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# Hotel Management Agreements After COVID-19: A New World?

Relationship Between Hotel Owners and Operators Tested in New Ways

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A hotel management agreement is the core document governing the relationship between hotel owners and operators and managers. In a subsector of the commercial real estate industry particularly hard hit by COVID-19 disruptions, this relationship is being tested in unique ways.

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It is too early to predict permanent changes to the owner-manager relationship which may be reflected in future agreements. Hotel brands may be able to offer owners short-term relief under franchise and management agreements, to test performance returns on an incremental basis without the need for sweeping document modifications. However, there are some long-term effects stemming from the disruption of COVID-19 that are likely to materialize.

**Management Fees**

Base and incentive fees paid to managers are both contingent on the success of the hotel. However, base fees are usually based on a percentage of revenue, whereas incentive fees are more typically expressed as a percentage of profit. Given the COVID-19 pandemic, both types of management fees have declined sharply.

Many third-party and brand management companies are currently foregoing revenue-based fee income at managed or franchised properties that are shuttered, while owners are continuing to pay for management of hotels closed to the public.

Following the COVID-19 pandemic, it is possible managers will request a minimum fee not linked to performance to cover their overhead and general running expenses in the event of further closures. In addition, base and incentive management fee structures may be revisited as owners and managers alike struggle to return to profitable levels.

Rather than a fixed base management fee — for example 3% of revenue — ramped or stepped fees may be introduced that increase each year — for example 1.5% in year one, 2% in year two and 3% in year three. Such an arrangement echoes the ramp-up of royalties for new properties under franchise agreements. Likewise, the incentive fee formula may be subject to such a ramp-up.

Looking further ahead, the industry could see a shift in management to favor base fees, rather than incentive fees, due to the financial certainty base fees offer. This would be a significant change in approach, particularly in the U.K., as incentive fees have largely been industry standard.

**Risk Allocation**

The allocation of risk has always been a key element of the relationship between owners and managers, with managers preferring owners to assume increasing levels of responsibility for the risks associated with the performance and operation of a hotel. Managers have, for example, required owners to procure insurance to cover management liabilities at the owner's expense, including employer liability insurance.

Management companies, particularly brand managers, have required broad indemnification from owners, excluding only specific instances of gross negligence or willful misconduct on the part of the manger.

One issue that is particularly relevant during the pandemic is that of hotel employees. The key question is: Who will bear the risk of illness to guests or employees with reopening after COVID-19? Are comprehensive liability insurance carriers or employer liability insurance carriers going to provide insurance for this risk? Even if management companies agree that the employees at the property are their responsibility, rather than the responsibility of the owner, it is likely they will attempt to exclude any liability for COVID-19-related illness or death, and may and expect the owners to insure against such losses.

In the U.S., where owners are likely to continue to favor hotel personnel being treated as employees of the manager, the additional costs associated with insuring pandemic-related liabilities will need to be addressed with managers to protect the owner's return. In the U.K. and Europe, owners tend to be recognized as employers of the hotel personnel, and this approach could be considered in the context of the allocation of risk in the U.S. going forward.

A number of management agreements do not include a pandemic as an event of force majeure. At best, they refer to "events beyond the reasonable control" of the owner or manager, which is far from specific. The scope of force majeure clauses, particularly in the U.K., is typically approached with a narrow interpretation by the courts.

Some management agreements do include as events of force majeure “epidemics, quarantine or any other public health restrictions or public health advisories” and allow the manager in consultation with the owner to close the hotel and possibly terminate the agreement.

In either event, management agreements are clear that in the majority of cases, a force majeure event does not relieve an owner of payment obligations.

Future management agreements likely will classify pandemics as force majeure events, with issues open to negotiation to include which payment obligations should remain in such event, and which party has the authority to close the property.

Closure or suspension of the hotel is frequently not addressed in hotel management agreements. In brand management agreements, the common position is that the manager determines whether a hotel should close; this decision is usually made in consultation with the owner. This is also the case with reopening.

The manager will be mindful of protecting the brand reputation, as well as the safety and feasibility of the general management of the property, and will therefore want to retain this decision-making for the greater control it offers. After COVID-19, we expect language allowing the manager to close the hotel in response to governmental guidance.

**Owner/Operator Relationship**

After experiencing COVID-19 shutdowns, owners will be looking for revenues from all sources. Managers will have the same interest, within the bounds of safe operation for employees and guests.

We expect managers to negotiate for increased control over hours of operation, food and beverage service, spa and ancillary guest services. Budgets will be tightly scrutinized, and managers may be given less latitude on deviations for capital expenditure and other budget line items.

Brands may be viewed by the public as safer than independent properties, and therefore expansion from core brands seems likely. The proliferation of sub-brands within major chains may reverse, with loyalty programs and the appeal of a "household name" drawing clientele to the established brands.

With increased concerns regarding employee health and conduct following the pandemic, managers may seek to shift more employee liability to owners, either by specific contractual provisions or designation as co-employers. What is not covered by employee liability insurance will be the subject of cross indemnifications; something which both parties will want to limit.

If the result of COVID-19 leads to a shift in favor of branded properties by business and leisure travelers, the number of brand-managed properties will increase accordingly. Owners will have less flexibility in negotiating terms with managers. However, in a tight revenue environment, owners may seek to reduce the cost of franchise royalty fees and marketing costs, and third-party managers can offer reduced fee structures to ownership. This tension will play out in the coming months and will be subject to how quickly owners are able to recover income.

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