

Hotel and Restaurant Relationships

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I. SCOPE OF ARTICLE.

Luxury and upscale hotels have long considered the restaurant to be an essential service to provide to its guests. Midscale and even some limited service hotels have also taken up the restaurant (including coffee shops or food counters) as a way to distinguish themselves from competitors. Despite the fact that hotels often continue to lose money on restaurants (or at least just break even)—even more so in the most recent economic downturn—the hotel restaurant or restaurant in a hotel, depending on how it is perceived—is no longer an option for a significant portion of hoteliers. The presence or absence of a restaurant in a hotel affects its star or diamond rating, where experts place it when segmenting the hotel market and how potential guests perceive the overall value of a stay. Thus, there is increased pressure on many hotel owners and operators to bring in third-party restaurateurs in the hope that the restaurant can be made more profitable, whether in terms of straight dollars or the more nebulous profit of association with another strong brand. Third-party restaurateurs are sometimes better able to provide (or perceived as being better able to provide) guests with the unique dining experiences they are seeking while (hopefully) cutting costs and increasing profit. On their part, restaurateurs seem more eager to grasp the opportunity to enter into relationships where patrons are relatively easy to come by, the location is great, banquets and catering can add income and where, sometimes, a celebrity chef can strut his stuff in a concept restaurant associated with a well-known hotel luxury brand (or two).

Adding to economic pressures are the cultural ones shaping hotel and restaurant guests' expectations. A lot of ink is spilled over consumers today seeking "experiences." Everyone knows the word "foodie;" *Top Chef* recently concluded its eleventh season, *Cake Boss* and *The Barefoot Contessa* are still going strong and The Food Network is well-entrenched and popular. Various food-related fashions and political movements have swept and continue to sweep through the country, with accompanying food-related articles, blogs, apps and other media burgeoning. The word "locavore" has entered the lexicon and anyone can be a connoisseur.

This article will discuss some of the most common relationships between hotels and restaurants, in which the hotel owns the underlying real property, as well as significant legal and practical concerns associated with them. We have also included a brief checklist at the end of the article of the issues we address, as well as some other that arise often when structuring these relationships.

II. SUMMARY

When a third-party operates a restaurant at a hotel, the relationship is generally structured in one of the following ways: lease (landlord/tenant relationship only), license or franchise, management, or consulting. Larger hotel properties may have one or more outlets operating under one or more of these various structures and depending on the parties' desires, the structures can be blended. Each has their benefits and detriments from both the hoteliers' and the restaurateurs' perspectives; each has particular legal and practical challenges. The main theme of these negotiations tends to be control—who has it, who will give it up and over what—which relates intimately to who bears the majority of financial risk and potential financial upside (i.e. by some combination of rent, revenue share or some other means).

For hotels operated by a separate party, additional concerns arise that are common to managed hotel relationships, generally relating to how or whether the hotel owner or operator will interact with the restaurant. For example, who is responsible for monitoring and enforcing compliance with restaurateur? What rights and obligations does the hotel manager have? In all cases, the operator will usually prefer to be identified as the hotel owner's representative with authority to act on its behalf; however, owners may need or want to get involved if, for example, major renovations to the restaurant space are required. Hotel operators should also think through how various structures may effect their compensation in the underlying hotel management agreement – calculation of revenues, operating expenses, gross operating profit, net operating income, etc. Inevitably, the introduction of a third party to own, operate or brand the restaurant operations will require some kind of allocation of common revenues or expenses (e.g. from parking revenue attributed to valet parking for restaurant patrons to utilities that are not otherwise separately metered).

Finally, when considering a structure in which two brands will be present and perceived by consumers, before approaching the other party to begin negotiations, one of the most important factors to consider for many hotels and restaurants is how and whether the two brands will “fit.” Two well-known brands should spend a lot of time internally determining whether adding a second brand—regardless of the structure of the relationship—will support and add value to their own brands. A good brand fit may help a smooth operational relationship. And, short of legal damage to trademark rights, selecting the wrong brand in this physically and, often, contractually integrated setting can do serious reputational damage to both the hotel and restaurant.

