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Newsletter

February 2024

Does a traditional hotel management agreement remain fit for purpose in a post COVID world ? - An Update

In brief

There have been many attempts to update hotel management agreements ("HMAs") to cater for the inherent uncertainty of dealing with the contractual relationship between an owner and an operator who are in the business of selling an inherently perishable service - if you don't sell that hotel room tonight you will never have the opportunity to sell that night ever again.

The overwhelming impact of COVID-19 has led to a fundamental rethink as to whether traditional concepts embedded in HMAs remain fit for purpose. In the opinion of the authors, significant aspects of the traditional HMA are in need of a calibration and in some instances a fresh approach. By way of background, traditionally HMAs are skewed in favour of operators – for example, as mentioned below, current variations of performance based termination provisions generally fail to give an owner the ability to terminate a HMA even in the face of obvious and profound operator underperformance. The inherent uncertainty with running a hotel business combined with the competitive tension amongst operators is tending to move the dial more in favour of owners. This is beneficial for owners, of course, but also operators as it makes investment in the hotel industry more attractive in a world with limited and increasingly selective capital to invest.

In November 2022 we published a newsletter seeking to deal with a number of the more significant curly topics on HMAs.

In this issue

In view of the significant number of HMA negotiations we have undertaken over the last year or so both in Australia and internationally, we consider it is timely to update the topics discussed in our previous newsletter.

As is usual, the views expressed in this newsletter are the writers' alone.

While the issues discussed are primarily from an Australian perspective, by and large the concepts are universal. We trust that you will find what follows at least worthy of your consideration and perhaps a little thought provoking.

1. Construction Milestones - for a new build hotel

Position as at November 2022	Suggestions as at November 2022	Explanation as at November 2022	February 2024 Update
• Absolute obligations on owner to achieve various construction milestones (e.g. finance commitment, development approvals, construction commencement, practical completion) by specified dates which constitute events of default if the milestones are not achieved.	• Absolute obligations to achieve milestones are moderated to reasonable efforts. • Events of default moderated to events of termination as a sole right and remedy.	Exposing an owner to a potential damages claim for these defaults is an unfair sanction given increased post COVID-19 commercial uncertainties, that are events beyond an owner's control or influence.	There has been general movement consistent with our suggestions, particularly with vulnerabilities seen in the construction industry.
• If milestones are not achieved, only operator can terminate HMAs.	• Operator has the right to terminate within specified period from date of milestone default (say 6 months) so as to not unreasonably tie up its Brand if the development is not progressing. If operator does not terminate within this period then owner may then have the right to terminate within another specified period . Termination rights may be subject to or suspended if there is any dispute under expert determination regarding permitted delays. • If the HMA is terminated then operator may be entitled to liquidated or agreed damages as a sole right and remedy.	• If owner is unable to construct the hotel and wishes to pursue other non-hotel uses for the land and the operator elects not to terminate the HMA, then owner is prevented from implementing their alternate use plans that has a drastic impact on the owner's asset. • Operator should be compensated for costs incurred to date and the opportunity cost of the deal, being an amount that the parties may agree on.	• Operators remain resistant to affording an owner termination rights if milestones not achieved and the operator elects not to terminate. • One possible course of action is to provide that if owner triggers election to terminate then it must pay the operator a substantial termination fee to reassure the operator that the owner is genuine in its inability to meet the milestone(s). Additionally the owner will be expected to undertake that it will never construct a hotel on the site or if the owner resumes development of a hotel, the operator has a first right to operate the hotel on substantially the same terms.

2. Brand Standards - during construction and operation of hotel

Position as at November 2022	Suggestions as at November 2022	Explanation as at November 2022	February 2024 Update
• Brand Standards details are usually only disclosed after the HMA is signed • Aspects of Brand Standards are often more demanding than relevant Australian standards e.g. fire safety requirements or regulations, attracting non-budgeted costs and potential construction delays as well as ongoing operational cost issues. • Operator may update their Brand Standards during construction and operation tenure of the Hotel and an owner is required to implement changes to meet	• Brand Standards to be disclosed earlier than HMA execution - perhaps under stringent confidentiality obligations – to provide clarity as to what is required for hotel works to meet the Brand Standards. • A freeze on Brand Standard changes should apply once final plans and specifications for the Hotel construction are approved by operator and also for a certain period of time e.g. 5 years after Hotel Opening. There may be certain exceptions for fire, health and safety requirements. To the extent there are changes to Brand	• The impact of Brand Standards compliance on construction and operational costs should be able to be determined as soon as possible once the operator is identified to assist development planning, scope of construction works, development program and costing to both parties' benefit. • Implementing Brand Standards changes may not only require significant capital outlay that are not budgeted but may also cause delays to completion of a new build hotel that also carries a cost and may trigger defaults under financing arrangements.	• There has been no change to the November 2022 position. • However, if the operator is not prepared to disclose the Brand Standards then warranties may need to be obtained from the operator to the effect that there are reasonably detailed written Brand Standards that the owner can easily access and which will not delay construction or add to the construction costs – this is particularly the case in relation to the launch of a new brand where there are no existing hotels that can serve as benchmarks to the finished product. • However operators are increasingly agreeable to a Brand

