Majeure.

As a general matter, force majeure provisions excuse parties from nonperformance when an unanticipated event or series of events, through no fault or negligence of the party seeing excuse of its nonperformance, prevents performance of the contract. Force majeure clauses appear in many different contexts across the hospitality industry and should always be assessed on a case-by-case basis.

(a) **Force Majeure Event**. The first step in this analysis is determining whether Covid-19, the economic fallout therefrom, or any of the various legislative actions taken in response thereto falls within the scope of contractually defined force majeure events. A generic reference to "act of God," without more, is unlikely to be triggered by the Covid-19 outbreak or ensuing fallout, while specific references to "epidemic," "pandemic," "disease outbreak," "public health crisis," "National Emergency," "acts of civil or military authority," "acts, regulations, or laws of government," "disruption of supply chain," or "disruption of labor force" could trigger the provision. If the force majeure clause enumerates specific events and includes catchall language such as “other similar causes,” New York courts interpret the catchall language as limited to events of the same kind or nature as enumerated. Where a force majeure provision's list of enumerated events purports to be non-exclusive, New York courts are split on whether to treat such list expansively or narrowly. Going forward, we expect to see inclusion of terms such as “pandemic” or “disease outbreak” incorporated into force majeure clauses.

(b) **Unforeseen Triggering Event; Absence of Fault/Control**. New York law implies into every contract a requirement that a party seeking to invoke a force majeure clause must establish that (i) the triggering event was unforeseen or unanticipated at the time of contracting and (ii) it is not at fault for (or was not in control of) the triggering event.

The implied foreseeability requirement reflects New York public policy that contracts should expressly allocate the risk of known or foreseen events. If, for example, the contract was executed after Covid-19 was a known risk, the force majeure defense may be more difficult to establish.

With regards to the no fault requirement, the important distinction is between an event that *itself* prevents performance (which may constitute force majeure) and a party's *response* to an event (which, unless the clause is sufficiently broadly drafted, will not constitute force majeure). Thus, standing alone, poor macroeconomic conditions or financial hardship rarely, if ever, provide a basis to invoke a force majeure clause.

(c) **Contract Cannot be Performed**. Other than holding that mere financial burdens do not generally suffice, New York courts have not exhaustively addressed the question of what degree of impediment to performance must be shown to successfully invoke a force majeure clause. Of course, the level of showing is determined by the contractual language. Some clauses require impossibility. Others refer to seemingly lower burdens, such as impracticability or "hindrance." Where the contract requires a showing of impossibility or illegality, the force majeure clause may be triggered by government regulations that specifically prohibit fulfillment of the contract (i.e., non-essential business closure orders). (Be sure to consider the timing of the triggering event! Where, for example, a non-essential business closure order is in effect until April 30, 2020, the counterparty may not be able to claim impossibility or illegality when attempting to cancel their event on May 5, 2020.) New York courts have not addressed in any detail the meaning of "impracticability," as used in force majeure clauses, but impracticability may be established when it would make no economic or societal sense to require performance. Separate from force majeure, in sale-of-goods cases, the U.C.C. contains provisions addressing commercial impracticability of performance that may apply when the contract fails to address the issue. See N.Y. U.C.C. § 2-615(a).

(d) **Notice**. Many force majeure clauses contain notice requirements, and failure to give timely notice or to give notice in the required manner may prevent the party invoking the force majeure clause (whether for purposes of terminating the contract or excusing nonperformance thereunder) may be denied the benefit they seek. Given the current work-from-home orders in effect across the nation, it may be difficult for parties comply with all formal notice requirements in a contract, and the parties may wish to propose alternative methods of providing notice under the contract for so long as the Covid-19 crisis continues.

4.2 Material Adverse Effect.

Where a US hospitality business is party to an agreement to acquire or dispose of certain stock or assets (including real property) (presumably entered into prior to the rapid escalation of the Covid-19 outbreak in the US), it should consider whether the contract contains a "material adverse change" or "material adverse effect" (an **MAE**) provision and, if so, whether Covid-19 or the ensuing economic fallout constitutes an MAE that would allow the US hospitality business or its counterparty to terminate the agreement or avoid performance thereunder.