III. STRUCTURES AND GENERAL ATTRIBUTES

A. Lease

This is a standard commercial lease relationship, in which the restaurateur is a tenant with sole responsibility for operating the restaurant and the hotelier the landlord. The tenant restaurant could be an independent, self-branded operation or it may be using third-party brands and other intellectual property under license. As in all such leases, the most significant issues are the description and extent of the rented property, what uses the tenant may make of the property, how rent is calculated, whether and how the tenant may make improvements or alterations, whether and how the tenant may use any existing personal property on the premises and who is responsible for repairing what. The lessor will provide a fairly limited indemnity and the tenant, a broad one. This can be the most “arm's length” or “hands off” structure and it's usually the simplest and most familiar for both parties. However, landlord-tenant law can be heavily regulated by state law and both entities must be aware of any common law rights and obligations that form the background within which the lease will be interpreted in a court. Rent is usually made up of base rent plus percentage rent (calculated as a percentage of gross profits or net operating income), utilities' payments (separately metered or as a negotiated percentage of the entire hotel's utility bill), and, if applicable, percentage rent for use of common areas.

Generally, this relationship gives the restaurateur the greatest control over its own operations (and, therefore, the greatest risk), and, provided the hotelier is reasonably certain about the creditworthiness of the restaurateur (or there is a guarantor), the least amount of risk (and control) for the hotelier.

B. Franchise/License

Under this structure, the hotelier (not the restaurateur or a third-party) operates the restaurant under a license or franchise agreement, keeps all the profits and pays the licensor a license or franchise fee. The licensor licenses brands, menus, trade dress (look and feel), and trade secrets (primarily recipes) to the hotelier to implement in accordance with guidelines, sometimes in the form of brand books or brand standards, issued by the licensor. The form this relationship takes will vary in scope based on amount of control over restaurant operation the licensee wishes to exert – from franchise (much control) to a simple license agreement (little or no involvement from the licensor, just the minimum necessary to protect its brands). While franchise forms are heavily regulated and well established, license agreements can take many forms and present multiple alternatives for fee structures. This is, in effect, the opposite of a lease—“hands off” in the other direction—as this structure presents minimal risk and reward for the licensee, and maximum risk and reward for hotelier.

C. Management

This structure sits between the lease and license, with elements of both. The restaurateur operates the restaurant, but is not a commercial tenant. Rather, the parties enter into a somewhat simplified version of the hotel management agreement, with varying levels of control to be exercised by the hotel and varying levels of responsibility incumbent on the restaurant operator. The hotel is compensated by a license fee that is often calculated like the rent in the lease example. This is the most flexible structure and, depending on the relationship the parties agree to, can present a moderate amount of risk and reward for both. The relationship can be as entangled or as separate as the parties desire.

D. Consulting or Endorsement

This structure is most like the license structure but with even more freedom, risk and reward for the hotelier. The hotelier operates the restaurant and the consultant—whether an individual, a famous restaurateur or chef or some other entity—simply provides guidance from time to time, usually along with his or her endorsement of the restaurant if he or she has a recognizable name. This approach presents maximum risk and reward for hotelier and minimal risk to the consultant or endorser (although, depending on the consultant’s name recognition, the reward can be pretty good). Contract forms vary widely and may include consulting services plus a one-line endorsement on the hotel restaurant’s menu, kitchen training plus a consultant’s “secret sauce” to a celebrity chef who appears four or five times a year at special events, trains the restaurant’s chef and sous-chefs and agrees to use his or her name to promote the hotel restaurant. Compensation usually consists of a flat consulting fee, a percentage of profits or both, and the consulting fee may change during the course of the agreement if the consultant is brought in pre-opening but stays around.

