New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
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SEPTEMBER 6, 2022

Lessons Learned: Important Considerations for Hotel Management Agreements in the Post-Pandemic Era

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The first half of 2022 has seen the hotel industry stage a remarkable recovery from the pandemic-triggered downturn of the last two years. According to recently released data from STR, a hotel industry analytics firm, in July 2022 the U.S. hotel industry reported record-high monthly room rates on a nominal basis, while also reporting an all-time high revenue per available room (RevPAR).

With data justifying increased optimism, tempered by still-persistent inflation concerns and the looming threat of a recession, industry stakeholders are proceeding deliberately as they evaluate opportunities and potential transactions.

One industry strategy that appears to be continuing after the tumult of the last two years is the strategy of most major hotel operators, including Marriott, Hilton, and IHG, among many others, to focus on the hotel management and franchising aspects of their business. By this "asset-light" strategy, hotel brands are increasingly reliant on fee income from management and franchise agreements to support their growth and valuations. While these revenue streams historically have been considered relatively stable and low-risk, it is important to consider whether this still holds true in the post-pandemic era.

This article explores some of the key negotiating points in hotel management agreements (HMAs) and how they impact the stability of such agreements as a source of reliable, low-risk income for brands.

Judicial Exhaustion

An owner's right to terminate an HMA may be limited by so-called "judicial exhaustion" language. For many contracts, including HMAs, a notice-and-cure procedure prior to termination is already common practice, yet parties may take this a step further by expressly stating that a non-defaulting party may not terminate the HMA on the basis of a default if the allegedly defaulting party contests the occurrence of the default. In that case, any such termination will not be deemed "effective" until a court or arbitrator issues a binding ruling finding that a default has, in fact, occurred.

While parties see this as an added protection against pretextual defaults and premature terminations, it is important to be aware that this protection likely will not eliminate a party's ability to terminate an HMA—it simply leaves the terminating party little room to argue that a termination in violation of the contractual procedure was proper under the contract. The net effect is to give greater stability to the contract as the terminating party must consider the financial risk associated with such unilateral and premature termination.

Nature of the Parties' Relationship

Historically, HMAs generally established hotel managers as express agents of the hotel owner. This principal-agent relationship provided benefits to both parties: the hotel manager, as an agent to the owner, is protected from liability so long as it is acting within the scope of its agency,

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while the hotel owner obtains the protection afforded by the fact that agents owe fiduciary duties to their principals, such as the duties of care and loyalty.

But an agency relationship also confers a significant additional power to owners (as principals): the ability to unilaterally terminate the HMA at any time, for any or no reason. It is well-settled (even axiomatic) that a principal always maintains the ability to terminate its agent, such that a principal will never have the service of an agent unwillingly foisted upon them.

While such a termination may later be determined to be wrongful—entitling a hotel manager to breach of contract damages—this power is generally understood to be irrevocable, notwithstanding express contractual language limiting or eliminating an owner's ability to terminate.

Hotel managers seeking to protect their interests address this imbalance in a number of ways. One such method has been to invest in the equity of ownership and to thereby fit within an exception to the general irrevocability of a principal's ability to terminate where an agent, in this case the hotel manager, possesses an

interest in the subject of its agency, here the hotel property.

Known as an "agency coupled with an interest," by securing an interest in the managed asset, managers can impose limits on an owner's unilateral right to terminate. However, not only is this inconsistent with the "asset-light" strategy, but it may not work to prevent a termination, as courts interpret this exception narrowly and will not accept anything less than an actual and present interest in the hotel property (a conditional interest, such as a right of first refusal, or an actual interest held by an affiliate will not suffice).

Managers have also sought to limit an owner's ability to terminate by structuring the agreement to eliminate the agency relationship altogether, opting instead to be designated independent contractors. But this is also not necessarily effective, as courts will look to the nature of the relationship between parties, and will not necessarily rely on the language of an agreement. In New York, courts are likely to find that agency exists—regardless of what the parties say in an HMA—unless the manager has "unfettered discretion" over hotel operations, i.e., where the owner does not exercise any control over manager decision making.

Prevailing Parties Attorney Fees

This seemingly ordinary clause often has an outsized impact when a dispute arises between owner and manager or franchisor. Risk of an early termination may be able to be mitigated by including a clause that enables the prevailing party of any dispute arising out of the HMA to recover its legal costs. While seemingly ordinary and neutral on its face, a prevailing party fees provision may have a disparate impact depending on the relative resources of the hotel owner and manager.

A prevailing party attorney fees provision may chill owners from bringing valid claims and seeking to prematurely terminate an HMA, especially where—as is often the case—they find themselves opposite a manager with meaningfully greater resources. Conversely, such a provision may disincentivize an owner from terminating a hotel management agreement on more tenuous grounds if there is a likelihood that, if the termination is later found to be wrongful, the owner will be liable for potentially sizeable legal costs in addition to breach of contract damages.

Of course, such a provision only protects a party if it "prevails" in the dispute. In New York and elsewhere, an attorneys' fees provision does not entitle a prevailing party to actual legal costs, only "reasonable" costs, which differ in key aspects. First, parties are only able to recover for successful claims, meaning a mixed ruling across several claims could result in a diminished fee award.

Moreover, even on successful claims, parties must prove that their fees are reasonable. Claimed fees can be attacked in several ways, such as the rate charged, the number of hours billed, and the number of attorneys staffed to the case; and court-adopted methods for calculating reasonable attorneys' fees, such as the lodestar method, may also result in sweeping adjustments to a fee award based on a court's overall impression of fairness. Last, any attorneys' fee award usually will not include any costs spent to recover the fees, often called "fees-on-fees," unless specifically contemplated and authorized under the agreement.

Applicable Law

In recent years, the choice of law provision has become a key negotiating point in hotel management agreements. While ordinarily there are many factors that impact a party's preferred choice of law, hotel managers/franchisors are increasingly insistent on the inclusion of a provision dictating the application of Maryland law—regardless of where the hotel and the parties are located. This is because of a Maryland statute, Section 102 of Title 23 of Maryland Code Commercial Law, which purports to authorize courts to grant the remedy of specific performance of a hotel management agreement regardless of any conflicting common law doctrines (such as the power of a principal to terminate a principal-agency relationship, as discussed above).

However, this statute, though enacted in 2004, has yet to be significantly tested and may be subject to attack (among other reasons) as violative of the prohibition of specific enforcement of personal services contracts. Recently, a New York court avoided this conclusion by reasoning the Maryland legislature would not have enacted a law that violated the 13th Amendment, and therefore that HMAs must not be considered contracts for personal services under the statute (even though, in New York and elsewhere, it is generally understood that HMAs are personal services contracts). Another court considering the issue may not be as deferential, so parties should exercise caution in relying on choice of law to cabin the risk of early termination.

Conclusion

As hotel operators seek to protect their income streams, it is important for both hotel owners and managers to consider the impact of the post-pandemic realignment of risks and rewards as they negotiate terms for new hotel management agreements. Parties are well-advised to be deliberate and consider these new dynamics carefully as they seek to transact new business.

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