The 2009 Hospitality Law Conference

February 9-11, 2009

The Incentive Fee in Management Agreements: It's All Negotiable

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THE INCENTIVE FEE IN HOTEL MANAGEMENT AGREEMENTS:

IT'S ALL NEGOTIABLE

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All practitioners in the area of hotel development are well acquainted with standard dual fee formula of the typical management agreement for a full service hotel (1).

The base fee that is a percentage of the hotel's total or gross revenue ("Gross Revenue") that rewards the management company's revenue generating capability, but not efficiency, and can be a substantial fee for the management company even if the hotel has a negative net cash flow and the hotel owner is experiencing losses month after month.. While three percent of Gross Revenue is typical, it has become standard for the management company to add on another one to two percent for "international marketing" or other service, with the only distinction from the three-percent fee being that some management companies will commit to dedicate this add-on fee to chain (brand) marketing programs. The only aspects of the base fee that may be negotiable are the percentage amount and perhaps a ramp-up in the early years. The formulation of Gross Revenue is generally quite standard, with possible exclusions for revenues generated from hotel facilities that are not under direct management control of the management company, such as a garage, or the inclusion of net rent (as opposed to gross rent) where a third party leases commercial space in the hotel, such as a chain brand restaurant or a health club.

In any event, as a percentage of Gross Revenue, the base fee is not an indicator of what bottom line distribution, if any, will be available to the owner.

The incentive fee, by contrast, is intended to incentivize management efficiency because it is a percentage of some level of operating income after certain expenses are deducted. Not too surprisingly, these expenses that are subtracted from total revenue are typically referred to as "deductions". If the standard definition of "deductions" is used, an incentive fee will typically be in the 8%-10% range. The standard formulation for the incentive fee is a percentage of gross operating profit ("GOP"). GOP is the result of subtracting (deducting) the departmental expenses ("Operating Expenses") from Gross Revenue. A typical description of standard Operating Expenses is found in Exhibit A.

As is apparent, the standard formulation of "Operating Expenses" found in Exhibit A rewards the management company for its ability to control the hotel's routine expenses that its perceives as within its ability (and obligation) to control. Other expenses that are not included as Operating Expenses are "below the line". These non-deductible expenses are expenses that are deemed to be within owner's ability (and obligation) to control and fund, the most obvious being debt service, property taxes and property insurance. Capital expenditures, one can argue, are more in the management company's control or at least are often mandated by the management company to bring the building into compliance with its brand standards, but capital expenditures are typically "below the line" and are not deducted for purposes of calculating the incentive fee.

Management companies try to adhere to the standard percentage of approximately 10% of GOP. Owners, on the other hand, prefer a formula whereby the incentive fee is not earned, or at least not paid, until the owner has realized a satisfactory level of return on investment after payment of all expenses associated with the hotel, including those that are traditionally "below the line" – the FF&E reserve, debt service, property taxes, common charges, land rent (if any), property insurance and capital expenditures.

It is precisely at this juncture in the negotiation – typically in the letter of intent stage – that the incentive fee formula can become "nuanced" and depart from the standard formulation to provide owner with some level of comfort that its interest and the management company's interest will be more closely aligned right through the final distribution of hotel cash flow to owner.

Here are some of the variations that can be found in modern management agreements.

A) Non- Recoverable Standaside to Owner's Priority

B) Recoverable Standaside to Owner's Priority

C) Percentage of Net Cash Flow Before Income Taxes, Depreciation, Interest and Amortization.

The concept of "Owner's Priority" is designed to assure that before the management company takes an incentive fee, the owner realizes some return on the owner's investment. The owner's investment is generally equated to total project cost. From the owner's perspective, total project cost should not remain fixed but should be subject to adjustment (increase) for subsequent capital improvements, at least those that are mandated by the management company to meet brand standards or otherwise approved by the management company. The amount of Owner's Priority will have to cover owner's debt service.

An accepted alternative to an Owner's Priority" based upon total project cost is an Owner's Priority that is the anticipated debt service for a loan that must comply with the limitations agreed between owner and the management company.

