

PREPARED for 2011 HOSPITALITY LAW CONFERENCE

REAL ESTATE TRANSACTIONS WORKSHOP

**KEY BUSINESS TERMS & CONCEPTS IN MAJOR HOTEL
AGREEMENTS**

**HOTEL ASSET MANAGEMENT OBJECTIVES,
SERVICES and TERMS**

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EDUCATION

- Duke University School of Law (1979) J.D.
- University of North Carolina (1979) M.U.R.P.
- University of Pennsylvania (1975) B.A.

EXPERIENCE

Jerry H. Herman has 25 years of broad-based business and legal leadership in the hotel and real estate industries. He has served as attorney, principal, senior executive and board member of public and privately held hospitality and real estate companies in the U.S., Japan, and Europe. Mr. Herman has extensive experience in negotiating and closing transactions on hotels and real estate in the U.S. and abroad involving diverse debt, equity, management, and franchise structures. He has played a lead role as principal and attorney in corporate and property level acquisitions and dispositions in excess of \$2.0 billion.

Mr. Herman's consulting business focuses on providing transactional structuring, strategic analysis and execution assistance, as well as advising on operating business, financing, corporate, regulatory, human resources, and transactional issues affecting hospitality companies.

PRIOR EXPERIENCE

As Of Counsel at DLA Piper US LLP, Mr. Herman's practice specialized in the structuring, negotiation and closing of management, venture, purchase/sale, financing, restructuring and franchise transactions for public, start up, entrepreneurial and turn around hotel ownership, brand and management companies and investors.

As CEO of Arlington Hospitality, Mr. Herman led a new corporate strategy which resulted in significant debt reduction and restructuring of the company's U.S. hotels. During his tenure, the board of directors was selected as the best governed in the U.S. hospitality industry by a nationally recognized independent hospitality organization.

As President of City Hotels USA, Mr. Herman was instrumental in establishing the U.S.-ownership affiliate of a publicly traded European hotel and travel company. The company bought, developed,

repositioned, and managed more than 20 full service, resort, extended-stay, all-suite, and limited service hotels throughout the US and Europe.

Prior to that, Mr. Herman served as general counsel and senior vice president, development at CRI, Inc., a national real estate investment firm based in Washington, D.C. During his tenure with CRI, the company's assets more than quadrupled to 300 multi-family/office/mixed-use/hotel projects.

PRESENTATIONS AND SEMINARS

- Speaker at hospitality conferences and seminars in the United States and Europe, including conferences in Phoenix and Monte Carlo.
- Author of numerous articles on operating, financing and transactional aspects of hotel industry.

CIVIC AND CHARITABLE

- Former Founding Member, Morry's Camp Inc.
- Chair, the PANIM Institute of BBYO, Inc.
- Former Chairman of the Board, PANIM, the Institute for Jewish Leadership and Values
- Advisory Board Member, the Netter Center for Community Partnerships, the University of Pennsylvania
- Treasurer, Mid Atlantic Regional Advisory Board, the University of Pennsylvania
- Vice President, Congregation Beth El
- Current Co-Chair, the Philanthropic Leadership Division, the Jewish Federation of Greater Washington
- Former President, The Young Leadership Division, The Federation of Washington, DC.
- Member, The Wexner Heritage Foundation

