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Hotel Bankruptcies: 8 Key Issues for Hospitality Advisors

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The COVID-19 pandemic has forced many hospitality professionals and their clients to confront bankruptcy, insolvency, and loan workout issues for the first time since the Great Recession. Chapter 11 presents a host of unique issues for hotels and other hospitality businesses. This article highlights a few key chapter 11 bankruptcy concepts for non-bankruptcy lawyers and other industry professionals to consider as they advise their distressed clients in the coronavirus environment.

1. **Chapter 11 of the Bankruptcy Code.** Chapter 11 allows a business to restructure its liabilities and remain as a going concern upon emergence from bankruptcy. In this way, chapter 11 is unlike chapter 7 of the Bankruptcy Code or state law liquidation proceedings where the business's assets are sold off to pay creditors according to a statutory order or priority. Chapter 11 can be filed voluntarily by essentially any type of business in the hospitality industry, including corporations, partnerships, and limited liability companies.
2. **Automatic Stay.** An immediate benefit for a distressed hotel property upon a chapter 11 filing is the imposition of the automatic stay. Bankruptcy Code section 362(a) triggers the automatic stay upon the debtor's commencement of the bankruptcy case. The automatic stay prohibits all creditors, including secured lenders, from continuing any foreclosure or other proceedings to collect on their debts. The automatic stay similarly halts any existing pre-bankruptcy litigation pending against the hotel debtor, such as personal injury or employee lawsuits. Creditors and litigation parties may request relief from the automatic stay from the Bankruptcy Court, but the stay nonetheless provides a critical "breathing spell" for the debtor to use to formulate a plan for the business to ultimately exit bankruptcy.
3. **Use of Cash Collateral and DIP Financing.** One of the most critical issues in any chapter 11 case is ensuring that the debtor has sufficient cash to operate as a going concern. The coronavirus pandemic has impacted hotel borrowers' liquidity like never before. Secured lenders will generally hold a security interest in a hotel debtor's bank accounts and the cash generated through the operation of the business. The hotel debtor can only use this "cash collateral" with the secured lender's consent or pursuant to a Bankruptcy Court order. In addition, debtors often require liquidity beyond normal operating revenues in order to meet the increased costs associated with operating as a debtor in chapter 11, including professional fees and fees owed to the U.S. Trustee. Bankruptcy Code section 364 permits debtors to obtain post-petition debtor-in-possession or "DIP" financing during the bankruptcy case from existing lenders or third-parties in the market. The Bankruptcy Court, secured lenders, and other parties in interest will expect the debtor to prepare a

detailed 13-week cash flow budget showing projected revenues and expenses. The budgeting process will be instrumental in identifying any DIP financing needs.

4. **Single Asset Real Estate.** The Bankruptcy Code contains provisions that apply to single asset real estate or “SARE” debtors. A SARE debtor is a business that consists of a single property or project that is responsible for substantially all of the debtor’s revenue. Congress enacted the SARE provisions in order to streamline secured lenders’ ability to obtain relief from the automatic stay and foreclose on the property unless the debtor is quickly advancing a plan of reorganization or has resumed making monthly interest payments. From the debtor’s perspective, a determination that a hotel constitutes a SARE debtor can have a substantial negative impact on the prospects for a successful chapter 11 case. A hotel debtor can demonstrate that the SARE provisions do not apply by establishing that it conducts operations and provides goods or services beyond simply owning the real property.
5. **Guarantees of Hotel Obligations.** Hotel owners and sponsors often guarantee the property’s debt obligations, frequently in the form of non-recourse carve-out or “bad boy” guarantees. The automatic stay does not extend to non-debtors and, accordingly, the debtor’s bankruptcy filing will not stop collection actions against the guarantors. Under certain circumstances, the Bankruptcy Court may enjoin creditors from pursuing guarantors during the chapter 11 case, but the debtor’s bankruptcy case alone will not discharge any guarantee of the property’s debt. Guarantees are often a critical business and legal issue in a hospitality bankruptcy case, and the debtor and its advisors should carefully consider the impact of any given course of action on any existing guarantees.
6. **Franchise Agreements.** The automatic stay prohibits a franchisor from terminating the hotel debtor’s franchise agreement. The Bankruptcy Code also permits the debtor to decide to either assume or reject executory contracts, including any franchise agreement. If the debtor elects to assume a franchise agreement, and keep the franchise agreement intact following emergence from bankruptcy, the debtor is required to cure—or provide adequate assurance that it will promptly cure—any outstanding defaults under the franchise agreement. The franchisor is also entitled to adequate assurance that the debtor will be able to continue to perform under the franchise agreement on a go forward basis.
7. **Section 363 Sale vs Plan of Reorganization.** There are two routes for a business to exit chapter 11 as a going concern. First, the debtor can attempt to sell substantially all of its assets under Bankruptcy Code section 363(b). Section 363 sales of material operating businesses are nearly always subject to a robust marketing and auction process. The hotel debtor will need to retain advisors, including attorneys and brokers or investment bankers, capable of conducting such a process. The secured lender will have the right to credit bid its secured claim in connection with any sale process. Second, the debtor can elect to attempt to confirm a plan of reorganization. The debtor’s existing owners and management have the exclusive right to seek confirmation of a plan at the outset of the chapter 11 case. The plan of reorganization will provide for a comprehensive restructuring of all of the debtor’s liabilities, including secured debt, unsecured debt, and vendor and trade obligations. Chapter 11 imposes extensive substantive and procedural requirements that the plan proponent must satisfy in order to obtain confirmation of the plan.

8. **Retention of Professionals.** The hotel debtor's attorneys and financial advisors must file retention applications that are subject to the Bankruptcy Court's approval. If the hotel debtor has existing lawyers that commonly provide advice regarding hospitality issues, such attorneys can continue to represent the debtor during the bankruptcy, with an experienced bankruptcy lawyer serving as co-counsel. Lawyers' and financial advisors' fees and costs are also subject to Bankruptcy Court approval. Some Bankruptcy Courts permit attorneys and other professionals who will not have an active role in the bankruptcy case to serve as an "ordinary course professional" with streamlined retention and payment requirements.

The coronavirus pandemic is making hospitality industry lawyers and other advisors confront critical legal and business issues that are challenging the survival of many businesses. Attorneys and other professionals should thoroughly consider the bankruptcy issues presented by this article in order to help their clients formulate a game plan to successfully navigate the chapter 11 process.



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