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new or additional Brand Standards.	Standards that relate to such requirements that are more stringent than Australian standards and require significant capital outlay for owner, then owner should be able to refer matter to expert determination.		Standards freeze period (usually three (3) to five (5) years) from the HMA commencement date or the Hotel opening date save where the change to the standards relate to compliance with laws. A concession on Brand Standards is usually documented in a side letter.

3. Assignment, Novation Deed and First Refusal Right

Position as at November 2022	Suggestions as at November 2022	Explanation as at November 2022	February 2024 Update
• **Assignment** - Restrictions usually apply to the person who can purchase the hotel (e.g. not an operator competitor, financially sound, of good reputation) which are not usually clearly defined. • **Novation Deed** -This is typically an operator specific document and should be reviewed carefully. One recent example sought to make a purchaser liable for the period from execution of the HMA until acquisition of the hotel by the purchaser - this is a major commercial and risk issue for an owner that has to present such a sale condition to prospective purchasers. • **First Refusal Right** – There are various forms of a first refusal right but generally it gives the operator a priority to acquire the hotel either when the owner receives an unsolicited offer or seeks to undertake a market sale of the hotel.	• Any disputes to be referred to expert determination rather than arbitration or court proceedings although this practically requires clarity on the relevant criteria e.g. how financial capacity of an assignee is to be measured. • A further or alternative approach to any problematic consideration of the financial capacity of an assignee is for actual (rather than notional or accounting) contributions to the FF&E reserve and a capital expenditure account. • An owner's liability should only cover the period of that owner's ownership of the hotel. • First refusal rights should be given very careful consideration as they could significantly impede the sale of the hotel. If a right of first refusal is granted, then the terms should be clear and not effectively be a last right of refusal. A fee for such rights should be also considered.	• Experts can resolve disputes quickly (and relatively inexpensively). • If a new owner's liability exposure covers a period outside its ownership this is an unknown liability component which is very difficult/impossible to determine and complicates any sale of the hotel. • If there is a first refusal right then any potential purchaser will be reluctant to incur due diligence costs so will either not proceed or request the owner seller to underwrite their costs. • A first refusal right has value and the owner should be compensated for providing it.	• **Assignment – o**perators still require restrictions to apply. Owners and their financiers may negotiate further definition on competitor and financial criteria. • **Novation Deed –** the "recent example" referred to in the first column seems isolated to one operator. • **First Refusal Right** – this is seemingly in terminal commercial decline.

4. Financier Restrictions and Non-Disturbance Agreements

Position as at November 2022	Suggestions as at November 2022	Explanation as at November 2022	February 2024 Update
• Operators may impose significant restrictions on who an owner can borrow from and on what terms. • Operators usually require that the owner procure their financier to enter into a non-	• Any financing restrictions on owner would need to be considered very carefully. • While it is recognised that the principal purpose of a non-disturbance agreement is to preserve an operator's	• The financier landscape is changing significantly and it is increasingly uncertain in a post COVID-19 world as to who are the lenders and lending terms.	• Operators are generally sympathetic to owner concerns. In one international negotiation it was evident that the generally held approach of financiers in that jurisdiction was not to enter into NDAs. The operator was prepared

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disturbance agreement and this is an absolute obligation on an owner.	tenure under a HMA, the obligation to obtain a non-disturbance agreement may not be possible or feasible (or moderated to reasonable efforts).	• Any restriction should take into consideration the impact of multiple financiers (e.g. a syndicate of primary financiers rather than just one and one or more potential mezzanine financiers). Non-bank financiers are likely to have different lending policies and practices to those held by traditional hotel financiers. • Increased post COVID-19 uncertainty as to the identity and requirements of alternative financiers needs enhanced flexibility.	to waive the obligation on the basis that the obligation would be reinstated if the general approach adopted by financiers substantially changed. A waiver is more likely in relation to project financing of a new build hotel. Operators may require that this concession be contained in a side letter but this needs to be considered closely as it may have a negative impact on sale price.

