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# THE HOSPITALITY SECTOR: CONTRACTUAL CONUNDRUMS

## THE HOSPITALITY SECTOR: CONTRACTUAL CONUNDRUMS

Query	Response
 <p>What are the common types of operation agreements?</p>	<p>The common types of management agreement include the following:</p> <ul style="list-style-type: none"> <li>▪ Hotel Management Agreement (HMA) – Under such agreement, the Owner appoints an Operator to provide the Hotel with the day-to-day operations management assistance and other incidental services. The Hotel is branded as per the brand of the Operator who is responsible for the effective operation and management of the Hotel. HMAs are usually for a tenure of 15 (fifteen) to 25 (twenty-five) years. In most cases, Operators are entitled to a base management fee and an incentive fee. The base management fee is usually linked to the total revenue generated by the Hotel. However, the incentive fee is linked to the gross operating profits of the Hotel. Such fees are in addition to the fees payable for sales and marketing and for centralized services (such as reservations and other systems).</li> <li>▪ Franchise Agreement – HMAs which are typical arrangements between international hotel brands and Operators and Indian owners are by no means the only kind of relationship between hotel brands and Owners. Hotel franchising arrangements have made an inroad into the Indian market in the last few years as a natural consequence of its maturation. Under such agreement, the Operator grants a license/franchisee to the Owner to operate the Hotel. Unlike an HMA, the Owner is responsible for managing and operating the Hotel under the franchise model. The franchise agreement is generally signed for a period of 15 (fifteen) years. Usually, Operators are entitled to a franchise fee linked to the Hotel’s rooms revenue. In some cases, the franchise fee may additionally be linked to the Hotel’s F&amp;B revenue. The franchise fees are in addition to the fees payable for sales and marketing, loyalty program and for centralized services (such as reservations and other systems).</li> <li>▪ Manchise Agreement – While we are yet to see a ‘Manchise’ model in India, we note that model, which is essentially a hybrid between a HMA and a Franchise Agreement is being implemented in other jurisdictions. Under such model, the Operator manages the Hotel under its Brand for a few years (like it would do under a HMA). Subsequent to this, the Hotel could be operated under a franchise model (as explained above). This model enables Owners to gain the management know-how during the initial years which can then be utilized to operate the Hotel under the franchise model.</li> </ul>
 <p>What is the difference between hotel management agreements and franchise agreements?</p>	<ul style="list-style-type: none"> <li>▪ The cornerstone of a hotel franchise system is its brand, while one of the hallmarks of a franchisee agreement is that the Owner typically has control over the management and operations of the franchise Hotel. Operators are seldom involved in the day-to-day activities of the Hotel, and often only play a ‘big brother’ role. In order to safeguard the brand, Operators have designed methods to monitor the brand and its representation by the Owner. This finds expression in the franchise agreement through various provisions, including damages for failure to comply.</li> <li>▪ Hotel Franchise agreements are personal contracts for the benefit of the named Owner only and are further limited by the Owner’s ownership structure as of the effective date of the agreement. Often, the franchise agreement terminates with the change in ownership. But for those Operators that permit transfer, franchise agreements are rigged with a complicated transfer provision coupled with tedious conditions for the prospective transferee, much like the HMAs. In some cases, the Owner is</li> </ul>

	<p>required to pay a buy-out fee to the franchisor which increases the cost of acquisition for a third party, thereby limiting potential purchasers. Frequently, franchise agreements also require the Owner to seek franchisor approval in case of any invitations of private placement. The franchise agreement spells out considerable control by the franchisor over the process of private placement – the franchisor reserves the right to approve, amend or delete any provision describing the franchise agreement or of the relationship between Owner and Operator, or any use of the brand, contained in any offering memorandum or other communications or materials the Owner proposes to use in the sale or offer of any securities.</p> <ul style="list-style-type: none"> <li>▪ In any HMA, the provisions dealing with the restricted area almost always exclude any franchise operated hotel under the same brand. So also, the Hotel brand seldom provides the franchisee with an area of exclusivity, that is to say, a geographic area within which he will not own, run, operate or franchise a Hotel under the same brand.</li> <li>▪ In a franchise agreement, there also exists the potential of a lower cost. Hotel brands tend to be leery at times as their ceding control may impact standards. However, the franchise model also has certain advantages in the form of reduced operational and regulatory risks.</li> </ul>
 <p>What is the typical relationship between the Owner and the Operator under an HMA?</p>	<ul style="list-style-type: none"> <li>▪ Under the HMAs, the relationship between the Operator and the Owner can be either that of a principal-agent or of an independent contractor.</li> <li>▪ Under Indian law, an agent is defined as a person employed to do an act for another or represent another in dealings with a third person. The relationship of agency confers certain rights on both the agent and principal and also subjects them to certain liabilities. While the agent is empowered to bind the principal only in respect of acts performed within the authority conferred upon the agent, such authority of the agent may be express or implied. An authority is said to be implied when it is to be inferred from the circumstances of the case; and things spoken or written, or the ordinary course of dealing may be accounted circumstances of the case.</li> <li>▪ The relationship of agency binds the principal to the acts undertaken by the agent as if it were his own. The principal is liable to indemnify the agent against the result of all actions performed by agent in exercise of the authority conferred by him, provided the actions were performed in consonance with the instructions specified by the principal. The scope of the principal’s liability to third parties extends to all lawful acts performed by the agent necessary to carry out the act he is required to. In the situation where the agent has the authority to carry on a business, the principal is liable to all lawful things necessary for the purpose of the business activity and those acts usually done in the course of such business.</li> <li>▪ As per the relationship of agency, the agent has the right to receive both remuneration due to him and compensation for expenses incurred while performing his duty. The agent has the right to retain any sums of money received in the principal’s account until he is compensated for remuneration that is due to him or for expenses and advances incurred by him. This right is only a right of retention in the nature of a lien and the agent has no right to sell anything received by him while acting on behalf of the principal. If the agent is not indemnified, he is entitled to rescind the contract of agency and claim damages.</li> <li>▪ The principal is also bound by the acts of a properly appointed sub-agent with respected to a third person, as if he were an agent appointed by him. However, the principal will not be liable to a third party where the sub agent was appointed by an agent who did not have the express authority to do so.</li> <li>▪ If the relationship between the Owner and the Operator is that of an independent contractor, (i) the Operator would only be liable for the</li> </ul>

