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What Hospitality Cos. Should Know About Virus Relief Funds

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On March 27 and April 24, President Donald Trump signed the Coronavirus Aid, Relief and Economic Security, or CARES, Act, and the Paycheck Protection Program and Health Care Enhancement Act,[1] respectively, together providing roughly $2.5 trillion in relief for eligible businesses and governmental bodies affected by the COVID-19 pandemic, with specific provisions focused on the hospitality space.

The CARES Act is comprised of multiple programs for very different kinds and sizes of businesses. To date, all programs envision loans and loan guaranties provided by the U.S. federal government to eligible businesses.

While there are numerous programs addressing different industries and sectors of the market, this article focuses on the $659 billion Paycheck Protection Program, or PPP, and the three Main Street Lending Programs that would, with the benefit of leverage from the Federal Reserve, provide $600 billion for acquisition of participation interests of 85% to 95% in loans made to eligible borrowers. These Main Street Lending Programs are not yet operational.

There has been much written about the PPP as well as about the term sheets concerning the Main Street Lending Program. The purpose of this article is to highlight some issues that are particularly relevant to the hospitality industry.

Paycheck Protection Program

Eligible borrowers under the PPP are businesses with 500 or fewer employees (or in certain industries a higher number of employees) or other businesses that qualify under certain financial criteria. In order to make sure that the loans only go to small businesses, the size test (regardless of the metrics used) aggregates the numbers of employees (or financial metrics) of the borrower with those of its affiliates.

The hospitality industry — companies under an North American Industry Classification System code starting with 72 or recognized as being in the franchise space — won a great exception in the form of a 500-employees exemption per property (and no need to aggregate with affiliates), but there are still a number of aspects of the PPP that limit its effectiveness for the industry.

Who Files?

The unique structure of management agreements where the employees are employed by the manager but the economic burden is the responsibility of the owner has created some confusion over the party that should be filing for the loans. Most industry players have taken the position that the correct filing party should be the owner and it appears that most of the loans have been approved and disbursed that way.

Coverage for Fixed Costs

The PPP provides the borrower with an amount equal to 2.5 times its payroll and the funds received by the borrower may be used to cover the borrower's payroll and some other operating costs. However, 75% of the loan proceeds have to be applied to payroll costs — a definition that includes, in addition to cash compensation, certain benefits, allowance for dismissal or separation, and the state or local taxes assessed on compensation of employees.

And PPP rules limit the maximum reimbursement for the cash component of each employee's salary to a prorated portion of $100,000 per annum. Therefore, borrowers can apply no more than 25% of the loan proceeds to fixed costs such as interest (but not principal) on mortgages or rent, and cannot apply any proceeds to the principal of any loans (including the mortgage), all of which are very significant obligations.

Existing Loans

Most hotel properties carry significant debt, and most property loan documents require the consent of the existing lenders to obtain additional loans. Most lenders will not agree to add additional debt service to the capital stack, even if this comes at a very low interest rate.

Thus, for many properties the PPP loans are only relevant if all or most of the PPP loan is actually forgiven, creating risk for borrowers.

Forgiveness Issues

In order to receive full forgiveness, borrower needs to spend the full loan proceeds during the eight-week period after receiving the loan, as long as at least 75% of the loan proceeds are spent on payroll costs. Full forgiveness is also contingent on returning to precrisis full- time equivalent and salary levels.

This is problematic for businesses that are completely shut down and may not be legally allowed to reopen until after the eight-week forgiveness period is over. If such businesses rehire employees, they face the real possibility of paying for employees that cannot work and then having no funds to pay them after the money from the PPP loans is spent.

Among the many provisions of the CARES Act is one that increases unemployment insurance benefits by $600 per week. This is a sizable increase that makes it difficult for hotels, restaurants and other businesses to rehire employees, as many of their former or potential new employees would be making more in unemployment benefits than what they would make if they came back to work.

To address this issue, a recent change in guidance by the Small Business Administration clarified that if a business made a good faith offer to rehire an employee at his/her pretermination salary and the employee refused the offer, the employee would be excluded from the forgiveness calculation.

Necessity Certification

The PPP application requires the applicant to certify that "current economic uncertainty makes this loan request necessary to support the ongoing operations of the applicant." There have been many questions about this certification and recent guidance by the SBA has provided the following changes/clarifications:

While the CARES Act waives the "credit elsewhere" requirement, borrowers (whether private or publicly traded) must nonetheless carefully review and make the necessity certification in good faith. In so doing, borrowers must take into account their current business activity and their ability to access other sources of liquidity sufficient to support their ongoing operations in a manner that is not significantly detrimental to the business. The SBA has indicated that it is unlikely that a public company with substantial market value and access to capital markets will be able to make the required certification in good faith.

Hedge funds and private equity firms are ineligible to receive PPP loans as they are "engaged in investment or speculation," though portfolio companies of private equity funds may still be eligible if they meet applicable size standards after application of the affiliation rules and can make (after careful consideration) the necessity certification.

There will be a maximum cap of $20 million on the total amount of PPP loans that a single corporate group can receive. Businesses are part of a single corporate group if they are "majority owned, directly or indirectly, by a common parent."

