

In the Media

Looking Ahead: Management and Franchise Agreements in a COVID-19 World

By *Ronald S. Kornreich*

The COVID-19 outbreak is wreaking havoc on the hotel industry. Hotels across the nation have closed their doors and suspended operations. Some have been repurposed to house patients and first responders; those that remain open are functioning at limited capacity and seeing drastic declines in revenue per available room (RevPAR).

While the recovery may seem far off, it is important for hotel owners to review their management and franchise agreements to determine whether to seek modifications in light of closures or suspensions as well as the potential for future lingering effects of the virus on the travel industry.

Modifications due to Closure and Suspension

There is an episode of the classic television series *The Twilight Zone* entitled “A Kind of Stopwatch” where a man is given a watch which can stop time. While time may feel like it has stopped for many of us, time may be running out in management or franchise agreements to the detriment of one or both parties.

Take, for example, management or franchise fees. Many agreements provide for a fee ramp-up, or discounted fees in the first few years following the commencement of the management or franchise term. A hotel owner that negotiated a reduced fee for 2020 and then shut down its hotel in March of this year, or that kept its hotel open but is now operating at strikingly reduced rate and occupancy, would not be receiving the full benefit of the ramp-up. While the agreement may contain some type of force majeure provision to excuse performance, an amendment may be required to suspend or extend the ramp-up period.

Where furniture, fixtures, and equipment (or FF&E) reserve contribution percentages are reduced in the early years of a term, a similar ramp-up issue would apply.

The length of the term of the agreement is also something to consider, given that most agreements will not extend the term due to closure or suspension. While in many cases this may be more of an operator/franchisor concern (since the operator/franchisor will frequently prefer a longer term), an owner will also want to think about whether an extension is warranted.

For development/conversion projects, agreements often contain milestone dates by which the owner agrees, for example, to commence work, obtain financing and complete and open the hotel. The owner should review these provisions to determine whether the milestone dates need to be extended and whether it would benefit the owner contractually to extend those dates. It is also important for the owner to review the force majeure provision in the agreement to determine whether it would extend the milestone dates, whether there are limits on the length of the extension and whether notice to the operator/franchisor is required to rely on the extension. In some agreements certain obligations of the operator/franchisor, such as, for example, to pay key money to the owner, may be contingent on achievement of milestones; therefore, the owner should analyze any such contingencies and seek appropriate extensions.

Many agreements contain a radius restriction, pursuant to which the operator/franchisor agrees to limits on it operating or franchising hotels within an agreed area of protection. While ideally for the owner this restriction would run for the entire term of the agreement, in many cases the restriction lapses on a selected date, or an agreed number of years following the opening of the hotel under the management or franchise agreement. Take, for example, a recently signed franchise agreement



with a 20-year term that restricts the franchisor for only five years. If the hotel, and other hotels within its vicinity, are closed for much of 2020, the owner would not be receiving the full benefit of the restriction. The owner should therefore consider whether to push for an extension.

Performance tests will also be an area of intense interest for owners and operators. Many management agreements provide that the operator cannot fail the test due to force majeure, but obviously a review of the force majeure definition will be critical. Many agreements provide for multiple-year tests (e.g., in order for the operator to fail the test, the hotel must fail to achieve the performance targets in two consecutive years). The owner should review the force majeure exclusion to determine whether the “excused” year is counted as passed or merely disregarded. If the operator failed the test in 2019, is excused in 2020 due to force majeure and fails again in 2021, it is important to determine whether 2019 and 2021 would be the two test years or whether the first test year would be 2021.

Changes due to Potential Future Lingering Effects

Besides modifications based on time, owners will undoubtedly be looking for ways to reduce costs and increase liquidity.

Owners should consider seeking relief from their operators/franchisors on FF&E reserve requirements, allowing them to retain extra cash in lieu of making reserve contributions.

Many owners will seek “relaxation” of brand standard requirements. This of course includes waivers or deferrals of physical brand standard requirements, such as obligations to complete hotel renovations and replacements and additions to FF&E. Owners and asset managers may also look to relax standards such as required employee staffing levels, food and beverage offerings and other amenities. For example, as social distancing may be a continuing part of our daily lives, the need for restaurants serving three full-service meals per day may be replaced, at least temporarily, with restaurants offering carry-out or delivery service.

Fees and charges are an area that owners will be looking at closely. Management agreements typically provide for a base fee to the operator, based on a percentage of gross revenues, and an incentive fee based on the hotel’s profits. It remains to be seen whether owners will be able to shift more of the fees to an incentive-based structure, thereby reducing fees that are paid regardless of the hotel’s profitability.

As the need for hotels to operate less expensively is more imperative, owners will also be pushing operators/franchisors to reduce their centralized service charges, including for loyalty programs, brand marketing, reservations, shared services and accounting. Owners may increasingly question whether these charges are reasonable in light of the services they receive in return and seek caps or discounts.

Of course, any modifications to management/franchise agreements may very well require lender approval; the owner should carefully review its loan documents to ensure that the changes comport with loan requirements.

Ultimately, it is in the interest of all parties to restructure agreements in a manner that reflects the new hard realities of the travel sector so that hotels emerge from this global pandemic economically viable.

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