Leisure Law Insider - Vol. 3 (July 2024)

Terminating Hotel Management Contracts During Periods of High Inflation

July 30, 2024

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Key Take: Hotel owners considering terminating their long-term management contracts should be aware of the role high interest rates and inflation can play in the calculation of wrongful termination damages.

The significant and sustained increase in interests rates, coupled with high inflation have caused uncertainty throughout the economy, including the hospitality industry. While a recent survey of hotel asset managers spreads hope that revenue per available room (RevPAR) for U.S.-based hotels will return to 2019 levels by 2025, hotel owners still face significant headwinds resulting from the COVID-19 pandemic, high periods of inflation, and sustained increases in interest rates.[1]

Rates of high inflation and interest rates present myriad challenges for hotel owners. While much has been written about high inflation and interest rates making credit difficult to access and reducing hotel owners' ability to leverage their current assets, high inflation also presents other pitfalls that may be less apparent to hotel owners. This includes the decision to, and ultimately the potential cost of, terminating long-term management contracts.

We have previously written about the effect of the pandemic on the termination of hotel management agreements, observing that the damages for the wrongful termination of such agreements by an owner during the pandemic could be lower than in an average year.[2] And as the hospitality environment remains uncertain, certain hotel owners may still decide that the best business solution for them is to terminate their management agreements with their hotel operators, even though such a wrongful termination would entitle the operator to damages.

But hotel owners should be aware that periods of high inflation could affect the cost of terminating hotel management agreements. This is because the commonly applied damages calculation associated with wrongful termination of hotel management agreements can be influenced by long-term periods of increased inflation.

As such, before considering whether to terminate a hotel management agreement, hotel owners should understand how inflation affects the damages analysis.

Terminating a Hotel Management Agreement and Calculating Damages

Hotel owners that wish to terminate their hotel operators and hotel operators that face the threat of termination should evaluate their respective rights and obligations under all applicable agreements and consult with counsel before taking such actions.

As we have previously written, hotel owners have the right under common law to terminate hotel management agreements, and thus their hotel operators, at any time and without cause. Because such agreements are generally classified as agency agreements or personal services contracts, they remain unenforceable by specific performance or injunctive relief. The termination of hotel management agreements will, therefore, inevitably result in a calculation of the damages to be awarded to the terminated operator in the event the operator is to prevail on a claim for wrongful termination.

Generally, hotel operators that prevail on such claims are entitled to the present-day value of the management fees that they would have earned for the remaining duration of the agreement, had the parties continued under it. Also, hotel management agreements typically calculate management fees as a percentage of the hotel's gross revenue. As such, hotel operators will generally claim damages for their lost profits or the presumed loss of their future stream of management fees for the remaining duration of the hotel management agreement.

In calculating these lost profits, one first reviews the amount of management fees generated in the most recent years and then extrapolates from that data to project the amount of fees that would have been generated over the remainder of the contract. After doing this, a growth rate is applied to this projected amount. Finally, a discount rate is applied to the projected amount of fees. Sustained inflation can play a role in these damages calculations.

The Impact of High Inflation on Damages for Terminating Hotel Management Agreements

Because inflationary factors are often considered as part of the analysis in a wrongful termination damages analysis, it is important to understand how sustained periods of high inflation may influence the amount of damages available to hotel operators that prevail on such claims.

In particular, inflation is often considered when analyzing the amount of projected fees over the remainder of the contract term and the appropriate discount rate to value any lost management fees in present dollars.

First, when projecting management fees over the duration of the remaining term of any management agreement, a growth rate is commonly applied year-over-year. As a general matter, the growth rate is typically meant to reflect ordinary inflation, such as 2-3 percent. After years of sustained high inflation, there is a risk that the growth rates will be higher than has historically been the case, which would result in higher gross operating revenues projected over time and thus higher projected management fees. However, a hotel owner may be able to demonstrate that long-term assumptions of high inflation are speculative and that a constant inflation rate is a better indicator of future performance.

Second, periods of high inflation and high interest rates may also have an impact on the discount rate that is applied. The higher the discount rate, the lower any wrongful termination damages, and vice versa. Often, experts begin their discount analysis by considering a hotel operator's weighted average cost of capital (WACC), at the time the contract was entered into, at the time of any alleged wrongful termination, and/or at the time of any damages award.

WACC itself represents the average cost of acquiring capital from both sources of equity and sources of debt, and is thus also susceptible to inflationary effects. Specifically, during high inflation, the cost of debt goes up as the value of capital declines, and, in turn, lenders raise interest rates. In addition, high inflation causes the cost of equity to increase the future value of capital decreases and markets seek higher returns to compensate.

As high inflation increases the cost of equity and the cost of debt, when inflation goes up it tends to cause increases in WACC as well. This in turn could result in a higher discount rate being applied to the amount of projected fees determined in a damages calculation, which could offset the application of high inflationary factors applied in the growth factor analysis. Additionally, periods of high inflation may also make the future performance of the hotel riskier, which an expert may consider as a reason for adding bases points to the discount rate calculation, reducing any wrongful termination damages.

Thus, it is possible that high rates of inflation will result in higher growth rates being applied to the projection of gross revenues, resulting in higher projections of future management fees. However, because inflation may also result in a higher discount rate being applied to these projected fees, an increased discount rate may counteract the increases in the overall fee projections generated from the application of higher growth rates.

Therefore, while inflation can affect both the growth rate and discount rate used in damages calculations, how these elements may interact in a particular damages calculation will depend on the specific circumstances pertinent to a particular hotel. For example, hotels that are currently performing well may be less incentivized to terminate their hotel management agreements, as their future performance may be viewed as less risky and subject to a lower discount rate, while also potentially absorbing the cost of future projected inflation. By contrast, hotels that are significantly underperforming, may be incentivized by the same inflationary factors to make a business decision to terminate a management agreement.

Given these competing effects, and the potential for wrongful termination suits to result in increased damages awards, hotel owners should carefully weigh their options and consult with knowledgeable legal counsel before considering whether to terminate any management agreements with their hotel operators.

[1] *https://app.box.com/s/ia7uk2r8kh3hsld50zcu46xe0okbtwpj*

[2] *https://www.law360.com/articles/1370411/terminating-hotel-management-contracts-amid-covid-19*