

Insights

GLOBAL COVID-19: IMPLICATIONS OF CORONAVIRUS FOR HOTEL OWNERS AND OPERATORS

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SUMMARY

Hotel owners and operators will need to work together effectively during the current outbreak of novel coronavirus, foremost to ensure the health and safety of their guests and employees, but also to ensure the continued financial health of the hotel's business.

The novel coronavirus could have a dramatic impact on global tourism. Some commentators speculate the impact could be far greater than that of SARS in 2003, citing, for example, the massive increase in global tourism from China - approximately 163 million Chinese tourists travelled overseas in 2018, compared to only 20 million in 2003.

This outbreak will have major implications for hotel owners and operators. Hotel occupancy and average daily rates are likely to suffer, as governments impose travel restrictions and hotel guests cancel trips. Hotels may be subject to increased health and safety compliance and reporting obligations, as health authorities look to curtail the spread of the virus - not to mention the negative PR impact of having a suspected case of the virus occur at your hotel.

Hotel management agreements ("HMAs") contain a number of provisions that are hotly debated during negotiations, but then largely forgotten when business is good. However, during difficult times (such as the current outbreak) when hotel performance suffers, these provisions become very relevant. Owners and operators need to be aware of them and their potential implications for the parties' ongoing relationship.

Performance tests and guarantees

Many HMAs contain performance tests that allow the owner to terminate the HMA early if the operator fails to achieve certain financial targets in a testing period. They can also include performance guarantees where the operator underwrites a certain pre-agreed return to the owner.

These clauses typically include carve outs for external factors affecting the hotel's performance that are beyond the operator's control. If the operator can show that any of these external factors apply during a testing period, the operator can potentially avoid early termination for a performance test failure, or having to make a top up payment under a performance guarantee.

Performance test and performance guarantee clauses vary, but it is possible that a virus outbreak could fall into one of these carve-outs. For example, a common carve-out is action of governmental authorities, which could arguably include the imposition of travel restrictions and additional health requirements.

Expect to see operators invoking these carve-outs, where available, to excuse any performance test failures or performance guarantee shortfalls, not just during the outbreak, but also during future testing periods when effects of the outbreak are still felt.

Unbudgeted operating expenses

Control of operating expenses is at the forefront of many owners' minds. HMAs typically include detailed provisions for the approval of the hotel's annual budget, and an obligation on the operator to adhere to the annual budget once approved. They can also include other controls, such as restrictions on incurring financial obligations above certain thresholds and owner control over bank accounts.

However, hotels are dynamic businesses with expenditure demands that vary from day to day and are difficult to forecast accurately. If operators are too constrained in their spending of the annual budget, this can negatively impact their ability to operate the hotel effectively. Consequently, operators look to include exceptions to their obligation to comply with the approved annual budget and any other financial controls in the HMA.

One typical exception is expenditure required to address an "emergency situation." Emergency situations can be broadly defined, but usually encompass situations posing imminent threat to health, life and safety. They can also cover threats to property, or to the operator's brand. It is not difficult to see an operator arguing that the current outbreak constitutes an emergency situation, and therefore justifies any unbudgeted expenditure that the operator needs to incur to protect hotel guests and employees from contagion (and, depending on the drafting of the exception, protecting the operator's brand if any cases of the virus occur at the hotel).

Another typical exception is expenditure required to comply with applicable legal requirements. If government authorities impose additional health and safety requirements on the hotel, the owner may have little oversight over the associated costs if the HMA includes this exception.

Employees

Hotel employees are usually all employed by the owner. However, the operator will retain full control over the hotel's employees and employment policies.

This is arguably justified, as the operator is operating the hotel and needs day-to-day control over the employees, but it leaves the owner bearing all liability for employment costs without any control over the employees or the employment policies adopted by the operator.

This could become an issue for the owner in the current outbreak. For instance, declining occupancy could force the operator to reduce staffing levels incurring redundancy costs and other employment liabilities that the owner will have to bear, but will have little or no say over.

Compliance with law

Given that the operator is generally in full control of hotel operations, it would be reasonable to expect HMAs to include an obligation on the operator to ensure that the hotel is operated in full compliance with laws.

However, this is not always the case, and operators are noticeably pushing back on including this obligation in HMAs. Instead, they often look to place the onus of ensuring that the hotel is in full compliance on the owner (even though the owner has limited or no rights to interfere in hotel operations).

The owner should therefore monitor the relevant government authorities for any new legal requirements imposed on the hotel aimed at tackling the current outbreak, and ensure that these are properly implemented. Where the onus to do this falls on the operator, the owner should nevertheless continue to monitor the situation to ensure that the operator fulfils its obligations, and does not expose the owner to potential liability for non-compliance (as well as hotel guests and employees to possible contagion).

This is of particular concern for the owner, as some operators disclaim any liability arising in connection with the hotel, and seek an owner indemnity covering any claims brought against the operator in this regard.

Force majeure

Most HMAs will include a clause that excuses the parties from their obligations if performance is prevented by a “force majeure event.” The definition of a force majeure event may expressly include virus outbreaks, or may be drafted on a wider basis which nevertheless could be argued to include such an outbreak.

Assuming that the current outbreak does constitute a force majeure event under the HMA, the owner and the operator could escape liability for non-performance of their obligations if performance is prevented by the outbreak. An example of this is the obligation to maintain the hotel to the operator’s brand standards - this may not be possible for a luxury hotel that requires a high staff to guest ratio which cannot be maintained during an outbreak due to high staff absenteeism.

Temporary closure

Some HMAs allow for a temporary closure or curtailment of operations of the hotel to protect the health and safety of hotel guests and employees. The operator would typically have the final say over this, but some HMAs allow for consultation between the parties or even give the owner the right to implement a temporary closure or curtailment if deemed reasonably necessary. This would likely require formal notices, so the parties should check their HMAs carefully to ensure that they comply with any procedural steps that have to be followed before the hotel can be closed or operations curtailed.

Business interruption insurance

Owners are recommended to check to ensure their business interruption insurance policies provide adequate cover in case the hotel is forced to close during an outbreak. This insurance should cover not only the owner's lost revenue but also the operator's fees, as operators typically require owners to continue to pay these during any period of closure (in some instance, limited to the amount of business interruption insurance proceeds received by the owner, but in other instances whether or not any insurance cover is available).

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