	<p>performance of such duties as are expressly agreed under the HMA; and (ii) the Owner would only be liable to indemnify the Operator and for third party liabilities on account of acts performed by the agent, in the manner as is expressly agreed under the HMA.</p> <ul style="list-style-type: none"> <li>▪ Typically, we find that most Operators prefer the relationship between the Parties to be that of an independent contractor.</li> </ul>
 <p>What are the typical performance obligations on an Owner?</p>	<ul style="list-style-type: none"> <li>▪ The Owner is generally responsible for building or converting the Hotel in accordance with the standards and specifications provided by the Operator. The Parties usually agree on a property improvement plan in this regard. Owners are usually expected to consult the Operators at all stages of construction and have the designs pre-approved by the Operators.</li> <li>▪ The Owner is required to provide funds for the opening inventories and working capital of the Hotel. Any shortfall of funds is to be replenished by the Owner. Owners are also expected to create a reserve for meeting any expenditure in respect of replacements or addition to the furniture, fixtures and equipment of the Hotel.</li> <li>▪ Under most HMAs, Operators prefer passing on the obligation to obtain licenses, permits and approvals required for the operation of the Hotel on the Owner. Operators, especially international brands, are weary of bearing any legal risk in this regard.</li> <li>▪ Owners are required to pay the agreed fees to the Operator at the timelines agreed under the HMAs.</li> <li>▪ During the different stages of the construction or operation of the Hotel, the Owner is required to obtain and maintain specified insurances, including but not limited to public liability and indemnity and property insurance, Hotel workmen's compensation, employers' liability insurances and use and occupancy (business interruption) insurance.</li> <li>▪ All rents and taxes associated with the Hotel property are to be paid by the Owners.</li> <li>▪ Owners are required to repair, rebuild or replace the Hotel in case of any damage to or destruction of the Hotel or any part thereof. However, threshold in terms of the damage is usually negotiated under the HMA. The Owner would not be liable to repair the Hotel for damages exceeding such threshold.</li> </ul>
 <p>What are the typical performance tests agreed to under management contracts?</p>	<p>The typical performance tests are as follows:</p> <ul style="list-style-type: none"> <li>▪ RevPAR Test:             <ul style="list-style-type: none"> <li>- Under the RevPAR Test, the revenue per available room (RevPAR) of the Hotel is measured against the average REVPAR of comparable hotels forming part of a competitive set. The Owner would be entitled to terminate the HMA, if the REVPAR of the Hotel is found to be below the agreed percentage of the average REVPAR of the hotels in the Competitive Set. The percentages typically vary from 80% (eighty percent) to 95% (ninety five percent) of the average REVPAR of the competitive set. Usually, such test is measured for a period of 2 years. The hotels forming part of the competitive set, are usually specified at the outset, with the option to mutually remove or add hotels from time to time. The RevPAR is usually the most common performance test under HMAs as RevPAR data of Hotels is publicly available. The principal issue with the REVPAR Test is that it is only a test of revenue and it does not compare the profits. Further, this test does not factor in any revenue from the non-rooms departments (which may be significant in the Indian market).</li> <li>- While we are yet to come across this in India, the GOPPAR test is also gaining popularity abroad. Under such test, the gross operating profit (GOP) of the Hotel for a is measured against the average GOPPAR of</li> </ul> </li> </ul>