This rule applies to all loans not fully disbursed as of April 30 (and to the undisbursed portion of any partially disbursed loans). For purposes of this new provision, businesses "are subject to this limitation even if the businesses are eligible for the waiver-of-affiliation provision under the CARES Act or are otherwise not considered to be affiliates under SBA's affiliation rules."

The necessity certification and the above changes and clarifications create some significant issues for hospitality industry companies seeking to access PPP loans. The key issues are as follows:

This guidance creates significant uncertainty as to whether a borrower can make this certification when it may have access to other sources of liquidity (e.g., cash reserves, other investments or assets, access to undrawn lines of credit or other debt). It is not clear what constitutes liquidity or when the use of such liquidity would be significantly detrimental.

How does a borrower having an owner or owners with significant capital factor into its evaluation of other sources of liquidity, and therefore necessity for a PPP loan? Such lack of clarity around owner capital and liquidity is particularly relevant for private equity portfolio companies, where sponsors may have complicated ownership structures that involve layers of debt and equity financing. While the affiliation rules had made most potential PE-backed borrowers from other industries ineligible for PPP loans anyway, that was not the case for hospitality businesses with North American Industry Classification System 72 codes or that are franchises.

The single corporate group $20 million cap significantly alters the utility of the PPP for hospitality businesses. Previously each hotel or restaurant in a single corporate group would individually be eligible for a PPP loan up to $10 million each with no aggregate cap, but now such groups are collectively limited to $20 million.

Given the specific guidance concerning public companies, real estate investment trusts are hard pressed to make the necessity certification. In addition, most REITs are organized in corporate structures and would be subject to the $20 million cap.

The lack of clarity around whether, for purposes of the $20 million cap, ownership will be strictly based on equity interest or if a control element is contemplated (or will be later introduced) is problematic for funds that invest in North American Industry Classification System 72 companies. A control test could result in such companies with a common general partner (that has a minority equity interest) being deemed part of a single corporate group and subject to the $20 million cap even when the affiliation waivers would have otherwise made such companies eligible for independent PPP loans (up to the individual per-property $10 million cap with no aggregate cap).

Main Street Lending Programs

In order to qualify, borrowers under the Main Street Lending Programs must have 15,000 or fewer employees, or 2019 annual revenues of $5 billion or less. While these tests would generally make the Main Street Lending Program easier to access for businesses that are not eligible for PPP loans, there are a number of features of this program that limit its availability to some hospitality industry participants.

The SBA affiliation rules applicable to PPP loans also apply to the Main Street Lending Programs, but it appears that the exceptions, including the exceptions that benefit the hospitality industry under the PPP program, do not apply. This means that large companies or companies owned by private equity or other groups that are invested in and control a large number of businesses may not be eligible.

The maximum loan size is limited to an amount that, together with existing outstanding and undrawn available debt, would not exceed four or six times adjusted earnings before interest, taxes, depreciation and amortization of the borrower, depending on the applicable facility. Given the high leverage that is typical for businesses in the hospitality and broader real estate industries, this significantly limits the utility of this program to such industries.

A borrower under the Main Street Lending Programs must agree not to repurchase its or its parent's stock or issue dividends for so long as the loan is outstanding and for 12 months thereafter. The Federal Reserve recently revised the terms of the program to clarify that an S corporation or other tax pass-through entity may make distributions to the extent reasonably required to cover its owners' tax obligations in respect of the entity's earnings.

It is unclear whether this revision was intended to apply to REITs or other pass-through tax conduit structures that are required to distribute most of their income (and not merely owners' tax obligations) as dividends. As many real estate companies are structured as pass-through entities, this could pose a significant problem.

The Main Street Lending Programs loans are not forgivable, and have a four-year maturity. It is likely that existing lender consent would be required to incur, service and repay the new program loans, particularly if they mature inside any existing facilities with a tenor longer than four years.

This is even more difficult given that borrowers are required to agree that they will not repay principal or interest on any other outstanding loans unless they are mandatory and due, meaning that the Main Street Lending Programs' loans could be granted an effective priority for repayment over any existing loans in the event of any voluntary repayment, including in connection with a sale or refinancing.

Eligibility of foreign-owned U.S. businesses to the Main Street Lending Programs remains unclear. The guidance provided in the published FAQs limits foreign ownership of jointventures to 49%, but does not define what constitutes a joint venture, and does not expressly impose any such limitation on other types of businesses.

Under SBA rules, specifically Title 13 of the Code of Federal Regulations Section 121.103(h)— which is not one of the SBA rules cited in the relevant FAQ, a "joint venture" is defined as an association with limited purpose, engaging in no more than three business ventures over a two-year period.

It is not clear whether the FAQ's reference to joint ventures is intended to follow the SBA definition, or why the Main Street Lending Programs would exclude limited purpose entities but not exclude more permanent structures that are majority-owned, or wholly owned, by non-U.S. persons. Further guidance is needed on this topic to determine whether foreign- owned U.S. businesses are eligible under the Main Street Lending Programs.

Conclusion

While the CARES Act has provided some attractive financing programs, they are all new and pose some significant commercial and legal risks for potential lenders. This is an evolving situation and despite the difficult times and need for liquidity, borrowers should approach these loans with diligence and evaluate their options.

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[1] https://www.congress.gov/bill/116th-congress/house-bill/266/text.

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