MAE clauses in the acquisition context are highly negotiated and should always be analyzed on a case-by-case basis. As a general matter, an MAE clause provides a buyer with a walk away right where during, the period between signing and closing, the target experiences an event or series of events that so severely impact its long-term value that the buyer effectively loses its benefit of the bargain. There is no bright-line test for proving an MAE under Delaware or New York law, but it is an undeniably high bar; the party asserting the provision must demonstrate that the triggering event materially threatens the earnings potential of the target (or the asset) in a durationally-significant manner. Moreover, negotiated MAE clauses often exclude effects related to general economic conditions as well as effects stemming from epidemics or other natural disasters (subject in each case to disproportionate effects on the party in question as compared to the industry in

which it operates). The fact-intensive nature of the inquiry means that MAE-specific claims are unlikely to be resolved at an early stage of litigation. Coupled with the high evidentiary bar and the uncertainty of medical progress on the disease (and the recovery of the US hospitality industry), this means that pursuing such a claim would likely be both expensive and burdensome, with no guarantee of success.

4.3 Common Law Defenses.

If a New York-law governed contract is silent on force majeure and MAE (or any such force majeure clause or MAE Clause does not encompass the Covid-19 outbreak or ensuing fallout), the common law doctrines of impossibility and frustration of purpose may be available to the party seeking excuse of its nonperformance.

(a) **Impossibility**. Under doctrine of impossibility, a party's duty under a contract is discharged when, due to an unanticipated event, and without fault of the party seeking discharge, such duty becomes impossible to perform. The party asserting this defense bears the burden of proving the triggering event (1) was unforeseeable and (2) rendered its performance of its obligations under the contract objectively impossible (not merely more expensive or difficult). The New York courts apply this doctrine narrowly.

(b) **Frustration of Purpose**. The doctrine of frustration of purpose will excuse a party from a contractual duty where an unforeseen event renders the contract in question virtually worthless (not merely more expensive or burdensome). Rather than demonstrating that performance is impossible, the party attempting to avoid performance must demonstrate that the frustrated purpose is so completely the basis of the contract that, without it, the contract would have made little sense. As with impossibility, New York courts apply this doctrine narrowly.

4.4 Preserving Relationships

Every businesses considering its risk mitigation options during these unprecedented times should bear in mind that, eventually, the Covid-19 outbreak will subside and the economy will recover. In order to ensure its own recovery and maximize its growth going forward, every business will need to lean on its longstanding business relationships. Just because a company has a legal right to terminate its contract does not necessarily mean it is in such company's best interests long-term (or even short-term) to cancel that contract.

5. Liquidity; asset-backed loan facilities

Having already experienced significant revenue losses, and still facing substantial reductions in forecasted revenues and an uncertain timeline for industry recovery, many US hospitality companies are seeking to maximize their liquidity and access to cash in order to stay afloat. More and more, we are seeing companies (across all industries) drawing down the maximum amount allowed under their committed credit facilities. Below, we consider some of the potential complications that can arise under these facilities during this protracted Covid-19 crisis and the economic fallout therefrom.

5.1 Financial Covenants, Events of Default, Drawing Conditions.

Generally speaking, a borrower's breach of specified covenants and representations will allow the lender to either declare an event of default and accelerate the loan or declare a drawstop event and restrict the borrower from any further borrowing under the facility. Credit facilities also typically include conditions to any additional drawdowns on the facility, including representations as to the borrower's solvency, no default under the credit facility (and perhaps certain of the borrower's material contracts), and the absence of any

MAE. Prior to any drawdowns, both the drawing conditions and the current and projected future effect on any financial covenants should be carefully considered. In particular, a US hospitality borrower (and its lender) should consider revenue-related covenants (whether based on EBITDA or net income), liquidity covenants, and any borrowing base adjustments that can decrease available credit (i.e., adjustments tied to the borrower's accounts receivable).

