

Insights

THOUGHTS FOR WHEN THE LIGHTS COME BACK ON

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SUMMARY

As we all scramble to adapt to ever changing business conditions brought on by the Covid-19 pandemic, one industry which has been overwhelmingly impacted is the hotel industry. Worldwide, hotels have been forced to close as part of mandated “lockdown” situations. Business travel and tourism has been extinguished. The few hotels which remain open have found themselves with no customers left to perform for and global hotel occupancy is now running in single digits.

Dealing with the daily challenges brought about by the COVID-19 pandemic is itself enough but it is also time to start thinking about how to address those legal and commercial issues which are relevant for when the lights come back on for the hotel sector.

We set out below some initial thoughts, which every hotel owner and operator no doubt can supplement with their own unique circumstances.

1) Employees & Utilisation

Hospitality is by nature a people business and hotel employees define and deliver the guest experience. With current demand collapse, various personnel options are being adopted by hoteliers: salary reductions (at senior levels too?), unpaid leave or accelerated holiday, furloughs enabling state aid payments and the more draconian redundancies.

If we are betting on a near term recovery (3-6 months), operators and owners will need to factor in the cost of redundancies and recruiting and training anew (and recognise the lost employee goodwill which arises from redundancies). Keeping employees on board in some form may make economic sense, especially where state aid programs designed to facilitate the retention of those employees are adopted.

This shutdown is also a good time for hotels to reassess their future staff utilisation. Now is the time to consider greater outsourcing, clustering or cross training of certain positions to improve utilisation. Where local labour laws permit, devising revised employment terms (e.g.,

redeployment, part base/part flexible contracts or similar models) may improve efficiencies going forward.

2) Force Majeure and Business Interruption

Virtually the first thing anyone asks a lawyer today is whether Covid-19 is a force majeure (“FM”) event. Firstly check if your contract has a force majeure clause (most HMAs do) and secondly check the choice of law.

In civil law countries, FM is often a statutorily defined concept with less room for negotiation (further information on this can be found [here](#)). In common law countries (e.g., England) there is no general legal definition of FM as it is a contractual concept negotiated by the parties, so courts will not infer what is meant by this term and therefore it must be clearly set out. If an event that relates to the outbreak of the coronavirus, or a “pandemic” has not been specified, it is unlikely to trigger a FM clause (further information on this can be found [here](#)).

The party claiming FM relief has the burden of proving causation that the FM event “prevented” (a high threshold) or “hindered” or “delayed” performance (easier to establish). “Government action” and/or “Pandemics” would be wording to look out for. If these have been specified then the FM clause may be triggered.

Before claiming FM, it is important to consider the ramifications. Is there a better way to proceed with a less negative outcome? Can another agreement be reached? Is there an alternative course of action? If the contract is only partially affected, then parties could agree to amend the contract and exempt liabilities for breach of contract. Also, remember hotel management agreements (“HMA”) and franchise agreements (“FA”) are long term relationships and your counterparty will hold a long memory if they feel aggrieved.

Normally a FM event allows a party to delay or suspend performance, although many HMA/FAs allow the operator (and sometimes the owner) to terminate if the FM event exists for an extended period (usually 6-12 months).

Where a party cannot assert a FM occurrence, other remedies such as the common law concept of contract “frustration” may be available where circumstances have made the contract impossible to perform or its performance is radically different to that originally envisaged. However, the threshold for proving frustration is high.

Civil law countries variously provide comparable remedies such a “material change of circumstances” where the court seeks to rebalance the parties’ interests where these have been substantially distorted by unforeseen circumstances.

Even if you establish a FM occurrence, it may not be covered by your business interruption (“BI”) policy. Typically BI cover is purchased as a bolt-on to a property damage policy and only kicks in

where the property has suffered physical damage from a named peril (e.g., fire, earthquake, flood, etc.). Hotel agreements usually extend BI to also cover condemnation or government taking which might apply in the current situation where, for example, a government opts to utilize a hotel as a temporary hospital site.

Many hotels do now buy cover for losses caused by infectious disease, but this is often restricted to a known infectious disease (Legionnaires) occurring at the property (not widespread disease like Covid-19) and leading to closure/restriction by government order.

Individual policy wording will define what is/is not covered (and governing law will play an important part). It is therefore imperative to check your policy to see whether the COVID 19 pandemic would be covered (further information on this can be found [here](#)).

Looking forward with the benefit of hindsight, owners and operators should review their FM contract provisions and BI policies in both their HMA/FA agreements, as well as supplier agreements, to better position themselves for comparable future situations.

3) Supplier Contracts

Many of your regular suppliers are hurting and may unfortunately become insolvent as the pandemic unfolds. Are there some (especially smaller) suppliers who you can work with to help them get through this, in exchange for better terms in the future? You may also want to investigate possible new suppliers should your existing ones fail. The market fallout is that enhanced competition is likely to replace any previous pre-virus complacency amongst suppliers.

