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MANAGEMENT AGREEMENTS

Key
Business
Terms at
the LOI
Stage

PRESENTER



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THE LOI STAGE

**For good background on the legal implications of term sheets
and LOIs -**

**“TERM SHEETS AND LETTERS OF INTENT -
The Contractual Ether World”**

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<http://author.acc.com/chapters/socal/upload/ACCA-Presentation-10-15-08-6-1.pdf>

THE LOI FOR A MANAGEMENT AGREEMENT INTENDED TO BE (MOSTLY) NON-BINDING

■ What Kind of LOI?

- Intended as just a reflection of non-binding negotiations
- Allows the parties to focus on the material points of agreement without being bound
- Allows exchange of complicated business terms for consideration and refinement.
- Consider explicit disclaimers that include:
- Document is non-binding in every respect and is for discussion purposes only
- Parties will not be bound in any respect until and unless a written agreement is signed and executed
- There is no other agreement relating to the subject matter, written or oral
- The parties understand that the negotiation may not result in any enforceable contract
- There is “no agreement to agree.”
- **A fully non-binding document with no binding provisions – EXCEPT.....**

BINDING PROVISIONS

- **CONFIDENTIALITY**
- **EXCLUSIVITY**
- **REPRESENTATIONS** (e.g., Ownership of the land or validity of the option to acquire....)
- **DUE DILIGENCE DELIVERABLES**
- **GOVERNING LAW**
- **PREPARATION AND DELIVERY OF THE DEFINITIVE AGREEMENTS**
– **TIMING**
- **SUBMISSION OF THE DEAL TERMS FOR BOARD APPROVAL** (Not a good idea to wait until the definitive agreements are executed)
- **WAIVER OF CLAIM FOR NON-APPROVAL**

Good Faith Duty Of Negotiation

- In some jurisdictions, notwithstanding a finding that a LOI does not constitute a contract, courts may impose a “good faith duty of negotiation” relating to the parties efforts to finalize the contract - Includes California, New York*, Illinois, Maryland, Massachusetts
- In other jurisdictions, no such right is recognized - Includes Tennessee, Kentucky, Texas, Washington
- General rule: look to the terms of the LOI to determine if the duty has been breached.

***NY CASE LAW** has also given us “Type I” (binding) and “Type II” (non-binding) LOIs. The United States Court of Appeals for the Second Circuit in a treatise-like opinion explored the development of these two types of LOIs applying New York law in the case of *Vacold LLC v. Cerami* 545 F.3d 114 (2008)

KEY TERMS

The Time to Identify and Settle them is Now

- If an LOI is utilized, then this is the time and place to confront issues that if addressed later could be “show stoppers”.
- Generally confronting key issues in the midst of negotiating the definitive agreements can be expensive or can impose pressure upon a party to “cave” on the point “at this late stage and after all the expenses we have incurred”.
- Consequently, it is at this stage that the parties must identify for themselves the terms they insist upon.
- How the terms are phrased will dictate later how they are rendered in the definitive agreements.
- The alternative of having a term sheet with a few bullet points – “kicking the can down the road” – usually is not a good strategy.

WHAT ARE KEY TERMS FOR A TYPICAL HOTEL MANAGEMENT AGREEMENT?

IDENTIFICATION OF THE PARTIES (Can be an issue on the Developer's side)

- Is the Developer entity the ultimate owner or will the Developer be a partner, member or shareholder in the entity into which equity investments will be made and that will own the project?

DESCRIPTION OF THE "HOTEL" OR THE "PROJECT"

- Is the key count a critical element for the management company?
- Is the parking garage included in the "Hotel" and therefore it will be managed by the manager and its revenue stream will be included in the Hotel's "Gross Revenue"?
- Is commercial space to be managed as part of the Hotel or leased to an operator? (Affects how its revenue is treated)

KEY TERMS (continued)

RESIDENCES

- Will they be branded, marketed and managed by the Manager?
- Will there be a Rental Program?
- What Hotel amenities will be available to residence owners?
- What are the branding and management fees?
- Was is the split of rental proceeds with residence owners?

THE DEVELOPER'S/OWNER'S FINANCING TERMS

- Limitations on LTV
- Requirement for the Developer to obtain an SNDA for the benefit of the Manager

KEY TERMS (continued)

TERM

- Typical: 30 years renewable at Manager's election
- Negotiated:
 - Early no-fault termination by Owner with a payment of Liquidated Damages; expect a long "black-out" period
 - Manager's renewal option subject to Manager's not having failed the Performance Test
 - Termination Upon Sale - tough to obtain
 - SNDA may provide the lender with termination rights upon or some time after foreclosure or acceptance of a deed in lieu of foreclosure

KEY TERMS (continued)

PERFORMANCE TEST

- **Typical:** the two-prong test – e.g., Manager does not achieve 85% of RevPAR of the Competitive Set AND fails to meet 90% of Budgeted Gross Revenue (or GOP or NOI) for two consecutive years after the ramp-up period and failure is not due to Force Majeure of Rooms Out of Service;
- Manager will demand cure rights and will have to cure only one of the two failed prongs (not the RevPAR prong) and for only one of the failed years, and the clock is thereby reset
- Owner will counter with higher percentages and a failure in any two of three consecutive years; Owner may also ask that “AND” be changed to “OR” – not likely to be allowed
- A More Meaningful Test: Owner Must Obtain a Targeted ROI – not likely to be agreed by Manager