5. Dispute Resolution

Position as at November 2022	Suggestions as at November 2022	Explanation as at November 2022	February 2024 Update
• Arbitration as the dominant dispute resolution mechanism if specified in the HMA, or court proceedings (if the HMA is silent), with disputes in relation to specific provisions or issues (e.g. annual operating budgets) subject to binding expert determination.	• Either binding expert determination for all provisions in the HMA or binding expert determination as the dominant dispute resolution mechanism with arbitration for specific provisions (e.g. default based termination).	• Binding expert determination is relatively quick, inexpensive and conclusive. To have an efficient dispute settlement mechanism is a commercial issue because of the potential disruption to operations or impact on operational costs.	• The need to consult dispute settlement mechanisms in HMAs has increased significantly. • These provisions should be negotiated to operate as clearly and effectively as possible as when a dispute occurs the parties are generally not well disposed to agree on anything. In particular the identity of an expert should be specified and the expert determination and/or arbitration process mapped out comprehensively.

6. Operational impacts

Position as at November 2022	Suggestions as at November 2022	Explanation as at November 2022	February 2024 Update
• **Employees -** All employees (except potentially general manager, financial controller and director of sales and marketing) employed by the owner but under the operator's control. • **Marketing -** All marketing, both system wide and hotel specific, under the operator's control. • **Operations (including partial and total closure) -** All operational decisions made by the operator.	In pandemic like circumstances: • owner to be consulted with respect to employee issues such as new employees reduction of hours and termination/redundancy. • where borders are closed and free movement interrupted, owner to have enhanced ability to review and determine marketing expenditure to the extent it relates exclusively to the hotel and not the brand generally. • owner to be consulted to determine when and in what	• A pandemic significantly impacts ordinary operating conditions resulting in the need for the owner to have more involvement with hotel operations some aspects of which may be influenced or driven by their financier's imperatives. A crisis affecting a hotel invariably will require all parties who have collective interests in the hotel to work co-operatively to protect the hotel enterprise.	• **Employees –** owners are increasingly demanding greater control over the engagement and selection of the head chef and the employment terms relating to this position, particularly if the hotel is destination based and F&B offerings of the hotel is a key component of the business. • **Marketing** – owners are increasingly requiring that marketing funds be channeled toward more hotel specific activities – particularly where the brand and/or the operator are new to the jurisdiction.

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	manner hotel operations should be scaled down, modified (e.g. to be a quarantine hotel) or completely closed down and for what period, subject to considerations as to Brand Standards and overall hotel business and market reputation.		• **Operations –** there are increasingly collaborative commercial arrangements with named or established F&B operators in hotels, especially the split between the F&B aspects of a hotel business and otherwise with an independent dedicated F&B operator in control of those aspects including the relationship between the hotel operator and the F&B operator and between these operators and the owner need to be carefully considered.

7. Annual Budget [Body Text]

Position as at November 2022	Suggestions as at November 2022	Explanation as at November 2022	February 2024 Update
• Operator prepares draft budget for owner approval excluding specified line items (e.g. operator fees and charges, utility and insurance payments, employee remuneration). •	• owner approval exceptions should be limited to the maximum extent e.g. operator fees and charges but not utility and insurance payments, employee remuneration. • Either owner or operator has election to revise budget should circumstances change with the other party's approval (subject to potential impact on any relevant performance termination provision and proportionate adjustments of thresholds in those provisions).	• Living in enhanced economic and operational uncertainties post COVID-19 or any future similar crisis means that the process of formulating a budget should be as flexible as possible and amenable to maximum collaboration between owner and operator to accommodate unpredictable circumstances.	• Operators are increasingly more open to owners having certain approval rights over major budget items or if there are none then there needs to be detailed explanations as to proposed budgets. • Owners generally do not have an issue with the expenditure item or the rationale but wish to weigh in on the means by which the expenditure is undertaken and particularly the cost.

8. Area of protection

Position as at November 2022	Suggestions as at November 2022	Explanation as at November 2022	February 2024 Update

• Operator prohibited from operating another hotel under the same brand as the hotel within a specified area for a specified period.	Such restraint on the operator to be dispensed with.	• Questionable what benefit such a restraint on the operator provides when many operators (particularly international operators) have many brands and there are no restrictions as to adding new brands which are similar to or even compete with existing brands. Also query if an owner of another hotel in the area would choose to operate their hotel with the same brand.	• Owners still favour AOP restrictions despite the shortcomings. In fact owners are adopting a more stringent approach and seeking to eliminate or minimise any exceptions to the AOP restrictions. For example:
			  • Owners are insisting that AOP restrictions remain in place for the full HMA term.
			  • If an operator acquires a competing chain which has one or more hotels within the AOP then owners usually prohibit any conversion of any such hotels to operate under the same brand as the subject hotel.