When the Owner's Priority is subtracted from GOP (or some lower-down "adjusted GOP" that might have been reduced for certain "below the line" charges such as the FF&E reserve or property insurance), the resulting cash used to pay the incentive fee that has been determined as a percentage of GOP – e.g., 10% of GOP – but that is paid only to the extent of available cash after all operating expenses and then Owner's Priority is deducted. If there is insufficient cash to pay the full amount due (i.e., 10% of GOP), the deficiency is either:

a) "forgiven" – that is the Incentive Fee for the year in question is the higher of 10% of GOP or cash available after all Operating Expenses and Owner's Priority are paid;
b) accumulates as deferred incentive fee and is aggregated with all previously deferred incentive fee payments; the aggregate deferred amount may or may not bear interest – this too is negotiable.

One company illustrates the "deferred/catch-up" incentive fee formulation by attaching an exhibit to their management agreements, along the following lines. In this example, the Owner's Priority is defined as the "greater of $6 Million or actual debt service" – good from the owner's perspective. That exhibit, modified to use the same definitions as are used herein, is attached as Exhibit B.

From an owner's perspective, a simpler alternative that is aligned to owner's interest but rewards the management company with a potentially higher incentive fee if the hotel is successful after ALL expenses are taken into account, including those that admittedly are not within the management company's control, such as debt service and property taxes, is the alternative whereby owner and the management company simply split net cash flow, perhaps on a 75/25 basis.

As management company's counsel, I prefer the basic percentage of operating income formulation because the management company has little or no control over those items that are "below the line" and even some of the basic operating expenses are really not within the management company's control, to any significant degree, such as the cost of utilities or labor costs pursuant to existing collective bargaining agreements. As owner's counsel, I am willing to share a much higher percentage of net cash flow from the hotel – even as high as 25%; this formula aligns the management company's and the owner's incentives to drive profit right down to the level of owner distributions before income tax.

What bout income from rental of condo hotel units as hotel rooms? How is the rental revenue factored into the incentive fee formula?

Assume that a condo-hotel unit, one bedroom, is rented within the rental program for $1,000 gross rent. Assume that under the terms of the agreement between the owner and the hotel management company, the management company takes a 4% rental commission. That leaves $960 to be split with the unit owner. Assume that under this rental program, the split is 50% to the hotel/ 50% to the unit owner. The hotel retains $475 and the unit owner receives $475 (possibly minus a reserve for replacement of FF&E – say 6% of the $1,000 or $60; from the remaining $15, the unit owner will have to pay all condominium owner expenses, such as HOA dues, property taxes and insurance).

Under this scenario – and the treatment of rent proceeds has not yet evolved to a consistent pattern – neither the $1,000 gross rent nor the $475 retained by the hotel should be included in Gross Revenues because the management company has already taken the equivalent of its Base Fee when it collected the 4% ($40) from the unit owner. Also, by not including the gross rent or the hotel's share in Gross Revenues, the FF&E reserve for the hotel – typically a percentage of Gross revenues – is not shorted because the unit owner has funded the reserve for the condo hotel unit. But should the $1,000 gross rent amount or at least the $475 retained by the hotel beaded back to the hotel's P&L for purposes of determining the incentive fee?

The hotel owner will argue that only the $475 retained by the hotel should be included in GOP for purposes of determining the incentive fee; the remittance to the unit owner is the equivalent of a deduction for Operating Expenses because it is money that the hotel had to pay out to earn the $575 that is retained. The management company will counter that the entire $1,000 should be added to GOP for purposes of determining the incentive fee because the gross rental proceeds are the equivalent of all of the rental proceeds that would be received from the rental of a dedicated hotel room (non-condo-hotel unit) and the split to the unit owner ($475) is the equivalent of the debt service that the hotel would have to bear if the rented condo-hotel unit had been financed by the hotel rather than by the unit owner. Once again, as with all variations of incentive fees, it's all negotiable.

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(1) While the standard base fee/.incentive fee formulae are obvious in a domestic (US) management agreement, in the international context, the fees may be allocated among three or four separate agreements that when taken together constitute the full-blown management agreement. Typically, for reasons having to do with the favorable treatment afforded to royalties by many tax regimes, the fees are heavily allocated to the "License Agreement" which is a separate agreement for license of the trademark, and these fees are characterized as "Base Royalty Fee" and "Incentive Royalty Fee" with only a very small portion of the agreed fees allocated to the agreement for local management services. These purely tax-driven allocations generally favor only the hotel management company without a downside to the owner, except that the owner may be asked to "gross

up" any fees to which a local withholding tax applies. Consequently, the owner must be careful to understand the implications of any such gross-up obligation.

