HOSPITALITYLAWYER.COM PRESENTS
2013 THE HOSPITALITY LAW CONFERENCE
FOCUSING ON LEGAL, SAFETY & SECURITY SOLUTIONS
FEBRUARY 11–13, 2013 • HOUSTON, TEXAS

NEGOTIATING THE INCENTIVE FEE & PERFORMANCE TEST

HOSPITALITYLAWYER.COM PRESENTS
2013 THE HOSPITALITY LAW CONFERENCE
FOCUSING ON LEGAL, SAFETY & SECURITY SOLUTIONS
FEBRUARY 11–13, 2013 • HOUSTON, TEXAS

HOSPITALITYLAWYER.COM PRESENTS
2013 THE HOSPITALITY LAW CONFERENCE
FOCUSING ON LEGAL, SAFETY & SECURITY SOLUTIONS
FEBRUARY 11–13, 2013 • HOUSTON , TEXAS

PRESENTERS

James A. Crolle III – Principal

- Independent transactions and legal consultant, specializing in the hotel and hospitality industry.
- Former General Counsel of Herhsa Hospitality Trust (NYSE: HT); Member, Business Division, Eckert, Seamans, Cherin & Mellot (Washington, DC); and SVP, Assistant General Counsel for Interstate Hotels & Resorts, Inc.
- Focused on corporate transactions, commercial contracts, and securities matters, including acquisitions/dispositions, joint ventures, financings, workouts, management agreements and franchise matters, primarily in the hotel and hospitality industry.

Daniel Marinberg, Esq. Shareholder, Greenberg Traurig, P.A.

- Transactional counsel focusing on hospitality and resort acquisitions, lending, and development domestically and internationally.
- Represent both owners and hotel brand managers in all aspects of financing, construction, and development of new hotel and resorts; reflagging of existing hotels and resorts; negotiation of hotel management agreements, technical services agreement, brand license agreement, and ancillary documents.
- Listed in South Florida Legal Guide as a Top Lawyer in South Florida (2010- 2012); Listed in Super Lawyers magazine, Florida Super Lawyers (2010-2011); Member of the Winning Team, Chambers USA Award for Excellence, Real Estate (2010); Team Member, Law360 "Real Estate Practice Group of the Year" (2011)

HOSPITALITYLAWYER.COM PRESENTS
2013 THE HOSPITALITY LAW CONFERENCE
FOCUSING ON LEGAL, SAFETY & SECURITY SOLUTIONS
FEBRUARY 11–13, 2013 • HOUSTON , TEXAS

I. Introduction

- Background/context
- Purpose
- Connection between Incentive Fee and Performance Test
- Importance of Definitions ("The Devil is in the details")
- Letter of Intent v. Definitive Agreements

II. Incentive Fee - Structure

- **Historical (pre-2008) – typically 10-20% of Gross Operating Profit (GOP) over predetermined Owner Priority Return hurdle (usually 8-10% return on investment).**

II. Incentive Fee – Structure

- **Historical (pre-2008) – typically 10-20% of Gross Operating Profit (GOP) over predetermined Owner return hurdle (usually 8-10% return on investment).**

- **Current (post-2008) – still a percentage of GOP over Owners Priority Return hurdle, but increasing creativity in setting thresholds or, at times, other mechanics.**

II. Incentive Fee – Structure

- **Historical (pre-2008) – typically 10-20% of Gross Operating Profit (GOP) over predetermined Owner return hurdle (usually 8-10% return on investment).**

- **Current (post-2008) – still a percentage of GOP over Owners Priority Return hurdle, but increasing creativity in setting thresholds or, at times, other mechanics.**

- **Future – Measuring Manager Performance v. Market Performance**
  - **Rewarding yachts over dingys when the market tide lifts (and lowers) all boats**
  - **GOP penetration vs. RevPAR penetration (See, "Hotel Management Fees Miss the Mark," Miguel Rivera, HVS Asset Management & Advisory, September 2011)**

II. Incentive Fee - Elements/Metrics

- **Gross Operating Profit (GOP) = Gross Revenue less Operating Expenses**
  - **Beware of how "Gross Revenue" and "Operating Expenses" are defined**
  - **Actual v. budget**
  - **Establishing budget**
    - **Owner approval rights (branded v. non-branded/independent management)**
  - **Risk of unreasonable Owner expectations or Manager "sand bagging" or "gaming" the system**

II. Incentive Fee - Elements/Metrics

HOSPITALITYLAWYER.COM PRESENTS
2013 THE HOSPITALITY LAW CONFERENCE
FOCUSING ON LEGAL, SAFETY & SECURITY SOLUTIONS
FEBRUARY 11-13, 2013 • HOUSTON, TEXAS

- Gross Operating Profit (GOP) = Gross Revenue less Operating Expenses
  - Beware of how "Gross Revenue" and "Operating Expenses" are defined
  - Actual v. budget
  - Establishing budget
    - Owner approval rights (branded v. non-branded/independent management)
  - Risk of unreasonable Owner expectations or Manager "sand bagging"; "gaming" the system
- RevPAR Penetration = hotel RevPAR divided by combined RevPAR of competitive set
  - Definition
    - Force Majeure and Capital Improvements carve-outs
  - Establishing the competitive set
  - Relation to performance test

