# Hotel Management Agreements: The Owner's Agenda

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*Negotiating hotel management agreements from the owner's point of view.*

When an owner negotiates a new hotel management agreement in today's market, the owner should expect to do reasonably well, if the owner knows what issues to raise and what outcomes to tolerate on those issues. Even an owner stuck with an older, more manager-oriented agreement may want to renegotiate parts of that agreement in exchange for lengthening its term or providing other benefits to the manager, if this makes sense as a business matter.

For either type of owner and its counsel, this article summarizes the important issues in negotiating or renegotiating any hotel management agreement—in each case from the owner's point of view. Managers will typically care about each of these issues as well, but from the opposite perspective, other than occasional "win-win" situations where one party's gain does not correlate with the other party's loss.

Management agreement negotiations often start with the manager's form document. This allows the manager to define the issues and the starting point for every discussion. The owner's role in such a negotiation is initially reactive, and this article describes the major elements of that reaction process.

For each issue, this article indicates what an owner would like to achieve, assuming an ideal world. In the real world, of course, outcomes will depend on market conditions and each party's unique leverage and timing needs in the particular context. No two deals are the same. An issue that is a no-brainer in one transaction may be crucial (or highly complex) in another. Every particular hotel will raise its own issues beyond those discussed here.

An owner's agenda and overall leverage will depend on whether the hotel already exists, is under development, or needs renovation; the nature of any existing management agreement; the local and regional hotel markets at the particular moment; the brand name; the owner's financing; and all the other variations among real estate transactions (including particularly the people involved).

Although this article discusses how the parties may structure the pricing of the management agreement, it does not provide actual percentages or dollar figures. Those figures will vary with the market and other circumstances, including the size and type of hotel, its revenue stream, and the manager's scope of services.

## TERM AND STRUCTURE

■ **Duration.** Rather than sign a long-term contract with renewal options for the manager, an owner will want the term to be shorter (e.g.,

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five years), with owner termination rights tied to unsatisfactory financial performance by the manager. Likewise, any option for the manager to extend will, if possible, depend on the manager's financial performance. An owner may want the right to terminate the management agreement upon sale, perhaps by paying a modest termination fee, which would reduce (burn off) over time.

■ **Subordination.** The owner and lender will want the management agreement expressly subordinated to any mortgage, so that upon any foreclosure (or deed in lieu), the management agreement will simply terminate. To the extent that a manager can continue to assert claims for deferred management fees or similar rights after foreclosure, the management agreement in effect becomes a prior claim on the asset superior to the mortgage, unless the manager's claims are highly contingent and subordinated. This will be a hot button for lenders. If the manager wins a right to remain in place even after foreclosure, the lender will need to worry about a wide variety of knotty issues regarding the lender-manager relationship, which are beyond the scope of this article.[1]

■ **Assistance with Financing.** Managers often say they can help owners obtain financing. As a result, managers often say they should be entitled to additional benefits and rights under the management agreement. This is an area where performance matters much more than promises. If the manager does in fact deliver financing as promised, the added benefits may be warranted. The owner should, however, look critically at exactly who and what the manager brings to the table in this area, in the context of the larger market for hotel financing at the particular moment.

■ **Brand Name ("Flag").** The owner should try, if possible, to obtain the brand name for the hotel through an agreement other than the management agreement (i.e., a franchise license), so that if the management agreement ever terminates, the owner does not automatically face the loss of the flag. The owner should demand a backup franchise license for the flag, to become effective on any termination of the management agreement, perhaps for a relatively short interim period only, to facilitate future reflagging.

■ **Non-Hotel Space.** To the extent that the hotel includes any space that is not part of hotel operations (e.g., retail space, a public parking garage, spa, or other facilities), the management agreement should clarify the extent, if any, to which the manager will be involved in operating that space and entitled to compensation for such matters as leasing commissions, management fees, income participation, and the like.[2] If the manager will not be responsible for particular ancillary space, the management agreement should clearly indicate whether manager's compensation takes into account the income stream from the ancillary space. To the extent that the manager will assume traditional real estate property management functions, the management agreement needs to address typical real estate property management issues such as collection of accounts, lease enforcement, write-offs, reporting, lease negotiations, and commissions.