(2)Uniform System of Accounts for the Lodging Industry, Tenth Revised Edition (2006), by the Hotel Association of the City of New York, Inc., published by the American Hotel & Lodging Educational Institute, with support from Hospitality Financial and Technology Professionals.

EXHIBIT A

DEFINITION OF OPERATING EXPENSES

[Capitalized terms, while defined in the management agreement from which this definition was taken, can be read with their common meaning]

"<u>Operating Expenses</u>" ["<u>Deductions</u>" in many agreements] shall mean the following expenses incurred by Manager in operating the Hotel:

> *1. the cost of sales; the payroll and related costs related to Hotel Employees to the extent such Hotel Employees are engaged in Hotel business, including, without limitation, salaries, wages, workers' compensation contributions, social security and other taxes and charges, and benefits and related administration costs (including employer contributions to retirement plans, stock incentive plans, tax equalization benefits, overseas premiums, cost of living allowances, mobilization, demobilization, and relocation costs, fees and costs related to visas, residence and work permits for Hotel Employees and their dependents, vacations, automobiles, housing for Hotel Employees and their dependents, and schooling for dependents); provided that the foregoing costs shall not include the salary and other employee costs of corporate executive staff who are located at Marriott's corporate headquarters;*
>
> *2. departmental expenses incurred at departments within the Hotel; administrative and general expenses; the cost of locally-generated advertising, marketing and business promotion incurred by the Hotel; the cost of utilities, including heat, light, power, air conditioning, water, and sewage treatment and disposal; computer line charges; and routine repairs, routine maintenance and minor alterations treated as Deductions under Section 5.01;*
>
> *3. the cost of Inventories and Fixed Asset Supplies used and consumed in the operation of the Hotel;*
>
> *4. a reasonable reserve for uncollectible accounts receivable as determined by Manager;*
>
> *5. the costs and fees of independent professionals or other third parties who are retained by Manager to perform services required or permitted hereunder;*
>
> *6. the costs and fees of technical consultants, professionals and operational experts who are retained or employed by Manager, Marriott, and their Affiliates for specialized services (including, without limitation, quality assurance inspectors, personnel providing architectural, technical or*

procurement services for the Hotel, tax consultants, and personnel providing legal services in connection with matters involving the Hotel) and the cost of attendance by employees of the Hotel at training and manpower development programs designated by Manager;

7. the Base Fee;

8. the costs and expenses of the operational insurance;

9. taxes, duties, levies, assessments, or fees, if any, payable by or assessed against Manager related to this Agreement or to Manager's operation of the Hotel (exclusive of Manager's income taxes or franchise taxes), but including taxes, duties, levies, assessments, or fees, if any, relating to Hotel Employees;

10. travel, living, and other out-of-pocket costs and expenses of corporate and regional personnel of Manager and its Affiliates visiting the Hotel on specific Hotel business; provided, however, that if any such travel involves more than one hotel during any one continuous trip, such costs and expenses shall be fairly allocated among the Hotel and any other hotels visited and only the portion allocated to the Hotel shall be an Operating Expense;

11. the costs and expenses incurred by Manager in complying with applicable Legal Requirements pertaining to the operation of the Hotel;

12. the costs and expenses for Central Services;

13. such other costs and expenses incurred by Manager (either at the Hotel or elsewhere) as are specifically provided for elsewhere in this Agreement or are otherwise reasonably necessary for the proper and efficient operation of the Hotel; and

14. the Hotel's fair share of any assessments or charges due to any CC&R for facilities or services shared by the Hotel that otherwise would be treated as a Deduction if the Hotel were a stand-alone facility and did not share such facilities or services with other project components (e.g. utilities).

