Key Issues in Hotel Management Agreements

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There are several different types of operational structure used in the hotel industry. In some instances the hotel owner (i.e., the party that owns the underlying real estate and business assets) will operate the hotel itself. This can be done on a branded or an unbranded basis; the former would typically involve the hotel owner being a party to a franchise agreement with a brand licensor. In other cases, the hotel owner will lease the underlying real estate to a hotel operator or brand pursuant to a lease. One of the most common structures, however, involves the hotel owner entering into a management agreement granting a third-party manager the right to manage and operate the hotel. This presentation will focus on management agreements, and will address certain key issues that often arise in negotiations and disputes involve hotel owners and managers.

I. Overview of Management Agreements

In very general terms, under a hotel management agreement the hotel owner appoints a third-party as its agent to operate the hotel on its behalf. Subject to certain items requiring owner approval, the owner turns over the keys to the hotel to the manager and the manager is responsible for day-to-day management, operation and oversight of the hotel on behalf of the owner.

There are two types of management agreement:

- Branded hotel management agreements are entered into between a hotel owner and a hotel brand. Under this type of arrangement, the hotel brand both provides a license to use its trademarks, service marks, and other identifiers in connection with the operation of the hotel, and owns and manages the hotel itself.

- Non-branded hotel management agreements are entered into between a hotel owner and a management entity that is unaffiliated with a brand. The hotel may either be independently flagged or flagged pursuant to a separate franchise agreement entered into between the hotel owner and a hotel franchisor. The franchisor will almost always have approval rights as to who serves as the manager of a hotel if there is a franchise agreement in place.

II. Key Areas of Negotiation and Dispute

a. Term and Renewal

There is an innate tension between the hotel owner and the hotel manager regarding the duration of the agreement. Typically a hotel owner wants to keep the initial term of the management agreement on the shorter side to retain flexibility to end the arrangement if it is not satisfied with the manager's results. Meanwhile, the hotel manager may want a longer initial term to provide certainty as to a larger return on its investment. Branded hotel management agreements do tend to have longer initial terms (between 20 and 30 years) as compared to unbranded hotel management agreements (between 10 and 20 years).

b. Fees

There are typically various layers of fees payable to the manager.

Base management fees are paid to the manager and are nearly always a flat percentage of gross revenues, so they are earned regardless of whether the hotel is operating profitably. Meanwhile, incentive fees are intended to incentivize the manager to operate the hotel in an efficient and profitable manner. As a result, they are typically a percentage of operating profit (i.e., gross revenues <u>minus</u> controllable operating expenses, <u>not</u> including things like debt and interest costs, taxes, required reserves, and insurance costs). In some instances, the manager may also charge an administrative or centralized services fee to pass along internal overhead for things like back office and technology support.

c. Termination Due to Performance

In a true arms-length management agreement, the owner will typically have the right to terminate the agreement if the manager fails to meet certain agreed-upon performance tests. Understandably, these are almost always highly negotiated terms.

In terms of specific performance metrics, there are numerous different ways these can be handled, including:

- A set percentage of budgeted operating profit

- RevPAR (i.e., revenue per available room for the stipulated time period)
- RevPAR Index (i.e., the index used to compare a given hotel's RevPAR performance against similarly situated hotels within a competitive set)
- Occupancy rates
- A combination of the foregoing

Most frequently, this termination right does not come into play until three to four years into the term, as the manager will insist on a ramp-up period for hotel stabilization. However, an owner with significant bargaining power may be able to get the manager to agree to an earlier commencement of the performance tests.

d. Owner Incentives

In a process where several different managers are bidding on the same project, managers will often offer certain incentives to the owner. These include:

- Key money – Some managers will provide "key money" to the owner near commencement of the management agreement. Key money is an upfront, flat amount payment to the owner intended to provide initial working capital for the hotel. Often, key money is amortized over the term of the agreement, so that it becomes non-refundable in tranches as the term elapses.
- Equity subscription – In other instances, a manager will make a capital contribution to the owner in exchange for equity in the entity that owns the hotel. While this helps ensure the manager has "skin in the game" and may serve as an incentive to maximize the hotel's operations, it can also blur the lines given that the manager is serving as both the operator of the hotel and an investor. An owner whose manager also holds equity in the hotel may also open itself to more scrutiny in the event of a termination of the hotel management agreement given that the manager has a true interest in the hotel.
- Operating guarantees – More recently, some managers are providing performance guarantees to the owner. In this instance, the manager will agree to reimburse the owner –

in cash – for any shortfalls in actual net operating income as compared to a predetermined target of net operating income. Limitations on the guarantee (e.g., ramp up periods, a monetary cap, and carveouts for causes beyond the manager's control) tend to be hotly negotiated.

e. Other Considerations

In addition to the topics discussed above, the following areas are worth considering in the context of a management agreement negotiation:

- The principal-agent relationship established by the management agreement, and evolving case law on this aspect;
- Budgeting, reserve, and capex considerations;
- Assignability provisions, and the impact of change of control transactions on these provisions; and
- Governing law and jurisdiction/venue provisions.