

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

In brief

There have been many attempts to update hotel management agreements (**HMA**s) 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 rethink or perhaps reinvigorate the discussion as to whether traditional concepts embedded in HMAs remain fit for purpose. In the opinion of the authors, certain significant aspects of the traditional HMA are in need of a calibration and in some instances a fresh approach. An instructive remark here - the authors' opinions in this newsletter are personal to them and may not be shared by other Baker McKenzie lawyers who practise in this space.

This newsletter seeks to deal with a number of the more significant curly topics including what we regard as the most sensitive of all topics - how to meaningfully deal with sustained and profound operator underperformance that is amplified in market challenging circumstances such as the COVID-19 pandemic. We consider that there is an eminently viable win/win solution to this age old dilemma. These issues should be addressed now - the next pandemic-like event could be just around the corner.

While the issues discussed in this newsletter are primarily covered 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.

In this issue

In brief

Construction Milestones - for a new build hotel

Brand Standards - during construction and operation of hotel

Assignment, Novation Deed and First Refusal Right

Financier Restrictions and Non-Disturbance Agreements

Dispute Resolution

Operational impacts

Annual Budget

Performance tests

Early termination

Conclusion

1. Construction Milestones - for a new build hotel

Current Position	Suggestions	Explanation
<ul style="list-style-type: none"> Absolute obligations on the 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. 	<ul style="list-style-type: none"> Absolute obligations to achieve milestones are moderated to reasonable efforts. Events of default moderated to events of termination as a sole right and remedy. 	<ul style="list-style-type: none"> Exposing an owner to a potential damages claim for these defaults is an unfair sanction and inhibits hotel developments given increased post COVID-19 commercial uncertainties that are events beyond an owner's control or influence.
<ul style="list-style-type: none"> If milestones are not achieved, only operator can terminate HMAs. 	<ul style="list-style-type: none"> The 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 the 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 	<ul style="list-style-type: none"> If the 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 the owner is prevented from realising the full potential and value of their asset. This is also not a position that is likely to be acceptable to a project financier.

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| <ul style="list-style-type: none"> determination regarding permitted delays. If the HMA is terminated then the operator may be entitled to liquidated or agreed damages as a sole right and remedy. | <ul style="list-style-type: none"> The 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. |
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2. Brand Standards - during construction and operation of hotel

Current Position	Suggestions	Explanation
<ul style="list-style-type: none"> 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 and an owner is required to implement changes to meet new or additional Brand Standards. 	<ul style="list-style-type: none"> Brand Standards to be disclosed earlier at negotiation of the HMA - under stringent confidentiality obligations – to provide clarity as to what is required for the hotel works to meet the Brand Standards. A freeze on Brand Standard changes should apply once final plans and specifications for the hotel works are approved by operator and also for a certain period of time e.g. 5 years after opening of the hotel. There may be certain exceptions for fire, health and safety requirements. To the extent there are changes to Brand 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. 	<ul style="list-style-type: none"> 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. An owner (and its financier) would need to focus on establishing and stabilising the income flow of the hotel on completion of the hotel and not have to contend with additional capital costs.

3. Assignment, Novation Deed and First Refusal Right

Current Position	Suggestions	Explanation
<ul style="list-style-type: none"> Assignment - Restrictions or criteria apply to a prospective purchaser (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 that can include onerous terms. 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,. 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. 	<ul style="list-style-type: none"> 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 to have an election 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. 	<ul style="list-style-type: none"> A sale of a hotel is a process that requires precision and timeliness. 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 . A misallocation of risk is a major issue for an owner and any prospective purchaser and complicates any sale of the hotel. If there is a first refusal right over the hotel any potential purchaser will be reluctant to incur transactional costs and is likely to either not proceed or request the owner seller to underwrite their costs if the refusal right is exercised. A first refusal right has value and the owner should be compensated for providing it.

4. Financier Restrictions and Non-Disturbance Agreements

Current Position	Suggestions	Explanation
<ul style="list-style-type: none"> Operators may impose significant restrictions on who an owner can borrow from and on what terms. Operators usually require that an owner procure their financier to enter into a non-disturbance agreement and this is an absolute obligation on the owner. 	<ul style="list-style-type: none"> Any financing restrictions on an owner e.g. loan to value, interest coverage to be considered very carefully, particularly in the context of portfolio and cross collateralisation arrangements of the owner. While it is recognised that the principal purpose of a non-disturbance agreement is to preserve an operator's tenure under a HMA, the obligation to obtain a non-disturbance agreement may not be possible or feasible (or moderated to reasonable efforts). 	<ul style="list-style-type: none"> 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. 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 requiring flexibility or accommodation of their requirements in HMAs.