The term "Operating Expenses" shall not include any of the following items, all of which shall be paid by Owner from its own funds:

(a) debt service payments pursuant to any Mortgage;
(b) payments pursuant to equipment leases or other forms of financing obtained for the FF&E located in or connected with the Hotel, unless Manager has previously given its written consent to such equipment lease and/or financing and to treatment of such payments as Deductions;
(c) rental payments pursuant to any lease, right of way, right of use, or similar arrangement applicable to the Site or the Hotel;

(d) *depreciation on the Hotel or any of its contents and amortization of good will on the Hotel;*

(e) *Impositions and income taxes imposed by tax authorities on the Management Fee paid by Owner (or by Manager on Owner's behalf) to Manager;*

(f) *the amount of any transfers into the FF&E Reserve;*

(g) *Capital Expenditures*

(h) *Pre-Opening Expenses;*

(i) *costs and expenses of the [property] insurance…..; and*

(j) *costs and expenses of obtaining and maintaining occupancy permits and other non-operating licenses, permits.*

In this standard formulation, a frequently negotiated item would be the inclusion of the FF&E Reserve as an Operating Expense, rather than its exclusion as in the listing above.

EXHIBIT B

ILLUSTRATION OF THE DEFERRED/CATCH-UP INCENTIVE FEE MODEL

Assume:

GOP =	$10,000,000
Owner's Priority (“OP”) =	$ 6,000,000
Debt Service =	$ 6,500,000

Current Incentive Fee = the lesser of the following (but not less than zero):

10% x GOP = $1,000,000

or

the amount by which GOP exceeds the greater of OP or Debt Service
= $10,000,000 – $6,500,000
= $3,500,000

Therefore, the Current Incentive Fee is $1,000,000 in Year 1.

Catch-Up Incentive Fee = the lesser of the following (but not less than zero):

the amount by which the Cumulative Catch-Up Amount exceeds all Catch-Up and Alternate Catch-Up Incentive Fees Already Paid
= 0 - 0
= $0

or

the amount by which GOP exceeds the sum of (a) the greater of OP or Debt Service, plus (b) 10% of GOP
= $10,000,000 – ($6,500,000 + $1,000,000)
= $2,500,000 = the Catch-Up Incentive Fee is zero in Year 1.

Yearly Catch-Up Amount = the least of the following (but not less than zero):

(10% x GOP) minus the Current Incentive Fee
= $1,000,000 - $1,000,000 = 0

or

GOP minus OP
= $10,000,000 - $6,000,000 = $4,000,000

or

Debt Service minus OP
= $6,500,000 - $6,000,000 = $500,000

Therefore, the Yearly Catch-Up Amount is zero in Year 1.

Under the “waterfall” provisions of the Management Agreement, the $10 Million GOP for Year 1 would be paid as follows (assuming no amounts are retained as Operating Funds):

1. Owner’s Priority	$6,000,000
2. Additional amount to cover Debt Service	500,000

3.	Current Incentive Fee	1,000,000
4.	Catch-Up Incentive Fee	0
5.	25% of remainder to Sr. Debt Reserve Acct	625,000
6.	Remainder to Owner	1,875,000

Year 2

Assume:
GOP = $5,000,000
Owner's Priority (OP) = $6,000,000
Debt Service = $6,500,000

Current Incentive Fee = the lesser of the following (but not less than zero):

10% x GOP = $500,000

or

the amount by which GOP exceeds the greater of OP or Debt Service
= $5,000,000 – $6,500,000
= - $1,500,000

Therefore, the Current Incentive Fee is zero in Year 2.

Catch-Up Incentive Fee = the lesser of the following (but not less than zero):

the amount by which the Cumulative Catch-Up Amount exceeds all Catch-Up and Alternate Catch-Up Incentive Fees Already Paid
= 0 - 0
= $0

or

the amount by which GOP exceeds the sum of (a) the greater of OP or Debt Service, plus (b) 10% of GOP
= $5,000,000 – ($6,500,000 + $500,000)
= - $2,000,000

Therefore, the Catch-Up Incentive Fee is zero in Year 2.

Yearly Catch-Up Amount = the least of the following (but not less than zero):

(10% x GOP) minus the Current Incentive Fee
= $500,000 – 0 = $500,000

or

GOP minus OP
= $5,000,000 - $6,000,000 = - $1,000,000

or

Debt Service minus OP
= $6,500,000 - $6,000,000 = $500,000

Therefore, the Yearly Catch-Up Amount is zero in Year 2.