HOTEL ASSET MANAGEMENT AGREEMENT OBJECTIVES, SERVICES & TERMS

I. THE NEEDS AND THE CONCERNS SURROUNDING ASSET MANAGERS

A. What are reasons for engagement of third party asset manager by Owner?	<u>Yes/No</u>
1. Management Selection Process	
2. Oversee Hotel Manager on behalf of Owner and establish Long-Term BENCHMARK YARDSTICKS for tracking key Owner objectives	
3. Focus Hotel Manager on areas hotel manager usually does not; Serve the purpose of keeping Hotel Manager on its “toes”	
4. Assist Owner on: (a) Strategic long-term positioning and VALUE ENHANCEMENT of Hotel, including: Competition, Brand, big picture REV MAX and Expense Control issues; and (b) Maximizing Hotel’s Annual Positioning through review of Annual Plan and Annual Budget	
5. Assist Owner on specific Hotel management concerns, such as Revenue Management, Hotel Accounting and Financial Reporting Accuracy, etc.	
6. Assist Owner on “below GOP” Budget line items	
7. Be “go-between” with Manager and/or Franchisor, i.e., serve as arms and legs of “Owner”	
8. Develop, update and evaluate Owner’s Annual Asset Management Plan for Hotel	
9. Need for set of “ <u>Eyes/Ears</u> ” during Critical Ramp-Up Period	
10. Assist owner in financing , sales process or investment advisory work	

B. What are the concerns or pitfalls of utilizing Third Party Asset Manager?

1. The Failure to Define Clear Scope of Asset Manager’s Services, which can result in unempowering, confusing or demotivating Management Company and/or General Manager
2. The Costs of Third Party Asset Management versus the potential benefits of asset management to the Hotel’s:
 - Bottom Line Annual Results
 - Long term Valuation and Positioning
 - Exit Strategy

II. POTENTIAL LIST OF ASSET MANAGEMENT SERVICES

	<u>Yes/No</u>
• Participate in review of Annual Budget and Business Plan of Hotel Manager, including Market Segments, Competitive Set Analysis; Operating Standards	
• Based on Annual Plan of Hotel Manager, Owner’s Objectives and Asset Manager Analysis, prepare Annual Asset Management Plan	
• Proactive Strategic Positioning and Value Maximization Functions	
• Review Weekly G.M. Report	
• Review Monthly Revenue and Operating Statement Report of Hotel Manager	
• Review detailed Monthly Financial Reports, including payroll, general ledger, balance sheet, capex, inter-company detail, A/R and A/P aging	
• Review detailed Monthly Reports (Operations, Sales, Marketing)	
• Based on Monthly Review, Prepare Monthly Revenue Enhancement /Cost Savings Opportunities for Owner/Hotel Manager	
• Review/Responsibility for the following Hotel expenses on behalf of Owner: Utilities, Energy, Insurance, Leases, Real Estate Taxes/Personal Property Taxes	
• Weekly Revenue Management Analysis with Hotel General Manager	
• Ongoing Legal and Administrative Overview for major contract compliance	
• Evaluate Capital Expenditures Requests	

	<u>Yes/No</u>
• Staffing Guidelines and Compensation Analysis Review	
• Purchasing Analysis	
• Sales and Marketing Department Effectiveness and Productivity Audit	
• Competitive Price Shopping	
• F&B Catering Facilities/Pricing Competition Analysis	
• Monitor Local/regional demographics for impact on Hotel	
• Oversee, organize and/or execute on Owner's exit strategy/sale program	
• Attend owner meetings	
• Advise or act as agent to Owner on Owner's approvals/rights under Management Agreement	
• Monitor performance of Operator, and credentials of key Hotel executives	

III. AGREEMENTS' KEY TERMS

	<u>Yes/No</u>
• Fees for Pre-Opening Hotel Services	
• Fees for Ongoing Post Opening Hotel Services - Base Fees - Incentives Fees tied to operations	
• Term	
• Termination Events	
• Termination Sales Fee	
• Standard of Service	
• Reimbursable Expenses Cap	
• Concept of Additional Services for Additional Compensation	

	<u>Yes/No</u>
• Commitment of Senior Staff Involvement	
• Legal Status of Asset Manager	
• Agreement not to provide Asset Management or Management Services to Hotel's Direct Competitors	
• Non-Solicitation of Employees of Owner/Asset Manager	
• "Reciprocal Indemnification"	
• Confidentiality	
• Use of Hotel Names/Images by Asset Manager	