KEY TERMS (continued)

FEES:

REVENUE BASED-

- Base Fee – Typical: 3% of Gross Revenue
- Marketing Fee – Typical – 1% of Gross Revenue
- Negotiable? Maybe a ramp up in early years of new hotel
- For an existing hotel, Owner may seek a fee that is a higher percentage, but only of Gross Revenue in excess of previously achieved levels; this will be resisted by the big brands

KEY TERMS (continued)

INCENTIVE FEE – Rewards not just volume (Gross revenue) but operating efficiency

Typical: 10% of Gross Operating profit – i.e., Gross Revenue MINUS Operating expenses – i.e., just those expenses that are within the control of the Manager and therefore include routine departmental expenses, but do not include:

- FF&E Reserve (negotiable)
- Capital Expenditures
- Property Insurance
- Property Taxes
- Debt Service
- Distributions/Dividends
- Owner's Income Taxes

KEY TERMS (continued)

SOME VARIATIONS ON INCENTIVE FEE FORMULAE:

- Earned as a percentage of Gross Operating profit but only paid to the extent of Net Operating Income in Excess of Owner's Priority which is typically a percentage of project cost increased by subsequent capital expenditures; earned but not paid fees accumulate and may or may not bear interest and are paid to the extent of excess NOI after current Incentive Fees are paid
- Or a higher percentage - say 25% - of Net Operating Income (all expenses before depreciation and income taxes)
- Or for an existing hotel, a higher percentage but only of Gross Operating Profit in excess of a previously achieved level.

There are many variations that are the 'stuff' of hard negotiation.

KEY TERMS (continued)

OTHER CHARGES/FEEES:

Central Service Charges – e.g., reservation charges (typically \$X per reservation), reward programs (typically a percentage of Room Revenue generated by the reward-program member who is a guest at the hotel), employee training charges, brand marketing charges and more - be sure to limit these to the extent possible to cost recovery and make them apply in the same manner as they apply to all other hotels in the chain.

Voluntary (Optional) Programs – such as optional purchasing programs, technical services for improvements, quality audits and more

KEY TERMS (continued)

CREDIT ENHANCEMENTS: Assistance from the Manager to Fund the Project to Build or Acquire the Hotel

Some examples -

- Equity Participation
- Subordinated/Mezzanine Loan
- Key Money
- Fee Subordination (e.g., Incentive Fee with an Owner's Priority)
- Debt Service Guaranty
- Contribution of Technical (and Other) Services

KEY TERMS (continued)

BUDGET APPROVAL BY MANAGER

- Budget more than operating expenses; an employment plan, a marketing plan, a CAPEX plan.....
- Owner wants more than a right to review the budget that the Manager prepares; Owner wants approval right
- Some items may be excluded as outside Manager's control, such as utility costs
- Items in dispute can be set at the prior fiscal year's level plus a CPI -based increase pending resolution by an "Expert"

KEY TERMS (continued)

EMPLOYEES

Who is the employer?

In the US, Manager typically will employ all hotel employees. This can have the (unintended) consequence of preventing the Owner from obtaining a roster of each employee's salary and benefits.

Outside the US, Owner will be the employer, but Manager will assign (second) certain if its personnel to serve in key positions...possibly the entire Executive Committee. If Manager is terminated, these employees will usually exit the property when the Management Agreement is terminated (or expires).

KEY TERMS (continued)

HIRING AND FIRING KEY PERSONNEL

- Owner typically requests and obtains the right to interview candidates and approve the hiring of “key personnel” = General Manager, Controller, Director of Marketing and Sales.
- Owner not likely to have the right to fire any personnel (each employee should serve one master) but should have the right to have Owner’s views taken into account when reviewing the performance of key personnel or at least Owner’s complaints should be given good faith consideration.

KEY TERMS (continued)

INDEMNIFICATION / INSURANCE

- Typical – Manager will expect Owner to indemnify Manager against all claims, losses, liabilities, etc. Except for Manager’s acts that constitute wilful misconduct or gross negligence
- For Manager’s indemnification to be meaningful, especially where all employees are employees of Owner, acts of key employees, such as the General Manager should be attributed to Manager; otherwise a claim against Manager for acts of employees will have to be based upon negligent hiring since on-site supervision is a function of the General Manager ; this point may be too “lawery” for the LOI
- Some management companies have no indemnification provisions, leaving the parties where the contract and law leaves them.

Insurance types (except property) and levels will generally be specified by Manager and both Manager and owner will be named insureds. This eliminates a right of subrogation.

IN SUMMARY.....

Dealing with these key provisions at the LOI stage is essential to knowing whether or not you have a deal, prior to all the sturm and drang among the lawyers over the definitive agreements. No point in kicking these cans down the road.