II. Incentive Fee - Elements/Metrics

- Gross Operating Profit (GOP) = Gross Revenue less Operating Expenses
  - Beware of definition of "Gross Revenue" and "Operating Expenses"
  - Actual v. budget
  - Establishing budget
    - Owner approval rights (branded v. non-branded/independent management)
  - Risk of unreasonable Owner expectations or Manager "sand bagging" or "gaming" the system
- RevPAR Penetration = hotel RevPAR divided by combined RevPAR of competitive set
  - Definition
    - Force Majeure and Capital Improvements carve-outs
  - Establishing the competitive set
  - Relation to performance test
- **Owner's Priority Return**
  - Definition is usually based on Return on Investment (ROI) calculation.
    - ROI = $\dfrac{\text{(Gain from investment – cost of investment)}}{\text{cost of investment}}$

II. Incentive Fee - Timing of calculation and payment

- Annual? Quarterly?
- Paid current or accrued?
- Ability to amend components and/or rates based on economic changes. Pro-Owner? Pro-Operator?
- Calculation in the absence of approved Budget
- Effect of pending arbitration or dispute resolution

II. Incentive Fee - Effect on other parts of Management Agreement

HOSPITALITYLAWYER.COM PRESENTS
2013 THE HOSPITALITY LAW CONFERENCE
FOCUSING ON LEGAL, SAFETY & SECURITY SOLUTIONS
FEBRUARY 11 – 13, 2013 • HOUSTON , TEXAS

- **Budget process**
- **Ramp-up; pre-stabilization grace period**
- **Capital expenditures by Owner during the Term**

II. Incentive Fee – Illustrations

- **Incentive Fee shall mean an amount payable to Manager equal to twelve percent (12%) of Operating Profit after payment of Owner's Priority Return. To the extent that the Manager does not receive payment in full of the Incentive Fee for any Fiscal Year pursuant to this Agreement, such amount shall be deferred without interest and paid out of available cash in later Fiscal Years pursuant to Section ____.**

- **See additional attached sample provisions.**

III. Performance Test - Structure

- **Historical (pre-2008) – "Conjunctive" two-prong test comprised of GOP at minimum % of budgeted gross revenue <u>AND</u> minimum RevPar Penetration**

III. Performance Test - Structure

- **Historical (pre-2008) – "Conjunctive" two-prong test comprised of GOP at minimum % of budgeted gross revenue AND minimum RevPar Penetration**

- **Current (post-2008) – "Disjunctive" two-prong test comprised of GOP at minimum % of budgeted gross revenue OR minimum RevPar Penetration**

III. Performance Test - Structure

- Historical (pre-2008) – "Conjunctive" two-prong test comprised of GOP at minimum % of budgeted gross revenue AND minimum RevPar Penetration

- Current (post-2008) – "Disjunctive" two-prong test comprised of GOP at minimum % of budgeted gross revenue OR minimum RevPar Penetration

- Future – minimum NOI threshold (a new Owner Priority Return threshold?) or possibly any two of three-prong test: (a) minimum NOI; (b) GOP at minimum % of budgeted gross revenue; or (c) minimum RevPar Penetration

III. Performance Test - Elements/Metrics

- Definitions
  - RevPAR penetration
  - Net Operating Income (NOI)
- Minimum NOI
- GOP at minimum % of gross revenue
- RevPAR Penetration in competitive set (unique to each hotel and market, but generally 90% or greater)
- Effect of Owner capital contributions to cover operating short-falls?

III. Performance Test - Timing

- Annual
- Pre-stabilization grace period or ramp-up
- Capital expenditures by Owner during the Term

III. Performance Test – Right of Termination/Right to Cure

- **Right of Termination -**
  - **Owner will normally have the right to terminate and replace the Manager without penalty (i.e., no termination fee) in the event Manager fails the requisite number of performance triggers.**

III. Performance Test – Right of Termination/Right to Cure

- **Manager Cure Right –**
  - **Manager may have the right to "cure" a failed performance test to threshold/trigger level (e.g.. 85% of budgeted GOP) or 100% of Budget (punitive)**

III. Performance Test – Right of Termination/Right to Cure

- Manager Cure Right –
  - Manager protections under force majeure provision for economic crisis
  - How many cures permitted during the term? During renewal term?
    - Cure both failed years? One year? If Manager cures one year, is the cure required to be the first failed year or the second failed year? Can the second failed year be used again for a subsequent two-year performance failure test (i.e., as the first year of the next two-year period)?
    - Query: is a RevPAR Penetration cure even possible?

III. Performance Test - Illustrations

- Test. Subject to the provisions of this Section ___, from and after the expiration of the _____ (__) Full Operating Year following the Opening Date (i.e. commencing with the __ (___th) and ____ (__th) Full Operating Years following the Opening Date), Owner may terminate this Agreement in accordance with the procedure described in Section ____ if for any two (2) consecutive full (i.e., twelve (12) consecutive months) Operating Years (each a "Measurement Year"), either (i) or (ii) below is applicable in the first of such Measurement Years, and either (i) or (ii) below is applicable in the second of such Measurement Years:
  - the Gross Operating Profit for such Measurement Year is less than ninety percent (90%) of the budgeted Gross Operating Profit set forth in the approved Annual Plan for such Measurement Year (the "GOP Test"); or
  - the RevPAR Penetration Index of the Hotel for such Measurement Year is less than ninety percent (90%) (the "RevPAR Test").

- See additional attached sample provisions.

IV. Summary and Questions

HOSPITALITYLAWYER.COM PRESENTS
2013 THE HOSPITALITY LAW CONFERENCE
FOCUSING ON LEGAL, SAFETY & SECURITY SOLUTIONS
FEBRUARY 11-13, 2013 • HOUSTON, TEXAS

- **Questions?**
- **Comments?**
- **Please contact Jamie with any further questions or follow-up issues at jamie.crolle@gmail.com or (202) 255-7284**
- **Please contact Dan with any further questions or follow-up issues at marinbergd@gtlaw.com or (305) 579-0726**