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KEY MANAGEMENT AGREEMENT CONSIDERATIONS

I. REVIEW OF THE KEY FACTORS IN SELECTING A MANAGEMENT COMPANY:

A. OWNER CONSIDERATION of KEY FACTORS for SELECTING A MANAGEMENT COMPANY WILL INCLUDE:

- Track record of company in similar hotels and markets, including STR penetration results and GOP and NOI Percentages
- Pro-forma of hotel prepared by company
- Geographic location of company
- Size of company, and depth and longevity of corporate and hotel management teams and services
- The subjective elements of trust and chemistry toward the company
- The importance of the Hotel to company's portfolio or key objectives
- The acceptability of management company to lenders, partners and franchisors
- If desired, the financial capacity of company to provide owner with Sliver equity or other financial inducements or guarantees; alternatively, the strength of company's financial statement
- Fee structure and management agreement terms
- Clout of company within hotel's brand franchise system
- Experience in turn around hotels and with down cycles
- The scope, professionalism and usability of company's reports and annual budgets and business plans

B. MANAGEMENT CONSIDERATION of the FOLLOWING OWNER ATTRIBUTES:

- Financial Strength of Owner

- Fee structure and management agreement terms
- Hotel ownership experience of Owner
- Asset and brand quality of proposed hotel vs. existing hotel portfolio of management company
- Cost/benefit of management opportunity for corporate overhead
- Potential for further business with owner
- The subjective factors of trust and chemistry with the owner
- Owner financial expectations and pro-forma for hotel's results

II. REVIEW OF THE KEY TRANSACTIONAL FACTORS IMPACTING NEGOTIATING A MANAGEMENT AGREEMENT:

A. IS THE MANAGER:

- Unaffiliated with the Owner?
- Affiliated with a majority of the Ownership? Or the Managing Member(s) or Managing Partners of Owner?
- Providing the majority of ownership equity?
- Making a “sliver” or equity investment in the transaction?
- Receiving “sweat equity” in the Ownership entity? or
- The brand owner, i.e., the licensor or franchiser as well as the manager?

WHAT ARE THE MANAGER’S PRIMARY OBJECTIVES?:

- Fee Income?
- Upside participation?
- Market presence?
- Building its name and track record?
- Brand growth?
- Enhancing an existing or potential strategic alliance?

B. IS THE OWNER OR ITS MAJORITY OWNER:

- Entrepreneurial or institutional?
- Comprised of a few or many investors, and who is the controlling party in the Owner?
- Experienced in real estate and/or hotel investments?
- An active or passive owner?
- Experienced in hotel management and/or asset management?
- A financial institution taking over a REO hotel?
- A purchaser of the Hotel out of bankruptcy or through a deed in lieu of foreclosure?

WHAT ARE THE OWNER'S PRIMARY OBJECTIVES?:

- Investment cash flow and appreciation return expectations?
- Putting key brand hotels “on the ground” in a few key cities?
- Investment time horizon?
- Sources of capital – and expected returns?
- Exit strategy?
- Hold until a better part of the cycle – and sell

C. WHAT ARE THE KEY ECONOMICS OF THE HOTEL AND THE TRANSACTION BETWEEN HOTEL AND OWNER:

- **What forecasts or financial proformas or budgets or market studies** are there for the Hotel or the Ownership/Manager Venture, and who prepared them?
- Will there be PRIORITY DISTRIBUTIONS to the Owner under the Management Agreement?
- **What are the economics, obligations, split of cash flow and residuals for the Manager or its Affiliate of the Ownership**, where Manager or its Affiliate is a partner?
- Will the Manager or any of its Affiliates **be providing any guarantees to the other investors** in the Ownership Group?

D. WHAT ARE CERTAIN KEY TRANSACTIONAL FACTS?

- Will the hotel be part of a mixed used development---what will the other uses be? When will such alternative uses be constructed and opened versus the construction and opening of the Hotel? Will there be shared services of the Hotel and other uses? Who will manage such services?
- Does the transaction involve a new development or an existing hotel?
- Does the transaction involve a major brand? Will a brand conversion and/or a substantial renovation be part of the transaction?
- Will the hotel be an independent or boutique hotel?
- Is the transaction best described as involving a restructuring/repositioning by REO owner for sale?; a restructuring/repositioning by owner for capital appreciation?; a stable property?
- Are there major third party agreements contemplated for the restaurant, shops, amenities or reservation systems?