	<p>comparable hotels forming part of a competitive set. As in the case of the RevPAR Test, the Owner would be entitled to terminate the HMA, if the GOPPAR of the Hotel is found to be below the agreed percentage of the average GOPPAR of the hotels in the Competitive Set. The challenge in implementing the test in India, is the absence of agencies collecting and maintaining GOPPAR data.</p> <ul style="list-style-type: none"> <li>▪ Budget Test:             <ul style="list-style-type: none"> <li>- The Budget Test is generally used, when the Hotel does not have a set of Hotels of the comparable size, quality and brand as itself in order to constitute a competitive set. Under the Budget Test, the actual performance of the Hotel, i.e. the GOP of the Hotel is compared against the forecasted/projected GOP under the annual budget of the Hotel prepared by the Operator. If the achieved GOP is less than a specified percentage of the GOP set out in the approved annual budget, such test would be breached. The percentages have a similar range as that indicated for the REVPAR Test. Considering that the budget is prepared by the Operator, this test may allow the Operators to avoid test failure by lowballing the GOP in the budget. As a result of this, the approval right of the Owner over the Annual Budget becomes important so that the Operator does not set a lower threshold of projected GOP.</li> <li>- A variation to the traditional Budget Test could be that at the end of each year, the Operator be required to submit the actual performance of the Hotel to the Owner pursuant to which the parties would jointly evaluate what the performance of the Hotel (i.e. GOP) should have been (based on certain specified factors). Such mutually arrived at GOP could be the benchmark for the Budget Test as opposed to the GOP set out in the approved annual budget.</li> </ul> </li> </ul> <p>In some cases, Operators insist that both the Budget Test and the REVPAR Test would have to be failed, to entitle the Owner to terminate the HMA. However, the same would be subject to negotiations and an Owner could require the Operator to fail either test to enable the Owner to treat that as a default by the Operator.</p> <p>In most cases, Operators insist that performance tests be subject to carve-outs for reasons beyond the control of the Operator, such as a Force Majeure event. In such cases, the HMA essentially provides that the test would not apply in the year the Hotel was subject to a Force Majeure event. However, if one were to take an example of the pandemic, while it may have continued for 2 years, the tests could have still been applied to measure an Operator's performance.</p>
<p>What are the liabilities (criminal and civil) which the Owner and Operators could be exposed to? How do such liabilities get addressed in contract?</p>	<ul style="list-style-type: none"> <li>▪ The Owner is primarily liable under an HMA for all matters related to the Hotel. The rationale for this is that the Owner, being absolutely entitled to the property and taking a large part of the proceeds of the operation of the Hotel should bear the responsibility for the Hotel.</li> <li>▪ However, the Owner has limited control over the Hotel under an HMA. Often HMAs contain specific language authorizing the Operator to do all and sundry in relation to a Hotel without interference from the Owner. All policies for the Hotel are set by the Operator. Even where hiring and firing is concerned, although the employees are on the books of the Owner, it is the Operator who makes the decisions. The rights of the Owner are limited to approval over certain key employees.</li> <li>▪ The Operator under the HMA, typically enjoys unfettered rights to manage and operate the Hotel in such manner as the Operator deems fit. From setting price policies and ancillary services for the Hotel, to appointment and recruitment of Hotel employees, everything is to be spearheaded by the Operator. The Owner has little control over human resource policies,</li> </ul>

vendors, from whom supplies are sourced, managing publicity and media for the Hotel, management of bank accounts, and so on.

- Under law, since the Owner owns the Hotel, the Owner would be liable for any non-compliance of applicable laws at the Hotel. Such non-compliances may result in civil or criminal liability depending on the nature of the contravention. Additionally, if any third party claims are made against the Owner, both civil and criminal liability may accrue to the Owner on account of such third party claims.
- The employees of a Hotel are mostly employed on the rolls of the Owner. Accordingly, the Owner may be held vicariously liable for the acts or omissions of the employees. This may include liabilities under a wide range of statutes.
- If the Owner or Operator is a company and any liability is imputed on the Owner or Operator, the directors of the Owner or Operator may also be held liable under the statutes. The role played by the directors in the day to day activities of the company would have a bearing on their liability.
- Usually, an HMA contains indemnities from the Owner to the Operator for all loss, damage and liability which the Operator may sustain or incur in the operation of the Hotel including liability arising due to the acts or omissions of the employees. The typical exceptions to such releases and indemnities are willful misconduct and gross negligence by the Operator. However, there are questions as to whether such broad indemnities are effective. For example, under Indian law, agents are generally expected to exercise reasonable care in and diligence in the performance of their duties.
- Judicially, the difference between negligence and gross negligence has always been held to be a matter of degree. The ability of an Owner to obtain relief against an Operator for its negligence is therefore limited to circumstances where such negligence is of a severely reckless nature, something that would depend on the facts of the case and that the Owner would be bound to establish.
- The other way of mitigating such risks is procuring adequate insurances against any third-party claims. However, fines and penalties and frauds are usually not covered by insurance.

We hope you have found the information helpful. For further details please reach out to the author:

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