Even in the absence of additional drawdowns, financial covenant breaches or violations certain key representations could constitute events of default. Borrowers and lenders should carefully review the insolvency-related provisions as they are often drafted to encompass far more than a formal bankruptcy proceeding (including, in some extreme cases, negotiations with creditors). A brief discussion of MAE Clauses with respect to acquisition agreements is set forth above. As in the acquisition agreement context, MAE Clauses in credit facilities (whether included as a drawing condition or an event of default) are highly negotiated and should be analyzed on a case-by-case basis.

5.2 ABL Considerations

Borrowers with asset-backed loan (**ABL**) facilities should pay careful attention to the values of the assets secured by the ABL, especially as they relate to borrowing base tests. As the value of inventory and receivables of US hospitality businesses decline, such businesses may be hit with heightened reporting requirements, stricter cash management and financial covenant compliance requirements, and even "top up" requirements to post additional collateral to make up for the decline in collateral value, all of which should be weighed against any such business's need for liquidity and the availability of alternative sources of capital.

5.3 Add-Backs, Waivers, Equity Injections

Borrowers facing non-compliance with their obligations under their credit facility can consider several options. Where revenue losses may potentially trip an EBITDA financial covenant, the borrower and lender may consider whether there are any applicable add-backs (i.e., synergies, cost savings, restructuring costs, transaction costs, nonrecurring operating costs and management fees). The borrower might seek a temporary waiver of a covenant or, in exchange for some fee to the lender, a covenant "holiday" for one or more upcoming quarters. In addition to a waiver of at-risk covenants, the borrower could also consider pre-emptive equity injections to remain in line with such covenants (in each case, keeping with any equity cure provisions in the document).

5.4 Amendment, Refinancing

Given that there is no clear timeline for containment of the Covid-19 outbreak or recovery of the US hospitality industry, a one-off waiver may prove insufficient and the borrower may prefer to either amend the credit facility or refinance the loan(s) entirely. In connection with any amendment or refinancing, lenders should consider thorough diligence of the US hospitality company's material customer and supplier contracts as well as its commercial insurance policies.

5.5 Alternative Sources of Liquidity

If a US hospitality business is unable to draw on its existing credit facility (and is unable, or declines, to refinance that debt), it should consider alternative sources of liquidity, including (solely with respect to payroll and certain other operating expenses) the federal relief descried in Section 1 of this Alert, junior lien debt, mezzanine debt, or preferred equity. With ample cash on-hand, private equity sponsors stand out as another source of liquidity; while Covid-19 related losses have required many private equity sponsors to inject cash into their US hospitality business holdings, the valuation reset across the sector also presents them with an opportunity for new investment.

6. Landlord/tenant rights

A hospitality business's leased real property is both a vitally important asset and likely one of its largest liabilities. Whether hospitality businesses have been required by government mandate to close their brick and mortar locations, have voluntary suspended operations, or are operating on a modified basis (i.e., take-out and delivery only), they are facing large monthly liabilities for assets they cannot fully use (with cash that, for the most part, they do not have). Hospitality businesses should review, with counsel, the material terms of their commercial lease agreements to better understand their rights and obligations.

6.1 Key Lease Considerations

(a) **Force Majeure Clauses, Doctrines of Impossibility and Frustration of Purpose**. See above, as the same analysis will apply to New York law-governed leases.

(b) **Continuous Operating Requirements**. Some leases include provisions expressly requiring the tenant to operate in the premises without interruption, even if the tenant is otherwise satisfying its rent obligations. Such covenants can take many forms, requiring that a tenant operate on certain days or between certain hours, and, often, declare that failure to satisfy the continuous operating requirements constitutes an event of default. Tenants defending against a landlord seeking to enforce a continuous operations-related default should consider force majeure or, alternatively impossibility or frustration of purpose.

(c) **Casualty Clauses**. Casualty clauses typically provide tenants and landlords with the option to terminate a lease (or, alternatively, require the landlord to provide the tenant with a rent abatement) in the event that the property is substantially damaged. These clauses focus tend to focus on physical availability of the building and are intended to cover events such as fires, floods, or explosions. As these provisions tend to focus on physical damage, it is unlikely they would provide tenants with any termination or abatement relief due to the Covid-19 pandemic.