III. GENERAL ISSUE AREAS FOR CONSIDERATION

A. CRITICAL ECONOMIC ISSUES

1. The **types of amounts and terms of fees to Manager**, including but not limited to:
 - **Base management fees**
 - **Incentive management fees** – tied to fixed or changing Amounts of GOP, NOI, STR Penetration, or other parameters; Analyze the interaction of such fees with any Owner’s Priority or Preferred Return Amounts, if any, and the impact of Owner’s provision of additional equity (capital after opening) on such fees; will there be a CPI factor?
 - **Residual Fee Upon Hotel Sale**
 - Maximum aggregate fee cap concept
 - **Sale or early termination fees**
 - **Accounting Fees** – often impacted by whether services are done on centralized or decentralized basis
 - Purchasing, design or construction management fees for ongoing capital expenditures or significant renovations
 - Corporate personnel and overhead charges – cost allocation of home office services
 - **“Centralized Services Fees”** – if so, for what?

- Licensing Fee
 - Marketing Fee
 - **Pre-opening marketing, purchasing and development services fees – and termination fee if Hotel does not open to public**
 - Reimbursement of expenses
 - **Restaurant Management Fees**
 - Logo items mark-up
 - Fees to affiliates for procurement or other services; ownership of procurement rebates/bulk savings
2. The economic role(s) to be played by Hotel Manager, including as described above, its provision of operator “sweat equity”, “sliver” or additional equity, and/or hard or soft guarantees based on economic or market based hotel performance standards.
3. The length or term of the agreement, and the rights of termination, including initial and renewal terms, and the rights of Hotel Owner to terminate agreement with or without cause, and the exit fees to be paid to Manager upon:
- a sale or refinancing of the Hotel
 - non-achievement of performance standards
 - a change in ownership or control of Manager
 - failure of Hotel to achieve certain Lender required financial covenants
4. Definitions of Certain Key Terms
- Gross Revenues
 - Operating Costs
 - Net Operating Income or Operating Profit or Available Cash Flow
 - Fixed Charges (exclusions to Operating Costs), and further subdivision into specified fixed charges– how are Land or equipment lease payments classified? How about Ownership costs, asset management fees, and capital expenditures>than FF&E reserves? How do such expenses impact performance standards or covenants?
 - Owner’s Priority; Owner’s Residual Priority

- The Uniform System of Hotel Accounts – will the accounting and certain other financial terms of Agreement be subject to Uniform System? Will there be exceptions?
 - The Competitive Set, both initially and on an ongoing basis
 - “Operating Standards” of Hotel
5. The amount and terms of required working capital funds
6. The specifics of the **performance standards**, if any, to be provided by Hotel Manager to Hotel Owner, and their terms and “consequences” for achievement or failure to achieve certain hurdles.
- are the standards tied to revenues, GOP, NOI, STR penetration; franchiser guest/quality assurance scores?
 - when do the performance standards commence?
 - if multiple standards, is it an either or test in each year, or does it take failure in consecutive years before termination right triggers?
 - What is the impact of Force Majeure events on the performance tests?
 - What Cure rights are given to Manager?
 - What is the impact of additional Owner’s Capital provided after opening on Owner’s Priority and/or Performance Standard?
7. The Importance of Owner and/or Manager Pro-forma, appraisal or lender criteria in determining fees and transactional “economics”.

B. CRITICAL HOTEL OPERATING ISSUES

1. The degree of Hotel Owner and/or Manager CONTROL, involvement, input and rights in the following areas:
- annual budget and capital expenditures budget formulation and approvals, as well annual hotel Business Plan
 - “major” changes and variances to such Budgets due to market, product or economic conditions, including if there are controls on individual vs aggregate budget line items
 - the ownership of hotel employees and/or key senior-level hotel managers by Hotel Owner or Hotel Manager
 - the hiring and/or firing of hotel senior level manager(s)