IV. SPECIFIC CONSIDERATIONS

A. Control

When the restaurateur is at the hotel and responsible for operating the restaurant (lease and management agreement models), the specifics of the agreement often deal with control: who is responsible for what, when, how often and where. These issues may arise in the other models, but the issue is less about two entities sharing physical space than it is control exerted through brand standards or other intellectual property licenses, which we will treat separately.

(A) Physical Space/Personal Property

In a lease agreement, the importance of the description of the leased premises cannot be overemphasized. Generally, a restaurant will want a separate street entrance so that patrons do not have to walk through the hotel to get to the restaurant. Is that feasible or desirable for the hotel? How do restaurant employees get into the hotel? Description of space is also important in a management agreement, but as a lease may have extra-contractual legal considerations, it is that much more important to describe the tenant's leasehold as precisely as possible.

Shared spaces may include the restaurant kitchen(s) itself, the loading dock, hotel employee-only areas, employee parking, property trash receptacles, patios, event and meeting space, technology or IT rooms (if the restaurant is using the hotel's technology systems). If the restaurant is not catering meetings and events for the hotel (or not exclusively catering them), and the hotel wants access to the kitchen for that purpose, this obviously needs to be stated clearly in the agreement. Shared equipment, if any, should also be described, along with who is responsible for keeping it up and who has to fix it if a hotel guest sneaks into the kitchen and breaks it.

And who has priority of use in shared spaces? How will the parties stay out of each other's way (most relevant in shared use of meeting or event space)? Although a lease can be a hands off-type of agreement, the parties will need to communicate clearly about these issues if the restaurant wants to make use of any meeting or event space on its own behalf, rather than on the hotel's. And conversely, if the hotel plans to use the restaurant to cater events, how are those bookings handled? How does the sales team at the hotel communicate with their counterparts (if any) at the hotel? Peak seasons and holidays can be particularly problematic. Detailed prioritization and mutually accessible scheduling functions and requirements are required.

Another element of control that can cause conflict between the restaurateur and hotelier under either the lease or management agreement structures is hours of operation. For certain star or diamond ratings, a hotel must offer three meals a day. For restaurants, breakfast can be a big loss. A hotel may want to have complimentary breakfasts, happy hours or free snacks; is the restaurant expected to provide them? Who staffs these events? On a related point, responsibility for room service should be clearly set forth in the agreement, including who is expected to deliver and clear up and whether and how the restaurant may alter or limit its menu after the restaurant is closed.

And although the entire point of a lease or management agreement is that the restaurant is not necessarily itself a shared space, the parties should address whether hotel guests should have priority over restaurant patrons off the street. Will a certain number of tables be allocated for hotel guests? When can those tables be released? For a popular restaurant in a popular hotel, this can be a serious point of contention.

(B) Control: Technology and Data Security

For guests' convenience, a hotel will want to allow restaurant charges to be billed to their room folios and, perhaps, the ability for guests to make reservations at the restaurant via in-room technology. The simplest way to handle this is to have the restaurant's POS interface with the hotel's PMS, which can raise a host of data security and privacy issues, depending on the hotel's privacy policy. Customer information is a valuable asset; presumably both parties will want to have access to and be able to use guest data collected at the restaurant. On a related point, what technological resources will the hotel provide to the restaurant, if any? Will the restaurant be expected to secure its own Internet access? Will it provide wireless access to restaurant patrons? What happens if the signals interfere? Given that Internet access providers might be considered liable for the illegal actions taken by users of their networks, the hotel and restaurant should discuss if and whether free Wi-Fi is a good option, whose network will be used and whether it is password protected.

(C) Control: Employees

The issues here are relatively straightforward as between the parties: who will be the employer of restaurant staff (usually the restaurant, but not always), how much input or control each party has in determining the attire, appearance, hiring and firing of employees, and whether the restaurant is exempt from or required to comply with any hotel collective bargaining agreements. Also, in any relationship other than a fairly arms-length lease transaction, the risk of the parties being considered joint employers is always present. In addition, shared employees may create wage and hour or other labor law compliance issues. And even if the restaurant employees are clearly the employees of one party or another, both parties will likely want some assurances (if not direct involvement) in the hiring criteria for restaurant employees, especially if—from the hotel side—restaurant employees will have access to hotel guests and their rooms.