There are likely to be many legal/insurance claims arising from contract non-performance during this crisis. Keep accurate records of any contract breaches by counterparties and any additional costs incurred. From your end, try to meet all obligations where possible and/or try to mitigate any breaches.

4) Working Capital

There is always tension between a hotel operator wanting to maintain healthy working capital balances (3 months expenses) and an owner wanting to reduce these idle funds balances once the hotel has achieved a stabilised performance trend. In times like this, some excess funding looks rather prescient and can help you sustain the business -including retaining personnel- over the slowdown.

5) Wrongful/Insolvent Trading

Many jurisdictions have legislation making directors of a business personally liable for the debts owed to creditors where they continue to trade and do not take every step to minimise losses to creditors in circumstances where the director knew or should have known that the company has no reasonable prospect of avoiding insolvency liquidation. Whilst certain governments are

relaxing/modifying these rules in light of the current crisis, an insolvency practitioner can still bring actions for misfeasance for a breach of duty so it is imperative for directors to take independent advice on their respective duties and to make sure that they document actions and justifications for them.

6) Business Downturn and Temporary Closure Costs

Ordinarily costs of debranding or closing a hotel are treated as owner costs. However, the costs for adjusting to a business downturn/quarantine (redundancies, temporary shuttering, etc.) are likely to be operating expenses for the purpose of any HMA. Whilst not important short term since the operator is not likely earning any significant revenue or Gross Operating Profit based fees where there is no turnover, this could have an impact on the operator fees calculations over the entire financial year. There could also be consequences for any owner's priorities or performance test measures to the extent these do not have exclusions for exceptional (e.g., force majeure or general business downturn) circumstances.

7) The Accidental Tourist

Absent some strong consumer protection provisions, government subsidized quarantine orders, or favourable booking terms, for guests who either cancel non-refundable bookings or who are sequestered at a hotel due to government ordered travel restrictions, the costs incurred during a quarantine or travel restriction may typically fall on the guest. That said, the negative goodwill -or bad TripAdvisor review- fallout from seeking to impose these costs on guests may outweigh the modest revenue benefits. For example, many of the OTA and "Brand.com" distribution channels have announced full refunds on non-refundable hotel bookings for some (if not all) their hotel listings.

8) Competition Law

Whilst it may be psychologically comforting to share or cooperate with competitors who are in the same predicament as you, horizontal sector collaboration such as sharing market data, pooling of resources or systems is a very sensitive area in many countries competition laws. Yes we are "all in this together", but if you do wish to collaborate, clearly document the justifications for doing so and seek advice as to what may be permissible during these times (further information on this can be found [here](#)).

9) Banking Facilities

Many hotels will need to reschedule their debt obligations in order to survive, including deferring the payment of interest and amortisation (or potentially moving the payment of interest to being on a PIK or capitalised basis), reviewing financial covenant tests and resetting debt service ratios and loan to value requirements given decreased valuations and a reduction in available cash. It's best to address these requests early, with lenders' credit committees being deluged by similar requests at

this time. Appreciating that financial covenants are viewed by lenders as the “early warning system” and will continue to be so throughout the life of the loan, it is important to be able to demonstrate the business’s scenario planning and the varying impacts on forecasted performance, particularly on the short term cash position. For lenders to agree deferrals, they will also want to know that the company has exhausted options from shareholders and other finance providers. When you’re at the front of the queue with your lenders, it is crucial to have this information available to you to support and justify the ask that is being made.

10) Renegotiation of Management and Franchise Agreements

As the economic balance and likely trading environment will likely have changed post Covid-19, many hotel owners may argue these changed economic circumstances justify renegotiation of their existing HMA/FA terms, seeking reduced fees or more sharing of the operational risk from the hotel brands. During the downturn, owners may also seek suspensions or refunds of non-revenue based fees (e.g., monthly per key reservation fees, training, web site update fees). All of these fee discussions will not realistically be contract law driven, but rather pragmatically based on maintaining a good commercial relationship between parties to a long term agreement.

General owner disquiet at the HMA/FA relationship balance was already an elevated issue pre Covid-19. A frequent refrain heard from hotel owners under HMA agreements is that they would like to shift to a FA in order to have better control over managing costs, including FF&E and capex expenditure where they feel the Brands overly focus on brand standards to the neglect of an owner’s commercial considerations.

Additionally, parties may need to revisit or temporarily waive certain continuing representations (e.g., solvency, ability to perform) one typically sees in HMA/FA agreements.

The hotel industry is suffering one of its biggest threats to date and sadly not all hospitality companies will emerge from this global pandemic. But the lights will come back on – the hotel industry is a mature one which has weathered various global terrorist attacks and the previous financial crisis. Then there will be a need for operators and owners alike to take stock, to reflect and rebuild. Hopefully this summary will help to direct some thought to the better days ahead.

RELATED PRACTICE AREAS

- Hotels and Hospitality

MEET THE TEAM



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