Under the "waterfall" provisions of the management Agreement, the $5 Million GOP for Year 2 would be paid as follows (assuming no amounts are retained as Operating Funds):

1. Owner's Priority	$5,000,000
2. Additional amount to cover Debt Service	0
3. Current Incentive Fee	0
4. Catch-Up Incentive Fee	0
5. 25% of remainder to Sr. Debt Reserve Acct	0
6. Remainder to Owner	0

Year 3

Assume:

GOP =	$8,500,000
OP =	$6,000,000
Debt Service =	$8,000,000

Current Incentive Fee = the lesser of the following (but not less than zero):

10% x GOP = $850,000

or

the amount by which GOP exceeds the greater of OP or Debt Service
= $8,500,000 – $8,000,000
= $500,000 = the Current Incentive Fee is $500,000 in Year 3.

Therefore, the Current Incentive Fee is $500,000 in Year 3.

Catch-Up Incentive Fee = the lesser of the following (but not less than zero):

the amount by which the Cumulative Catch-Up Amount exceeds all Catch-Up and Alternate Catch-Up Incentive Fees Already Paid
= 0 - 0
= $0

or

the amount by which GOP exceeds the sum of (a) the greater of OP or Debt Service, plus (b) 10% of GOP
= $8,500,000 – ($8,000,000 + $850,000)
= - $350,000

Therefore, the Catch-Up Incentive Fee is zero in Year 3.

Yearly Catch-Up Amount = the least of the following (but not less than zero):

(10% x GOP) minus the Current Incentive Fees
= $850,000 - $500,000 = $350,000

or

GOP minus OP
= $8,500,000 - $6,000,000 = $2,500,000

or

Debt Service minus OP
= $8,000,000 - $6,000,000 = $2,000,000

Therefore, the Yearly Catch-Up Amount is $350,000 in Year 3.

Under the "waterfall" provisions of the Management Agreement, $8.5 Million GOP Year 3 would be paid as follows: (assuming no amounts are retained as Operating Funds):

1. Owner's Priority	$6,000,000
2. Additional amount to cover Debt Service	2,000,000
3. Current Incentive Fee	500,000
4. Catch-Up Incentive Fee	0
5. 25% of remainder to Sr. Debt Reserve Acct	0
6. Remainder to Owner	0

<u>Year 4</u>

<u>Assume</u>:

GOP =	$12,000,000
Owner's Priority (OP) =	$ 6,000,000
Debt Service =	$ 8,000,000

Current Incentive Fee = the <u>lesser</u> of the following (but not less than zero):

10% x GOP = $1,200,000

or

the amount by which GOP exceeds the greater of OP or Debt Service
= $12,000,000 – $8,000,000
= $4,000,000

Therefore, the Current Incentive Fee is $1,200,000 in Year 4.

Catch-Up Incentive Fee = the <u>lesser</u> of the following (but not less than zero):

the amount by which the Cumulative Catch-Up Amount exceeds all Catch-Up and Alternate Catch-Up Incentive Fees Already Paid
= $350,000 – 0
= $350,000

or

the amount by which GOP exceeds the sum of (a) the greater of OP or Debt Service, plus (b) 10% of GOP
= $12,000,000 – ($8,000,000 + $1,200,000)
= $2,800,000

Therefore, the Catch-Up Incentive Fee is $350,000 in Year 4.

Yearly Catch-Up Amount = the least of the following (but not less than zero):

(10% x GOP) minus the Current Incentive Fee
= $1,200,000 - $1,200,000 = 0

or

GOP minus OP
= $12,000,000 - $6,000,000 = $6,000,000

or

Debt Service minus OP
= $8,000,000 - $6,000,000 = $2,000,000

Therefore, the Yearly Catch-Up Amount is zero in Year 4.

Under the "waterfall" provisions of the Management Agreement, the $12 Million GOP for Year 4 would be paid as follows (assuming no amounts are retained as Operating Funds):

1. Owner's Priority	$6,000,000
2. Additional amount to cover Debt Service	2,000,000
3. Current Incentive Fee	1,200,000
4. Catch-Up Incentive Fee	350,000
5. 25% of remainder to Sr. Debt Reserve Acct	612,500
6. Remainder to Owner	1,837,500