5. Operational impacts

Current Position	Suggestions	Explanation
<ul style="list-style-type: none"> Employees - All employees (except potentially general manager, financial controller and director of sales and marketing) are employed by the owner but under the operator's control. Marketing - All marketing, both system wide and hotel specific, are under the operator's control. Operations (including partial and total closure) - All operational decisions are made by the operator. 	<p>In pandemic like circumstances:</p> <ul style="list-style-type: none"> the owner would be consulted with respect to employee issues such as new employees reduction of hours and any termination or redundancy. where borders are closed and free movement of people interrupted, the owner is to have enhanced ability to review and determine marketing expenditure to the extent it relates exclusively to the hotel and not the brand generally. the owner is to be consulted when and in what 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. 	<ul style="list-style-type: none"> 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. Although the parties are more than likely to consult and attend to the matters as suggested, owners and in particular their financiers are likely to seek more clarity in HMAs to deal with such matters. 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.

6. Annual Budget

Current Position	Suggestions	Explanation
<ul style="list-style-type: none"> Operator prepares a draft budget for owner's approval that typically excludes specified line items (e.g. operator fees and charges, utility and insurance payments, employee remuneration). 	<ul style="list-style-type: none"> 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 the owner or the operator has election to revise budget should circumstances change with the other party's approval (subject to potential impact on any relevant performance 	<ul style="list-style-type: none"> Living in heightened economic and operational uncertainties post COVID-19 or any future similar upheaval 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.

termination provision and proportionate adjustments of thresholds in those provisions).

7. Dispute Resolution

Current Position	Suggestions	Explanation
<ul style="list-style-type: none"> Arbitration is 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. 	<ul style="list-style-type: none"> 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). 	<ul style="list-style-type: none"> Binding expert determination is relatively quick, inexpensive and conclusive. To have an efficient dispute settlement mechanism should be a commercial priority because of the potential disruption to operations or impact on operational costs.

8. Area of protection

Current Position	Suggestions	Explanation
<ul style="list-style-type: none"> Operator is prohibited from operating another hotel under the same brand as the hotel within a specified area for a specified period. 	<p>Such restraint on the operator to be dispensed with.</p>	<ul style="list-style-type: none"> It is questionable as to the benefit such a restraint on the operator provides when many operators (particularly international operators) have many brands and there would be no restrictions on the creation of 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.

9. Performance tests

Current Position	Suggestions	Explanation
<ul style="list-style-type: none"> Common tests are: <ul style="list-style-type: none"> 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 that are usually in the form of a top up payment. Cure right payment is usually an amount to 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. 	<p>Either amend performance test provisions to narrow down the tests and cure rights and increase stringency of the tests or consider entering into a franchise rather than a HMA.</p>	<ul style="list-style-type: none"> The topic of performance tests is understandably a fraught subject with operators. Rather than fruitlessly seeking to negotiate a better performance termination provision, an owner may consider including in the HMA 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 franchise. This provides: <ul style="list-style-type: none"> The owner securing operational control of the hotel while retaining most of the operator provided benefits of a HMA; The operator retaining an ongoing association with the Hotel and continuing to receive a fee stream and other ongoing benefits.

- Potential removal of the requirement for any performance tests and the prospect of costly and potentially lengthy legal proceedings as to challenges to the validity of any attempt to terminate based on the performance termination provision.
- The parties may also consider the prospect of extending the term of the franchise agreement past the expiration date of the HMA as a further inducement to convert to a manchise.

10. Early termination

Current Position	Suggestions	Explanation
<ul style="list-style-type: none"> Without cause termination in the absence of sale is extremely rare. Vacant possession on sale is increasingly rare and if available is usually only applicable many years into the life of the HMA (e.g. 6 years into a 15 year HMA) and if exercised, requires a substantial termination fee to be paid to the operator. 	<ul style="list-style-type: none"> 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, the parties may 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 can be highly valuable. Owners however should expect to pay a substantial termination fee to operators if such a termination right is triggered. 	<ul style="list-style-type: none"> 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. There may be exceptions in certain markets but empirical evidence 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).

Conclusion

- COVID-19 has exposed or enhanced real flaws in the dynamics and concepts inherent in traditional HMAs.
- Serious thought needs to be given to addressing shortcomings of traditional HMAs to reflect current realities and anticipate future similar crises to the hotel industry.
- Moving forward, we would surmise that there will be much more focus on the extent the contractual relationship between an owner and an operator (whether this is a HMA, a manchise, lease or some other formulation) is connected to maximizing the economic value of a hotel and how such legal and commercial matters are balanced in the agreement between the parties.

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