

Hospitality Performance Tests: Fool's Gold?

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Hotel management agreements often contain language permitting a hotel owner to terminate if the hotel's performance fails to meet certain financial metrics. This provision, colloquially referred to as the "performance test," is touted as a form of protection for owners by providing a right to terminate (or to receive a "cure payment") if the hotel underperforms.

But the reality is performance tests are generally structured to make them difficult, if not impossible, to fail, leaving hotel owners without the financial protection they thought they bargained for—or worse.

In fact, some hotel operators have attempted to use the existence of a performance test as a defense to a claimed breach, arguing that a hotel owner cannot claim a breach by the operator if the performance test has not been triggered.

In this article, we discuss how performance tests function in the real world, recent case law interpreting performance tests, and the manners in which performance tests can and cannot provide additional protection to hotel owners.

What Is a Performance Test?

Hotel management agreements generally grant hotel operators significant discretion in performing their management duties. This grant of discretion may leave hotel owners with limited recourse if they become unsatisfied with the hotel operator,



which can be problematic given that these types of agreements often run for decades.

In one effort to address this issue, hotel management agreements often contain a "performance test" permitting an early termination by the owner if, under the operator's stewardship, certain financial metrics are not met.

While performance tests vary, they generally contain two prongs, each tied to a different metric. Most often, this will include the hotel's comparative performance against its competitors on revenue per available room (RevPAR). Another prong is generally tied to the hotel's actual profitability, as measured by gross operating profit (GOP), compared to its annual budget.

When a hotel underperforms on a prong of the test—often defined as performance less than

90% of the competitors' average RevPAR (with 100% being average) or the budgeted GOP, as the case may be—then the prong is considered “failed.” If the hotel fails both prongs—depending on the test, in any single year or in consecutive years—the performance test is failed, and a termination right may be triggered.

Most hotel management agreements provide the hotel operator a right to “cure”—and thereby avoid a performance test-based termination—by paying the hotel owner a sum of money designed to put the hotel financially in the same position it would have been had the test been satisfied. Generally, hotel operators may only cure a limited number of times during the term of the agreement.

Performance tests typically also contain limitations on their use or applicability, such that the test cannot be triggered if circumstances outside the hotel operator's control impact the hotel's performance. This can include force majeure events, major capital improvement projects, or the hotel owner's failure to meet its contractual obligations (such as by failing to provide working capital). Similarly, in recognition that opening a new hotel or a transition to a new operator involves a ramp-up period before performance stabilizes, performance tests usually only become effective after several years.

Do Performance Tests Actually Protect Hotel Owners?

As many hotel owners know, the numerous inputs and exceptions to performance tests often render illusory the so-called protection. While the test appears to provide hotel owners protection against declining performance, these tests are exceedingly difficult to trigger for many reasons.

A prime example occurs when a performance test prong is pegged to a percentage of budgeted gross operating profit. On its face, this appears to protect hotel owners against a material decline in profit. Tying an element of the test to the budget,

however, presumes that the budget prepared by the operator has not been manipulated to make the prong difficult to fail. This is a particular risk when performance tests require multiple “failed” years, providing hotel operators the opportunity to present lower budget projections after the first failed year to ensure the prong is met in the second year.

In turn, operators argue that budgets are the product of a collaborative process with the owner and reflect market realities and the condition of the hotel, both of which can significantly impact performance.

The prong comparing hotel RevPAR against its competitors is also capable of being manipulated, as the owner and operator have to agree on the set of competitors against which the hotel will be judged. Unsurprisingly, hotel operators are reluctant to agree to a set of aspirational competitors, instead seeking the inclusion of lower-performing competitors. For all of these reasons, it is rare for performance tests to be “failed” and therefore serve their ostensible purpose to protect owners.

A Shield and Sword for Hotel Operators?

Performance tests evaluate a hotel operator's performance strictly based on specific performance metrics. They do not address any of a hotel operator's operational duties, such as sales and marketing, property maintenance, and hiring and supervising hotel personnel. Operational failures breach distinct contractual obligations—such as the responsibilities to manage the hotel “as a reasonable and prudent operator” or “in such a manner as to maximize profits”—which, if left uncured, may constitute an event of default permitting the hotel owner to terminate the agreement. Given these types of standards evaluate distinct and independent obligations, performance tests can be failed when an operator meets all of its operational responsibilities, and vice-versa.

Nevertheless, there are numerous instances, in the context of a dispute between an owner and operator, where operators have sought to use the performance test as a shield to defend against claims of operational defaults, arguing that performance-based issues may only be measured by the performance test. Similarly, if the performance test cannot yet be triggered—such as because a newly opened hotel is in its ramp-up period—hotel operators argue that owners are precluded from asserting claims of default.

In raising these arguments, hotel operators rely on the fact that operational breaches may result in poor financial performance, which, when viewed in a vacuum, would otherwise fall within the ambit of the performance test.

However, these arguments are rejected by New York courts, which recognize that operational performance obligations are distinct and independent from the performance test. For instance, in *IHG Management (Maryland) LLC v. West 44th St. Hotel LLC*, Justice Joel M. Cohen rejected IHG's arguments about the contract's performance test, holding: "[T]hough owner refers to performance-based metrics to identify some of the[] alleged breaches...those allegations do not preclude owner from stating a viable breach of contract cause of action." *IHG Mgmt.*, 2020 WL 2066323, at *3 (Sup. Ct. N.Y. Cnty. Apr. 2020).

Justice Melvin L. Schweitzer (Ret.) rejected similar arguments made by Marriott in *Eden Roc, LLLP v. Marriott Int'l, Inc.*, 2013 WL 5345864 (Sup. Ct. N.Y. Cnty. Sept. 18, 2013), holding that the hotel owner could state claims that Marriott breached the hotel management agreement due to operational and contractual defaults irrespective of the performance test.

Most recently, Pyramid Global Hospitality argued that the performance test precluded claims by multiple owners that Pyramid mismanaged their

hotels in breach of the management agreements. On October 23, 2024, Justice Melissa A. Crane rejected these arguments, sustaining the hotel owners' claims. See *Fox and Main, LLC, et al. v. Pyramid-BMC Holdings, LLC, et al.*, Index No. 653020/2024.

Stakeholder Considerations

Performance tests in hotel management agreements tend to provide hotel owners with significantly less protection than they may first appear. Careful consideration and drafting are key to ensuring hotel owners can effectively rely on performance tests to their benefit, without the risk that the hotel operator will try to later use the test as a shield against liability for operational failures.

When negotiating a hotel management agreement, hotel owners should pay close attention to the performance test. Hotel owners should consider inserting clear and objective measures not tied to matters upon which an operator has significant control such as an annual budget.

Additionally, consideration should be given to incorporating language clarifying that the performance test does not excuse a hotel operator from its other operational and contractual obligations. Doing so will limit an operator's ability to dispute operational defaults, reducing (or eliminating) unnecessary legal disputes. Operators should also consider crafting performance tests in ways that ensure true accountability, as doing so will align all stakeholders to work towards a successful and profitable hotel.

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