

Insights

DISPUTES UNDER HOTEL MANAGEMENT AGREEMENTS IN A COVID-19 WORLD – PART II: OPERATIONAL PHASE DISPUTES

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SUMMARY

The COVID-19 pandemic has wreaked havoc on the hospitality sector, significantly impacting the financial performance of existing hotels and causing delays to new hotel projects. These impacts may result in hotel owners and operators breaching the terms of their hotel management agreements (“**HMA**s”), which could lead to disputes. In this three part series of articles, the team at BCLP examines the likely areas where disputes may arise under HMAs during the hotel’s development and operational phases, as well as key issues for the parties to consider when drafting or reviewing their dispute resolution clauses in the event they wish to invoke the same.

Introduction

The COVID-19 pandemic has wreaked havoc on the hospitality sector, significantly impacting the financial performance of existing hotels and causing delays to new hotel projects. These impacts may result in owners and operators breaching the terms of their hotel management agreements (“**HMA**s”), which could in turn lead to disputes between the parties. In this four part series of articles, the team at BCLP examines the likely areas where disputes may arise under HMAs as well as key issues when considering dispute resolution clauses.

In this Part II, we continue our discussion of potential disputes under hotel management agreements by examining typical disputes that may arise during the operational phase of the hotel.

Disputes During Operational Phase of the Hotel

Unfortunately, the potential for disputes does not end once the hotel is built and open to the public. There are several instances during hotel operations where the owner and operator are likely to disagree. Whilst one hopes that these would generally be worked out as part of the day to day

business relationship between the parties, this is sadly not always the case, and may be exacerbated by the effects of the COVID-19 pandemic.

Budget

The operator will prepare the annual budget for the hotel at least two months before the start of each operating year. The owner usually has the right to approve it subject to acting reasonably and without delay. Any line items that cannot be agreed between the owner and the operator by the start of the operating year are then referred for resolution by an independent expert. However, the operator will typically exclude certain types of expenditure from the owner's approval right. For instance, expenditure required for compliance with brand standards and insurance and legal requirements.

The COVID-19 pandemic could well cause disputes to arise between owners and operators when budgeting season starts. For instance, they may disagree on forecast rates and occupancy (which are likely to be difficult to forecast in the current environment), cost-cutting measures that either party proposes to preserve the financial viability of the business, and whether or not certain items of expenditure fall within any exceptions to the owner's approval right (e.g. if the operator implements enhanced cleaning regimes and social distancing requirements as part of its brand standards to help combat the pandemic).

Performance tests / guarantees

The operator is usually subject to financial performance tests that trigger an owner's right to terminate the HMA if the operator fails. The most common tests assess the operator's ability to:

- generate revenue in line with their competition (typically by comparing the revenue per available room ("**RevPAR**") generated by the hotel in a test year with the average RevPAR generated by an agreed set of competing hotels in that year); and
- operate the hotel profitability (typically by comparing the actual gross operating profit ("**GOP**") achieved by the hotel in a test year with the budgeted GOP for that year).

The HMA could include either or both of the above tests. The operator would usually be given a tolerance of -10% to -20% and they would also have to fail the tests for two consecutive years before the owner's right to terminate is triggered.

The operator will typically reserve the right to make cure payments to avoid termination and also include a number of exceptions for external factors beyond their control (e.g. force majeure events and major works or refurbishment at the hotel) that would nullify the owner's right to terminate if the operator can establish that any of those factors caused them to fail the test.

Under a performance guarantee, the operator would underwrite a certain level of GOP at the hotel for an agreed period. If this GOP is not achieved, the operator agrees to make a top up payment to

the owner. As with the performance test, the operator will usually include a number of exceptions for external factors that would excuse the operator from having to make a payment under the guarantee if any of those factors affect the hotel's performance.

Given the severe adverse impact that COVID-19 has had on the financial performance of hotels around the world, many operators may fail their performance tests or guaranteed GOP targets in the coming years. This could lead to disputes if owners look to terminate their HMAs or call for cure or guarantee payments and operators challenge this by invoking any exceptions that they have included in the HMA.

Owner approval rights

The owner usually retains approval rights over certain matters at the hotel. Typical examples include the right to approve:

- key personnel such as the general manager and director of finance;
- contracts, leases and other agreements with contract terms and values above a specified threshold;
- payments out of hotel accounts above a specified threshold; and
- litigation where the amount in dispute exceeds a specified threshold.

Again, the operator may include a number of exceptions e.g. contracts entered into under the operator's global procurement program or payroll payments.

With the COVID-19 pandemic placing added emphasis on operating cost-efficiency, the owner may pay closer attention to these matters, which may lead to disputes if the owner feels that the operator has acted beyond what it is authorised to do under the HMA.

Operator's general standard of performance

The HMA should include a general overarching standard of performance expected of the operator e.g. the operator should operate the hotel "in the manner of a prudent and experienced international hotel operator".

An owner who is unhappy with the performance of the operator, but who cannot point to any specific breach that might trigger a termination right under the HMA, may opt to build a case of persistent poor performance or minor breaches in order to argue that the operator is failing to achieve its overarching standard of performance.

Conclusion

There are a number of areas during the hotel's operational phase that are prone to disputes between owners and operators, even at the best of times. With the COVID-19 pandemic severely affecting the hospitality industry globally, these disputes may arise more frequently over the coming years.

In Part III of this series of articles, we continue our discussion of potential disputes under hotel management agreements by examining key issues for the parties to consider when drafting or reviewing their dispute resolution clauses, specifically the parties' choice of governing law as well as expert determination.

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