B. The Brands

The iterations of brand-related issues in each of the relationships described above are endless. Each party should carefully consider the strength and value of its own brand, the brand of the other party and whether and how these brands can fit together. A franchised restaurant in a branded hotel will involve a ton of brand standards; before entering into a contract, the parties must determine if such a relationship is even possible, let alone desirable. Brands are of importance in all structures; it seems unlikely that Mandarin Oriental is going lease space to a McDonald's any time in the near future. Apart from clear misfits, the parties should consider the nature and extent to which each wants or is required to maintain separate (but related) brand integrity or if a merger of the two brands is the better choice for both. Branding is also related to control—trademark owners in the United States in particular have obligations to protect and

police uses of their brands. In the relationships that do not involve trademark licenses (leases and management agreements, usually), although brand owners do not risk legal loss of trademark rights, a hotel or restaurant's brand could easily be damaged by the poor performance of the other. Two well-known brands may not want to give; one well-known brand may be suspicious of the ability of a lesser known one to meet its standards and a lesser-known brand might be entering into the relationship to add cachet to its own.

Brand standards can imply considerable investment on the part of either party. For example, a franchised restaurant will want to be assured that the hotel is capable of and will make the necessary capital investments to keep the restaurant up to the franchisor's brand standards. Similarly, a branded restaurant may require the hotel to make capital investments in any renovation of the restaurant space the restaurant requires to align with its own brand objectives. Alternatively, as a condition of the lease, a hotel might require the restaurant tenant to renovate in accordance with the hotel's standards in exchange for, possibly, shared marketing or promotional obligations.

Each position will bring its own demands—how marketing is conducted, whether mutual approval rights are required of any marketing collateral, where and whether restaurant signage appears on the street, in the hotel, in the guest rooms—right down to the light fixtures and color scheme in certain cases. The brand issue may severely limit the efficiencies of mutual hotel and restaurant operations or it may add value to an already mutually beneficial arrangement.

Generally, in the lease/management agreement the more blended the relationship, the greater control each party will hope to exert over the quality (if not the nature) of the other's operations. This can obviously create tension, including metrics for determining whether certain quality standards are being met, but issues like these should also be addressed in the agreement if possible—profitability (usually of the restaurant only), total number of guest complaints, maintenance of star rating, guest reviews, social media attention, etc.

C. Integration

As alluded to above, the level of integration of hotel and restaurant operations can affect almost every aspect of the relationship. Whether a matter of shared space, shared employees or shared brand visions, the desired integration of the hotel and restaurant is a matter of considerable importance. Aside from all the issues discussed above, hoteliers and restaurateurs should consider the following:

- **Guest Payment.** In addition to the folio charging referred to above, extended stay hotels can present a challenge to restaurant cash flow. The parties should discuss how and when payment for meals by an extended stay guest should be made and how and whether the hotel may pay a portion of that to the restaurant before guest check-out.
- **Packages:** Will either party (or both) be able to offer packages containing the other party's services? This usually is done by the hotel ("Stay two nights, get a complimentary dinner") and if the hotelier wants to include the restaurant in these kinds of promotions,

the parties must determine how these offers are to be structured, whether the restaurant has any right to approve or reject them, how redemption is to occur and how and when each party will communicate that to the other. On a related point, very often large groups will receive discounted food and beverage services. The restaurant will want to limit or at least be able to exercise some control over how and when such offers are made.

- Gift Certificates/Loyalty Programs. The parties should determine if and to what extent each will permit the other to offer any gift certificates or cards for its services, under what conditions and so forth. Redemption procedures should be agreed upon. The parties may also want to consider whether consumption of one party's services will qualify for points (or other accumulation method) in the other's loyalty program(s), if any.

