

# COVID-19 Offers Cautionary Tales On Hospitality Contracts

By **Anthony Cavanaugh and Jiah Park** (October 4, 2021)

The COVID-19 global pandemic hit the international hospitality industry especially hard, leading to forced closures and a long, protracted recovery.

It often is the hotel owner who bears a disproportionate share of the economic risks in operating a hotel and, thus, is especially vulnerable to events such as the pandemic.

It is in this context that hotel owners should look closely at the agreements that govern hotel investment and operation to learn lessons from the pandemic and to protect against such vulnerability in the future. For instance, in the context of hotel property purchases and sales, the pandemic highlighted issues that were previously overlooked, such as the absence of force majeure clauses.

And for hotels with branded or third-party operators, the pandemic has placed renewed focus on management agreements, particularly regarding owners' lack of visibility into daily operations, which inhibited owners from gauging the appropriate response to the pandemic.

More recently, hotel owners have struggled to understand the nature and coverage of their insurance policies to recover for the losses suffered. As many hotel owners now reevaluate and scrutinize their existing and future agreements, the following are some of the unique concerns that should be considered.



Anthony Cavanaugh



Jiah Park

## Purchase and Sale Agreements

Purchase and sale agreements, or PSAs, that straddled the pre- and post-pandemic time period left hotel buyers and sellers especially vulnerable. PSAs, executed and signed pre-pandemic, but not scheduled to close until the midst of the pandemic, created new and unforeseen difficulties.

Shelter-in-place orders prohibited potential buyers from traveling to conduct on-site due diligence; compliance with seemingly innocuous covenants such as the covenant to continue operating in the ordinary course of business became all but impossible; and the requirement for representations and warranties to remain true at closing became extremely challenging to satisfy or even verify.

These hotel PSAs too often did not contain force majeure clauses, creating challenges for both sellers and buyers. For sellers, problems arose relating to preserving the asset prior to sale. Many PSAs include an operating covenant or performance clause with strict standards as to the operation of the hotel from execution of the PSA through and at closing.

To preserve the asset, a typical operating covenant may require the seller to operate and maintain the hotel through the closing date in the ordinary course of business or in the same manner as it is currently operated in accordance with the applicable franchise and/or management agreement and consistent with the seller's practices in effect prior to execution.

Additionally, these covenants often contain provisions prohibiting the seller from materially reducing the number of employees, operations, services, maintenance and repairs through the closing date. These covenants became impossible to meet during the pandemic, and failure to satisfy any of these performance obligations arguably permitted the buyer, at its sole and absolute discretion, to terminate the agreement. On the flip side, buyers who were unfortunate enough to enter into purchase agreements pre-pandemic were often locked into the purchase of assets with falling market values due to the pandemic.

Seeing the difficulties experienced during the pandemic, both sellers and buyers of hotels should consider including force majeure clauses in their PSAs to protect themselves. For sellers, the inclusion of a force majeure provision is useful to appropriately delay or excuse their performance of certain operations in the event an unforeseen circumstance prevents performance of such obligations.

For buyers, a force majeure clause may prevent them from getting locked into a bad deal due to a crisis like the pandemic. When including such a clause, both sellers and buyers should consider how a force majeure event is defined — e.g., epidemic, quarantine or public health restriction.

A broad definition would include both the current outbreak of COVID-19, a mutation or renaming of the virus, and any new virus. Sellers should also consider including express authority to take such measures as may be necessary to comply with government orders or Centers for Disease Control and Prevention guidelines.

### **Hotel Management Agreement Controls to Effectively Respond to a Pandemic**

Hotel owners whose hotels are operated by branded or third-party managers should also review their hotel management and franchise agreements for controls that allow for collaboration with their managers and franchisers to respond to events like the COVID-19 pandemic.

Under common form hotel management agreements, or HMAs, owners often bear all risk of loss but may not have visibility into whether hotel managers are using best practices to respond to a crisis like the pandemic.

Most HMAs require the manager to provide some level of transparency. But operators tend to narrowly interpret these provisions, allowing access to only summary-level information for the specific hotel.

Under this approach, the manager takes the position that the hotel owner is not entitled to any above-property or corporate-level insight — e.g., information relating to staffing, service agreements bargained for at the corporate level, and corporate-level programs or systems imposed on the hotel, claiming such information is proprietary.

This lack of transparency raises several concerns that may lead to disputes during a crisis because they leave owners with uncertainty regarding whether the manager has appropriately and adequately responded to a crisis by, for example, reducing staff, renegotiating contracts, or reducing programs and services to counterbalance a loss in occupancy or average daily rate.

Special care should also be taken to understand the nature of the relationship between owner and manager. Often through HMAs or legislation, managers will attempt to either

expressly or impliedly limit or extinguish their fiduciary duties to owners as owners' agents. For example, managers lobbied the Maryland Legislature to enact Title 23 of the commercial law section of the Maryland code, which applies only to HMAs and subordinates common law agency to the terms of the HMA.

Managers have used this statute and language in HMAs to argue they do not owe fiduciary duties to owners, such as the duties of care, loyalty and candor. This can be problematic in the context of a crisis like the pandemic where owners and managers must act together and in each other's best interests to respond to the crisis.

HMAs also require the owner to procure and maintain property and operational insurance at the owner's expense. Business interruption losses can be addressed through prudent insurance coverage. As such, owners should scrutinize their insurance policies to determine whether losses from events like COVID-19 are covered or whether applicable coverage can be added.

Reviewing insurance policies and adjusting coverage can be problematic, though, in the context of HMAs. Owners may be required or persuaded to obtain policies that are either negotiated by the manager at the corporate level or, in the branded hotel management context, operated by captive insurance entities owned and operated by the hotel manager. Either way, as discussed above, managers often consider these to be proprietary, corporate-level programs and refuse to share the policies' details with owners.

This makes it difficult, if not impossible, for owners to fully understand the policies' terms, including the all-important coverage limits and exclusions. Moreover, considering the effects of an event such as the pandemic are often widespread, owners may realize too late that these captive entities are not sufficiently capitalized to handle the number of resulting insurance claims.

Accordingly, when negotiating HMAs, owners should insist on access to the terms of the insurance policies that they pay for and that are intended to cover the losses for business interruption.

## **Conclusion**

COVID-19 was not the first pandemic, and it may not be the last. Given the consequences experienced, hotel owners should carefully scrutinize their existing agreements and those they may enter into for adequate protection. PSAs would significantly benefit from force majeure clauses intended to protect both sellers and buyers.

Additionally, owners should be sure they understand their relationships with managers and have visibility into their hotels' book and records to review and confirm managers' expenses, especially in times of crisis.

Finally, owners should negotiate access to their insurance policies, examine them and discuss the coverage limits and exclusions with their insurers to ensure there is no ambiguity as to coverage. As the saying goes, an ounce of prevention is worth a pound of cure.

---

*Anthony F. Cavanaugh is a principal and Jiah L. Park is an associate at Miles & Stockbridge PC.*

*The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*