

To catch persistent and highly-evolved fraudsters, the Act confers statutory status upon the Serious Frauds Investigation Office (SFIO). Once authorised by the Central Government, the SFIO would have exclusive authority to investigate into the affairs of a company, and in such cases, no other investigating agency of Centre or State can investigate the matter.¹⁰ The Inspectors of SFIO have powers regarding all aspects of fact-finding and questioning in the investigation process.¹¹ Additionally, if authorized by the Central Government, the SFIO will also have the powers to make arrests with respect to offences that attract punishment for fraud. Enlarging SFIO's role and giving it more teeth should facilitate in taking expeditious action against errant entities/persons.

While the new Act came into effect on 1 April 2014, it will take companies a fair amount of time to implement and comprehend in totality. In essence, while the Act has all the ammunition required to fight fraud and white-collar crime, as is well-known, having a capable piece of legislation is not enough. What remains to be seen is how well these provisions are implemented, and eventually, complied with. The ball is now in the court of companies, who need to implement the provisions of the Act not just in letter but in spirit to make it truly effective.

Measuring Performance in a Hotel Management Agreement: Owner's Anxiety

By: Avimukt Dar and Prachi Bhardwaj¹

A hotel management agreement defines the relationship between the owner and the operator of a hotel. The relationship between these two parties is driven primarily by contract and not by equity or property, and as such aligning the interest of both parties is critical. The operator looks at a long-term undisturbed right to operate the hotel under its brand standards and the owner is interested in return from the property.

In such an agreement, one of the most heavily deliberated and opposed clauses is the performance test clause. Typically, operators do not voluntarily include a performance test clause within their standard agreement. This provision usually comes at the insistence of the hotel owner and generally requires intensive negotiations to structure a workable arrangement whereby the owner is protected from poor performance of the operator, by subjecting him to a performance standard that is fair and related to events and circumstances that are foreseeable and controllable.²

Standard Performance Test Clause

The standard performance test clause suggested by the operator would read as below:

Owner shall have the right to terminate this agreement, without payment of any termination fee, but subject to Operator's Cure Right and the other conditions for termination in this Clause if for any [two] consecutive Operating Years beginning with the fourth and fifth Full Operating Years (each such two-year period, a "Testing Period"), each of the following occurs in both of such Operating Years: (a) the Gross Operating Profit ("GOP") achieved by the Hotel for each Operating Year is less than [certain%] of the GOP set forth in the Operating Plan for such Operating Year, and/ or (b) the annualized revenue per available room ("RevPAR") for the Hotel for each of such Operating Years is less than [certain%] of the average of the Annualized RevPAR for the Competitive Set for each respective Operating Year (collectively, the "Performance Test").

¹⁰ Section 212 (2)

¹¹ Section 217 (5)

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² Rushmore, Stephen. 2002. "Performance Clauses Essential in Contract." Hotels, Vol.36, o.11,p.36.

In some cases the failure of one element of the performance test is enough to trigger the hotel owner's termination rights. In other cases to the advantage of the operator, both the elements could be conjunctive and hence, the operator would have to fail both the elements for the hotel owner to be able to exercise its termination right.

The commonly used performance test structures are:

a. Budget Test

In layman terms, this test seeks to ascertain the actual performance against an approved budget in a fiscal year. If the actual gross operating profit meets the percentage threshold (for example 80%-85%) of the forecasted/ projected profit), then the hotel operator has passed this test. However, the efficacy of this test is directly correlated to how well the hotel operator can predict the future and the extent of the hotel owner's right to analyze and approve the annual budget. The budget test may be cynically viewed as being less a test of the financial performance of the hotel, but rather the ability of the hotel operator to develop a budget which the operator can meet and which owner will approve. Therefore, if the threshold is too low, the owner should not approve the annual budget.

b. RevPAR Test

RevPAR stands for "revenue per available room". As commonly understood, RevPAR is calculated by dividing the gross revenue of a hotel for a period of time by the total number of available room nights over the same period. The resulting number indicates the revenue generated from each room in the hotel for that period.

This test ascertains the extent to which the actual RevPAR of the subject hotel is comparable with the average RevPAR of an identified group of comparable hotels ("Competitive Set"). Generally, for the purposes of the performance test, the Competitive Set will include a set of top three operational and directly competitive hotels in the hotel's immediate market area that are most comparable to the hotel in quality, price and market (with due consideration given to factors such as age, quality, number of guest rooms). Such Competitive Sets should be specified at the outset with the ability to review and update annually.