D. Compensation

The compensation structure of hotel and restaurant relationships does not appear to vary much. In a lease or operating agreement structure, the hotel usually receives a fixed monthly amount, called rent or a license fee, plus an additional amount based on a percentage of profits or net operating income of the restaurant. In franchise, consulting and license fee arrangements, the compensation structure is similar or identical, with the franchisor, consultant or licensor receiving the fees and the hotel keeping the rest of the restaurant profits. While the financials are probably one of the most significant parts of any contractual relationship, there are few or no significant legal or even practical concerns that arise, although getting the numbers settled can take a great deal of negotiation, as well as what metrics to use to calculate any incentive or profit/income-based payments.

That being said, sometimes the monthly (or annual) total fees vary based on a party's initial capital investment into the restaurant or renovations. Percentage rent might be lower or nonexistent until a restaurant has recouped its initial investment; other events relating to initial investments may trigger other financial terms.

Other financial deal terms may include responsibility for severance pay for any existing hotel employees who are terminated as a result of the third-party operator beginning operations, calculation of utilities and usage costs (which may be included in the monthly rent payment), timing of hotel payment or reimbursement for guests who bill restaurant charges to their folios, and the number and timing of any reconciliation of accounts between the parties, with the right (or not) to deduction and set-off.

E. Specific Concerns: Consulting and/or Endorsement Relationship

This relationship presents some unique challenges, although they may be familiar from any other independent contractor or consulting relationship. This model is virtually identical to the franchise model, but without the established and restrictive franchise agreement terms—more freedom, but more risk. In this model, a clear description of the services to be provided and the intellectual property being licensed by the consultant is as important as the clear description of the leased or licensed premises above.

If the consultant is licensing intellectual property—a name, an image, a secret sauce, interior design specs or all of the above—the hotel should expect the consultant-licensor to require the right to inspect or even control parts of the restaurant operation. This may be exactly what the hotel wants—*e.g.* training hotel employees in how to prepare signature dishes—or it may cause friction with the hotel’s own desire to run its operations as it sees fit. A branded consultant (like a celebrity chef) may not want to be associated with a hotel that has or develops a bad brand reputation; it is likely such individuals may start including “corporate morals” clauses in their agreements along the lines of those commonly associated with athlete endorsers. Of course, the hotel may want to add a morals clause of its own, given the notorious reputations of some famous chefs.

Exclusivity may be more of a concern in this relationship than any other, except franchising. Because the model is so fluid, and the consultant is not a franchisor, this issue can be particularly fraught. The parties’ interests will almost certainly be opposed. When dealing with a chef consultant, the hotel should also consider whether it wants the exclusivity to extend to, for example, the chef starting his own retail product line and whether it is desirable (or possible) to sell those products in the hotel restaurant.

V. CONCLUSION

The relationships described above are not, of course, mutually exclusive, and we expect variations to occur with greater frequency as the hotel-restaurant relationship evolves. Nevertheless, the issues identified above are each worthy of at least a few moments consideration when considering and then building a relationship between a hotel and a third-party operator, licensor or franchisor. Even a very general understanding of a party’s position about control of the physical space, brand and intellectual property licensing and employment concerns can shape the parties’ selection of a structure or even alter it once negotiations begin. There is always a balance between creating a solid, legally defensible agreement and giving the parties room to maneuver inside the written relationship; however, bearing in mind and addressing in the agreement the complexities that can arise in the hotel-restaurant space can, as in other potentially entangled relationships, help smooth the way.