- non-solicitation of Hotel employees by Owner for period of time after termination of agreement
 - the commitment of Manager to retain key hotel executives for period of time before any transfers to other hotel projects permitted
 - approval/termination of contracts, leases, agreements
 - modifying the Competitive Set of Hotels for operational and market penetration purposes
 - specific limitations on authority of Manager
 - changes in major operating standards or product requirements of brand and the responsibility of Owner to pay for such items
 - responsibility of Owner to comply with operating standards, programs and requirements of brand
2. The facts surrounding the operation of Restaurant and other “Key Amenities” – will they be operated by:
- the hotel management company? and if so under a separate restaurant agreement?
 - an affiliated entity; under a separate restaurant or other agreement?
 - an independent entity?
- **With regard to the restaurant and F/B Operations:** how will banquets, breakfast and room service be provided? Will F&B revenues be segregated from Hotel Revenues? Will there be separate fees and economics for the Restaurant Operator?
3. **The use of an objective or subjective standard by which Owner and Manager view the Hotel** – i.e., a “first class hotel”, a 4 star hotel; a luxury resort; etc. (the importance of this standard is often heightened for Owner and/or Manager if hotel is boutique and/or not part of “franchise system”). Other important concepts include:
- The definition of the Competitive Set and the definition of Operating Standards; are they related to: Licensor Standards; “Brand Standards”; Competitive Set; or other concepts?
 - the terms and specifics of insurance coverage
 - Management Information and Guest History Systems – who pays for the equipment and upgrading expenses? Who owns such systems?

- the ownership of liquor and other critical licenses
 - access to bank accounts and cash management
 - litigation commencement and/or resolution
 - emergency situations and expenditures
 - life safety and risk management procedures and programs
 - occurrence of condemnation, casualty or other “force majeure” events – who controls? Termination fees to Manager?
 - limitations on the amount of Owner debt and changes in Lender covenants due to owner refinancing of the Hotel
 - the impact of any “CC&R’s” on Cash Flow or Operating Profit
4. The requirements placed upon Hotel Manager for ongoing and annual financial and operating reports and meetings, and an Annual Business Plan.

C. OTHER IMPORTANT MANAGEMENT AGREEMENT ISSUE AREAS

- 1. Dispute Resolution Mechanisms**, including the use and role of industry experts, mediation and/or arbitration of a binding or non-binding nature for all disputes, or only certain decisions and disputes
- 2. Lender Requirements** for Hotel Management Agreement, including treatment of incentive fees under Subordination Agreement; and the rights of parties upon foreclosure; the non-disturbance of Manager?
3. If applicable, requirements of reservation systems providers, and/hotel standards rating agencies placed upon Hotel
4. If applicable, issues pertaining to shared services in mixed-use developments, or the existence of third party amenity or service providers to the Hotel, such as independent restaurant operator; timeshare or commercial tenants; retail beach or spa concessions
5. Protection of Hotel Manager’s **trademarks, proprietary materials**, operating manuals, marketing programs, guest profiles and other information
- 6. The Right(s) of first refusal**, if any, for Manager to acquire the Hotel
7. The Impact of significant **transfers of interest** by, or change in control of, Hotel Owner or Hotel Manager; The Impact of any changes in key personnel or Manager.
8. The **Territorial Restrictions** on Manager’s ability to own or manage hotels, or certain types of hotels, within a certain geographic area.

9. The **Indemnification standards** of each party and their liability exposure; also the standard of knowledge used in ascertaining a breach of representations/warranties/covenants --- what is Manager liability for acts or omissions and for which employees?
10. The Cure rights and costs/requirements of each party upon termination for default vs. non-default.
11. Issues pertaining to Hotel repairs, maintenance and replacement:
 - expensing versus capitalizing expenses
 - amounts, modifications to and control of FF&E Reserve
 - existence/amount, and modifications to additional CAPEX Reserve for major building systems upgrades or renovations
 - management of hotel renovation/construction projects, and impact on performance standards
12. **Force Majeure Causes** relating to marked downturn - - does an industry wide downturn of more than “x” number of months trigger relief of Manager from meeting certain Performance Tests? -- if so, does it only arise if Hotel retains a certain % “REVPAR” fair share vs. its competitors?