(d) **Condemnation Clauses, Eminent Domain**. These provisions typically provide the landlord or tenant with the right to terminate the lease in the event of that the government takes the property via eminent domain (or takes an action that permanently deprives the landlord and/or the tenant of their use of the property). Where a government action deprives the tenant of use of the property, but only for a limited time, these provisions also typically provide that the tenant is entitled to a rent abatement for the time it is deprived of its use of the leased space. While a tenant might be inclined to argue that the mandatory closure constitutes a government taking, such a tenant could have difficult time prevailing on a claim for compensation given that these closures are likely to be characterized as permissible exercises of the state's police power.

(e) **Untenablity Clauses**. Larger hospitality tenants may have negotiated for a provision entitling the tenant to rent abatement during any period when the premises is "untenable." Such a tenant might be able to argue that government-mandated closures render the premises untenable and, on such basis, may seek rent abatement.

(f) **Co-Tenancy Clauses**. Where a hospitality business leases space in an office park or multi-unit building, the lease might contain a provision whereby the tenant's rate is abated in the event other tenants in the park break their lease or cease operations. Given widespread business closures, such a provision could help a tenant get some relief under its lease.

(g) **Monetary Default**. If a hospitality tenant elects not to pay rent (whatever the excuse), a landlord will likely have the right to deliver a notice of monetary default, requiring the tenant to promptly cure the rent default. Failure to cure the default, might entitle the landlord to accelerate the full amount of the lease, draw down on the associated letters of credit, look to tennant's guarantor, and/or evict the tenant.

6.2 Other Considerations

(a) **No Eviction Mechanisms**. Despite that landlords are fully entitled to declare monetary default under the lease agreement for nonpayment of rent, landlords may have trouble enforcing their rights and evicting the tenants for the foreseeable future. In response to the nationwide Covid-19 outbreak, many jurisdictions have closed their courts (including housing courts) for non-emergency matters. New York both announced a postponement of all non-essential court functions and, on March 13, 2020, announced a 90-day moratorium on evictions of commercial tenants. Many jurisdictions are likely to follow suit. Tenants should note that as of now, the moratorium only relates to eviction proceedings, not rent obligations (which, subject to excuse as described above) will still be due.

(b) **Communication is Key**. As discussed with respect to other commercial contracts, hospitality tenants should approach this situation with both concern for the present and an eye towards the future. Depending on the relationship with its landlord, a tenant seeking relief under its lease should discuss the matter with the landlord. To be clear: tenants should not tell the landlord (formally or informally) that they cannot or will not pay rent (as this could be considered a threatened breach), but should instead look to open a constructive dialogue on the severity of the situation and the possibility of modifying lease provisions accordingly. Tenants should not assume that landlords are required to accommodate those requests; indeed the landlord might be proscribed from doing so under its financing obligations in respect of the property. That said, Landlords will likely be incentivized to keep a known tenant on for the long term by accommodating them with a short-term rent reduction (rather than evicting that tenant now and searching for a new tenant in an uncertain economic future). Tenants should be prepared to explain what measures they are taking to address the situation (including seeking any federal funding or alternative sources of liquidity), and should be willing to consider alternatives to abatement that the landlord may offer, including rent deferral or amortization over the remaining term.

7. Commercial insurance

Many hospitality businesses maintain business interruption insurance (**BI Insurance**), which insures against the risk of material damage to property that forces a company to partially or fully close down. Much like a casualty clause in a commercial lease, typical BI Insurance policies typically cover physical damage to commercial properties from events such as floods, earthquakes, fires, or other natural disasters. While some BI Insurance policies include an extension for infections diseases, such extensions are the exception rather than the rule. Indeed, following prior viral outbreaks such as rotavirus, SARS, and others, many BI Insurance policies were drafted to expressly exclude any communicable or contagious disease-related losses. The hospitality business may also have contingent business interruption insurance, which typically insures against losses resulting from an interruption in the policyholder's supply chain due to damage to a supplier's property. Some contingent business insurance policies cover non-physical business interruption.