Position as at November 2022	Suggestions as at November 2022	Explanation as at November 2022	February 2024 Update
			• Some owners are asking to be notified of any other hotels (under other brands) operated by the operator in the AOP and suggesting covenants on operators to not adopt biased or more favourable practices or services to other hotels.

9. Performance tests

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• Common tests are:
  • actual profit v/s budgeted profit; and/or
  • hotel RevPAR v/s competitive set RevPAR.
• A breach of the test(s) must occur over consecutive years (generally 2 or 3).
• Multiple cure rights usually in the form of a top up payment.
• Cure right payment is usually top up to around 85% of budgeted profit for one (1) of the test years selected by the operator.
• Expansive force majeure or other exceptions apply to the tests.
	Either amend performance test provisions to narrow down the tests and cure rights and increase stringency of the tests or consider entering into a manchise rather than a HMA.	• It is highly doubtful that operators will agree to suggested amendments to significantly increase the prospect that performance termination provisions can be triggered.
		• Rather than fruitlessly seeking to negotiate a better performance termination provision, an owner may an election (perhaps after a specified period) to convert from a HMA to a franchise (substantially in the form of a franchise agreement annexed to the HMA for a brand (if the hotel brand is not a franchise brand) on terms that are commercially acceptable to the operator) i.e. a manchise.
		• This results in:-
		  • owner securing operational control of the hotel while retaining most of the operator provided benefits of a HMA;
		  • Operator retaining an ongoing association with the Hotel and continuing to receive a fee stream and other ongoing benefits.
		  • Removal of the prospect of costly and potentially lengthy legal proceedings as to whether any attempt to terminate based on the performance termination provision is valid.
		• Further areas of consideration regarding manchises:-
		  • the ongoing need to have a performance termination provision in the HMA at all;
		  • the prospect of extending the term of the franchise agreement past the expiration date of the HMA
			The manchise concept is gaining traction both in Australia and elsewhere in Asia (noting that manchises have been in China for some years). We understand that manchises are a well settled form of hotel operation model in markets such as the USA.

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		as a further inducement to the operator to enter into a manchise.	

10. Early termination

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• Without cause termination in the absence of sale is extremely rare. • Vacant possession on sale is increasingly rare and if available is usually only capable of activation many years into the life of the HMA (e.g. 6 years into a 15 year HMA) and upon exercise, requires a substantial termination fee to be paid to operator.	• Operators are strenuously opposed to without cause termination and will probably never agree to its inclusion except in highly exceptional circumstances. In the absence of such a provision, consider a manchise. • Termination on sale at the owner's election is highly pursued irrespective of the quantum of the termination fee that would be payable as the ability to deliver vacant possession may be highly valuable. owners however should expect to pay a substantial termination fee to operators if such a termination right is triggered.	• A right to terminate without cause is normally sought to deal with sustained and profound operator underperformance taking into consideration the practical shortcomings of current performance termination provisions. Manchises provide the prospect of a win/win result for an owner and an operator in these circumstances. • Empirical evidence (and common sense) suggests that hotels attract a (significantly) higher sale price if vacant possession is available primarily because (a) it opens up the market to potential purchasers who may not wish to have the incumbent operator; and (b) it allows operator competitors who also invest in hotel assets to bid (although there are few who fall into this category).	• Owners are increasingly demanding termination on sale either from the commencement of the HMA or as soon thereafter as can be negotiated. While operators are less opposed to the concept there is usually significant discussion as to when the right arises and the quantum of the Termination Fee. Operators however express the strongest opposition to termination rights with respect to their luxury brands and prized locations.

Conclusion

The ramifications of the COVID-19 experience in confluence with tough economic conditions that are still in play have exposed and heightened real flaws in the dynamics and concepts inherent in traditional HMAs.

Serious thought needs to be given and is in fact being given to addressing shortcomings of traditional HMAs to reflect current realities and future similar crises to the hotel industry.

Moving forward, attention will continue to intensify on how a HMA can drive the maximisation of hotel operating performance and ultimately hotel sale value. This benefits not only owners but operators too.

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