In order to not fail the competitive set test or RevPAR test, the operator has to make sure that the RevPAR of the subject hotel should not be less than a certain percentage of the annualized RevPAR of a Competitive Set for a particular fiscal year. A realistic competitive set is a must for this clause to find a place in the hotel management agreements, and it is sometimes not

feasible to have a competitive set where location of the hotel is remote or in a new territory.

c. Owner's Priority Return Test

This test measures whether or not the hotel is operating in such a manner so as to provide the owner with a minimum return on its funds invested. This clause is typically seen in markets involving significant aggregation of landholdings (e.g. through REITs) and is not commonly found in India.

Such a clause would read as follows:

Owner shall have the right to terminate the agreement if after full (5) five fiscal years of the operation of the Hotel, [certian%] of the Adjusted Gross Operating Profit for any subsequent operating year does not equal to at least 15% (fifteen per cent) annual return for funds invested in the hotel.

For the purposes of this clause, 'funds' would typically include all the funds invested in or loaned to the owner by its principals and applied to construction and operation of the hotel.

Common Features of Performance Tests

The key components of a typical performance test clause would be (a) assessment period; (b) operator's cure right; and (c) performance exceptions.

a. Assessment period

Typically, a performance test clause become effective after the expiry of two years from the hotel opening date. For a new hotel, this accounts for the period within which the hotel achieves minimum operating levels or, in other words, the period that is necessary to stabilize the performance of the new hotel. Allowing a 24 month window actually protects the operator, as then operator will not be terminated if it suffers one bad year. On the other hand, this is not as favorable for the owner as even if the hotel operator fails the performance test every other year, the owner has no right to terminate under the performance test.

Operator's cure right

The owner's right to terminate in case of non-performance is often balanced by the operator's cure right. The operators are able to override the performance test termination clause by making a cure payment (usually the shortfall between actual performance of the hotel and the performance required as per the performance test). This right can be further balanced by

providing a conservative cap to the number of times an operator can cure its failure. The form of compensation may vary and could include the following mechanisms: (a) cash payment to the owner; (b) the operator choosing to forego payment to him of the management fee and/or incentive fee for a specified period as its cure remedy; (c) deferred payment of incentive fees; and (d) a loan method of compensation.³

The operators will often seek “claw back” provisions where they are able to retrieve a part or whole of the compensation paid to the owner under the cure rights from subsequent surplus profits of the hotel achieved in a specified period⁴. Such claw backs should be carefully considered given the opportunity cost to the owner.

b. Performance exceptions

Performance exceptions should be carefully defined (such as force majeure or a major renovation or significant capital improvement programs) and the hotel owner should be prudent to include only those events that have a direct material adverse effect on the business of the hotel. It is also important to predict and consider in so far as possible likely adverse effects before inserting the detailed list of performance exceptions. Any such event should demonstrably have direct bearing on the fall of the hotel revenue or rise of the hotel expenses.

Conclusion

The performance test clause, in the absence of a termination at will, is the only remedy available to the owner to terminate the hotel management agreement in the event of poor performance by a bonafide operator. However, as we have seen, the parties must carefully consider and negotiate the test, its exceptions as well as its assessment period, and cure right in the context of the business plan such that neither party feels short changed if projections go wrong.

Global Laws – An Indian Twist

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In an era of globalization, synergy of laws and interpretation as followed in more developed economies causes a factor of comfort for investors entering developing economies. On account of treaty obligations or with a view to mimic certain developed economies, India has evolved several of its fiscal and economic laws based on corresponding international laws. Under Article 253 of the Constitution of India, the Indian Parliament is also empowered to make legislation for implementing any international treaties/agreements/conventions.

Amongst the laws which India has legislated inspired by international laws are the relevant Indian legislation on Customs Valuation, Transfer Pricing, and the Competition law. While being internationally inspired, there is however a trend for India to introduce an Indian-twist either through legislative amendments or an administrative interpretation. This has caused India to suffer criticism that it deals with international laws with a municipal mind-set.

It is not uncommon to have a situation where, for example, under the transfer pricing laws, a transaction that is considered as on an ‘arms length basis’ in various other jurisdictions is regarded differently under the Indian transfer pricing regulations. While the issues in India from such interpretations are in themselves difficult enough, in the recent past with the easy exchange of information over the internet, there are instances where other developing jurisdictions are raising similar issues and seeking to follow the Indian interpretation. The divergence of legislation or interpretation not only creates challenges for the businesses in India but has on occasions also caused collateral issues for investors in other jurisdictions, who have chosen to follow the Indian interpretation.

Some illustrative instances where the Indian legislations and interpretations differ from established international guidelines or practices are discussed below:

³ Farrugia, Daniel. June 2013. “Operator performance tests in the international hotel management agreements”

⁴ Farrugia, Daniel. June 2013. “Operator performance tests in the international hotel management agreements”

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