

Insights

IMPACT OF COVID-19 ON PERFORMANCE TESTS IN HOTEL MANAGEMENT AGREEMENTS

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SUMMARY

COVID-19 has had a dramatic impact on the hotel sector, causing occupancy rates to plummet around the world. Periods of closure and low occupancy will have a negative effect on the financial performance of affected hotels and may trigger performance test clauses in hotel management agreements. In this article, we examine the typical structure of a performance test, whether they are likely to be triggered due to the COVID-19 pandemic and whether operators have any options to avoid termination.

Introduction

The COVID-19 pandemic has had a dramatic impact on the hotel sector, causing occupancy rates to plummet around the world. With many countries struggling to bring the pandemic under control and reopen their economies, as well as the risk of future waves of infection and lockdown until an effective vaccine or treatment is found, this impact is likely to be felt for some time yet. Periods of closure and low occupancy will negatively affect the financial performance of hotels and may trigger performance test clauses in hotel management agreements. In this article, we examine the typical structure of a performance test, whether they are likely to be triggered by the COVID-19 pandemic and whether operators have any options to avoid termination.

Typical performance test structures

Most hotel management agreements (“**HMA**s”) include a performance test that allows the owner to terminate the HMA if the operator fails to achieve certain financial performance metrics.

These tests are typically two-pronged and include:

- a gross operating profit test (“**GOP Test**”) that tests whether the operator is operating the hotel profitably. The GOP Test compares the actual gross operating profit (“**GOP**”) achieved by the hotel in a testing year against the budgeted GOP for that year. If the actual GOP is less than a

specified percentage of the budgeted GOP (usually between 80% and 90% depending on the bargaining strength of the parties when the HMA is negotiated) then the operator will fail the GOP Test for that testing year; and

- a revenue per available room (“**RevPAR**”) test (“**RevPAR Test**”) that tests whether the operator is generating revenue at the hotel in line with (hopefully better than) a set of competing hotels (generally referred to as the “competitive set”) using data available from industry benchmarking services such as STR. If the hotel’s RevPAR in a testing year is less than a specified percentage of the competitive set’s average RevPAR (again, usually between 80% and 90%) then the operator will fail the RevPAR Test for that testing year.

Under a typical performance test clause, the operator would have to fail both the GOP Test and the RevPAR Test in two consecutive testing years before the owner can terminate the HMA. Having said that, we are seeing an increasing number of single prong performance tests based on the GOP Test only so it is important to review the specific language of the performance test clause in the HMA. However, it would be unusual (if not unheard of) for the performance test period to be less than two consecutive testing years.

Is the COVID-19 pandemic likely to trigger an owner termination right for performance test failure in 2020?

In our view, the COVID-19 pandemic is not likely to trigger an owner termination right for performance test failure in 2020 for two reasons:

- Most performance tests can only be triggered if the operator fails for two consecutive testing years. So unless the operator has already failed the performance test in 2019, the owner will not be able to terminate the HMA if the operator fails in 2020. However, 2020 could be the first of the two consecutive failed testing years required to trigger the owner’s termination right meaning that owner may be able to terminate if the operator fails again in 2021.
- Most performance tests require the operator to fail both the GOP Test and the RevPAR Test. The COVID-19 pandemic has caused many hotels to either close for an extended period of time or to experience very low (in some cases single digit or even zero) occupancy. Whilst some hotels have been able to offset these losses by taking on government contracts to house quarantine patients and health workers, the pandemic will nevertheless have a devastating effect on hotel revenues and profitability. As a consequence, it may be that many hotels will fail the GOP Test in 2020, particularly as budgeted GOP would have been set at the end of 2019 when no one expected the coming pandemic. However, the position regarding the RevPAR Test is less clear. The pandemic is a global event and is likely to affect all of the hotels in the competitive set to some degree. It is therefore possible that a hotel may still pass the RevPAR test if the average RevPAR of the competitive set is equally affected by the

pandemic. If that is the case in 2020 then the operator will not fail the performance test in that year.

However, the effects of the COVID-19 pandemic are likely to be felt for a number of years to come so it is possible that we will start to see owner termination rights for performance test failure being triggered from the end of 2021 onwards depending on how quickly the sector recovers.

Does the hotel operator have any options to avoid termination?

Operators usually include a number of options in their HMAs to avoid termination following a performance test failure:

- Most operators include an exception for “extraordinary” or “intervening” events beyond the operator’s control that affect hotel operations. If such an event occurs and the operator can demonstrate that it caused the operator to fail the performance test then the operator will be excused from the failure. Whether or not an operator can invoke this exception for COVID-19 would depend upon the specific drafting of the relevant HMA. From our experience, exception clauses are typically widely drafted and often specifically include events such as epidemics, pandemics, disease, travel restrictions, labour shortages and so forth. If that is the case, operators may, subject to the terms of their specific HMA, be able to invoke this exception to avoid termination for performance test failure in 2020. But it is debateable whether operators will still be able to invoke this exception in 2021 onwards, even if the effects of the COVID-19 pandemic are still being felt. It will be a known event at that point and so can arguably be taken into account in budgeting going forward. This may be an area of dispute between owners and operators in future.
- Many operators also include the option to make a cure payment to the owner to avoid termination. This payment would usually be equal to the shortfall between the actual GOP and the budgeted GOP in one of the failed testing years, with the operator having the option to choose which year, or alternatively having to pay the higher/lower shortfall of the two failed testing years. We have also seen some operators agree to pay the average of the shortfall in both failed testing years. The number of cure payments that an operator can make is often capped. In some instances, owners are also obliged to repay any cure payments made by the operator if the HMA is subsequently terminated for any reason.

Conclusion

The effects of the COVID-19 pandemic are likely to be felt in the hotel sector for a long time to come. This raises the likelihood of many performance test failures over the next few years. However, whether this will result in owners triggering termination rights remains to be seen. Operators will have options to avoid termination. And owners should also consider whether it makes commercial sense to terminate their operators at a time when the strength of their brand and management services are potentially needed more than ever.

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