Assuming the policy does not exclude Covid-19-related losses, the policyholder must still prove that it was the Covid-19 outbreak or the resulting government restrictions caused the claimed losses. This can be a difficult burden to meet. For example, if the hospitality policyholder voluntarily shut down due to safety

concerns, it could complicate the policyholder's recovery under a BI Insurance policy as the insurer will argue that it was the policyholder's voluntary shutdown (not the Covid-19 outbreak or any government action) that caused the losses. Moreover, to the extent there was already a general downturn in business in the area prior to the voluntary shutdown or mandated closure, such a downturn would also undercut the policyholder's damages claims. Similar issues would apply to analysis of any complications with the hospitality business's supply chain.

As always, any assessment of recovery under a policy is a fact-intensive inquiry and should be assessed on a case-by-case basis.

Going forward, be sure to keep an eye on potential state and federal efforts to require insurance companies to retroactively cover Covid-19 business interruption and loss of use claims. As of April 1, New Jersey (A-3844), Massachusetts (S.D. 2888), Ohio (H.B. 589), and New York (A-10226) had all introduced such bills (through New Jersey's was ultimately withdrawn before a vote, and no vote had yet been held on the other three). On March 18, 2020, eighteen members of the United States House of Representatives wrote a letter to the CEOs of the following four insurance trade organizations, requesting coverage for business interruption claims arising from the Covid-19 outbreak: The Council of Insurance Agents & Brokers, The Independent Insurance Agents & Brokers of America, The American Property and Casualty Insurance Association and The National Association of Mutual Insurance Companies.

We will be monitoring these and other similar efforts and, when appropriate, will provide updated guidance on BI Insurance coverage of Covid-19-related losses.

---

[1] See STR: Special Forecast Revision (March 30, 2020).

[2] See National Restaurant Association: Survey of 4,000 Operators (March 25, 2020)

[3] Note: The CARES Act does not alter the SBA's definition of a "business concern." Pursuant to 13 CFR 121.105, a "business concern" is (1) defined as a business entity organized for profit, with a place of business located in the United States, and which operates primarily within the United States or which makes a significant contribution to the US economy through payment of taxes or use of American products, materials or labor" and (2) may be in the legal form of an individual proprietorship, partnership, limited liability company, corporation, joint venture, association, trust or cooperative, except that where the form is a joint venture there can be no more than 49 percent participation by foreign business entities in the joint venture.

[4] Industries with an NAICS code beginning with 72 include:

- Hotels and motels;
- Casino hotels;
- Bed-and-Breakfast Inns
- All Other Traveler Accommodation
- RV Parks and Campgrounds
- Recreational and Vacation Camps
- Rooming and Boarding Houses, Dormitories, and Workers' Camps
- Food Service Contractors
- Caterers
- Mobile Food Services
- Drinking Places (Alcoholic Beverages)
- Full-Service Restaurants
- Limited-Service Restaurants
- Cafeterias, Grill Buffets, and Buffets
- Snack and Non-Alcoholic Beverage Bars

ALLEN & OVERY

KEY CONTACTS

Bill Schwitter

New York

Tel: +1 212 610 6462

william.schwitter@allenovery.com

Jeff Pellegrino

New York

Tel: +1 212 610 6463

jeffrey.pellegrino@allenovery.com

Beth Troy

New York

Tel: +1 212 756 1138

beth.troy@allenovery.com

Devin Spencer

New York

Tel: +1 212 610 6347

devin.spencer@allenovery.com

Allen & Overy means Allen & Overy LLP and/or its affiliated undertakings. Allen & Overy LLP is a limited liability partnership registered in England and Wales with registered number OC306763. Allen & Overy (Holdings) Limited is a limited company registered in England and Wales with registered number 07462870. Allen & Overy LLP and Allen & Overy (Holdings) Limited are authorised and regulated by the Solicitors Regulation Authority of England and Wales.

The term partner is used to refer to a member of Allen & Overy LLP or a director of Allen & Overy (Holdings) Limited or, in either case, an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP's affiliated undertakings. A list of the members of Allen & Overy LLP and of the non-members who are designated as partners, and a list of the directors of Allen & Overy (Holdings) Limited, is open to inspection at our registered office at One Bishops Square, London E1 6AD.

© Allen & Overy LLP 2020. This document is for general guidance only and does not constitute definitive advice. | NYO1-2000076450