ATTACHMENT 1: CHECKLIST OF SIGNIFICANT ISSUES

(A) **Physical Property**

- _____ Description of leased or licensed premises
 - _____ Renovations/remodels—responsibility, permissions
- _____ Permitted use of premises
 - _____ Event/group catering
 - _____ Signage (hotel, restaurant and street)
 - _____ Room service (including staffing and responsibility for drop-off/pick-up from rooms)
 - _____ Exclusivity (products, food-types) (for hotels with more than one F&B outlet)
 - _____ Priority of use (*e.g.* hotel guest preferential treatment)
- _____ Repair, maintenance and upkeep responsibilities (including cleaning and night cleaning)
- _____ Description of shared spaces/common areas
 - _____ Meeting and event space
 - _____ Priority of use
 - _____ Scheduling methods
- _____ Hours of operation
 - _____ Breakfast
 - _____ Room service v. restaurant hours
- _____ Description of leased, licensed, transferred or equipment/personal property(excluding information technology)
- _____ Permitted use of personal property
- _____ Repair, maintenance and upkeep responsibilities for personal property

_____ Description of shared equipment

_____ Priority of use

_____ Scheduling methods

(B) **Information Technology and Data Security**

_____ Shared or separate systems or combination

_____ Access rights, maintenance, upgrades, upkeep

_____ Confirm sublicensing/shared access is permissible under license from providers

_____ Use and ownership of data collected

_____ Determine if additional providers (e.g. ISPs) permitted under existing hotel agreements or if bandwidth can be shared, as applicable

_____ System/bandwidth load concerns

_____ Guest data sharing (with or without shared systems)

_____ Conformity (or not) of hotel and restaurant data privacy policies

_____ Liability for system breach

(C) **Employees**

_____ Which party employs restaurant employees

_____ If shared, address wage/hour concerns

_____ Assess co-employment/joint employment risk

_____ Collective Bargaining Agreement compliance

_____ Criteria for employee selection, retention and severance

(D) **Branding/Intellectual Property (IP)**

_____ Identification

_____ Trademarks (including trade dress/look and feel)

_____ Selection/creation/clearance of new mark

_____ Copyrighted materials (menus, images, signage)

- _____ Trade secrets (recipes, primarily)
- _____ Right of publicity (image/name/characteristic of individuals)
- _____ Permitted uses of IP (licenses)
 - _____ Menus, signage (in-hotel, in-restaurant), marketing (websites, social media, fliers)
 - _____ IP owner's right to approve all uses
 - _____ Confidentiality/secret obligations (trade secrets)
- _____ Marketing obligations
 - _____ Rights clearance for collateral
 - _____ Ownership of co-created collateral/IP

(D) **Further Integration**

- _____ Permits and licenses—responsibility, timing, maintenance, display on premises
 - _____ General business/health
 - _____ Construction/renovation
 - _____ Liquor
 - _____ Music
- _____ Guest payment mechanisms
 - _____ Folio charges/other
 - _____ Financial records sharing/reimbursement
- _____ Services packages (room + meals/other restaurant services)
 - _____ Design of package (who, how, when)
 - _____ Timing
 - _____ Accounting
- _____ Loyalty programs
 - _____ Recognition/acceptance (hotel <-> restaurant)

- _____ Value assessment (how many points/punches, etc.)
- _____ Gift certificates/discounts/complimentary services
 - _____ Mutual acceptance or other structure
 - _____ Limits on timing, amount, people eligible to receive
 - _____ Communication of amounts issued but not redeemed
 - _____ F&B discounts for groups communicated to restaurant/subject to restaurant pre-approval/other

(E) **Compensation**

- _____ Base rent/license fee calculation
 - _____ Utilities
 - _____ Other “usage” based charges
- _____ Incentive fee calculation
 - _____ Timing of payment
 - _____ Annual “top-up” or other methods
- _____ Capital investments
 - _____ Relation to monthly fees
- _____ Performance metrics (primarily to calculate incentive fee)
 - _____ NOI or Gross Profits
 - _____ Other (guest reviews, social media presence, etc.)
- _____ Buyout/liquidated damages for early termination

(F) **Specific Concerns: Consulting/Endorsement**

- _____ Services description
 - _____ Scope of consulting
 - _____ Appearances
 - _____ Menu items/signature dishes

_____ Morals clauses

_____ Exclusivity

_____ Geographic scope

_____ “Services” scope