■ **Termination.** Ideally, the owner will have the right to terminate at any time if profitability (or some other measure of manager performance) falls below a certain level. The manager will try to tie the performance test to a comparison against a "basket" of comparable hotels rather than to a fixed dollar figure, as the owner might prefer. Ideally, the owner will also obtain a right to terminate the management agreement at any time for any reason or no reason, with or without a termination fee. To the extent that the owner obtains a totally discretionary termination right, though, the owner needs to keep in mind recent unfavorable case law that may limit a party's right to exercise a discretionary termination right if a court later decides this somehow violated an "implied covenant of good faith and fair dealing."[3]

Upon any termination, the management agreement needs to provide for transition of operations from manager to the replacement manager (or back to the owner). These provisions would, for example, cover transfers of permits and employees as well as the transfer of computer data from old management to new management in some usable format. Beware of proprietary software. The owner (and the next manager of the hotel) may need the right to keep using it for some period even after termination.

■ **Limitation of Liability.** The owner's liability should be limited to its interest in the hotel. As an alternative, if the hotel is held by a partnership, the manager could agree not to enforce

a judgment against assets of the general partners other than their interests in the hotel.

In contrast, an owner will typically not want to allow the manager's liability to be limited in any way. An owner should not automatically accept a nonrecourse clause (protecting the manager) simply because the owner may routinely expect to see such a clause in any real estate transaction.

■ **Ownership of Personal Property.** The owner should clearly be the owner of all personal property. Most lenders will require it.

## FINANCIAL OBLIGATIONS

■ **Fee Structure.** A manager's fee will typically consist of two or ideally three elements. First, there will be a base fee—a low, single-digit percentage of a relatively "gross" measure of revenue. Part of the base fee may be subordinated to debt service. The unsubordinated portion of the fee would be expected to cover the manager's actual out-of-pocket costs, but no profit. Only the subordinated portion would generate any profit for the manager.

In addition, the manager would receive an incentive fee, typically a percentage of some definition of profit. If the management agreement measures profit after debt service (or after an "owner's priority" to cover costs of capital generally), the manager's percentage could go as high as mid-range two digits. If the measure of profit contemplates fewer deductions, the manager's percentage will drop.

■ **Debt Service or Owner's Priority.** The definition of "debt service" (or "owner's priority") will become a critical battleground. The owner should try to capture, for itself or its lender (or preferred equity holders), as much as possible before the manager starts participating through its incentive fee. The owner would, for example, want to try to include (in the base for owner's priority return) such things as preconstruction carrying costs and appreciation of the site, staff time and corporate overhead, and a deemed investment amount (phantom equity).

If the priority return is identified as debt service (rather than return on equity or deemed equity), the owner will not want to see any limit on the principal indebtedness or on the terms of repayment. The manager will have precisely the opposite views of these issues.

■ **Chainwide Services.** Managers usually try to charge a few percentage points of gross revenue for chainwide services like advertising and marketing. An owner will regard these charges as another component of management fee and try to restrict them. At a minimum, the owner will want to assure that once the owner has paid these amounts, the manager will assess no further charges for chainwide services or related matters.

■ **Miscellaneous Charges.** Managers will also try to collect a range of miscellaneous fees, covering such things as training, inspections, reservations, and human resources. Managers will take the position that these charges, like the managers' charges for "chainwide services," merely constitute reimbursement for managers' chainwide costs.

The fate of these fees depends primarily on negotiating leverage and market conditions. Even if an owner can't eliminate these fees, the owner should try to cap them and avoid giving the manager the right to impose unidentified fees in the future, even if those fees must be uniform across all hotels managed by the manager for third-party owners.

When an owner negotiates the manager's fees for reservation services, the owner should try to look ahead to, among other things, how the Internet may change the hotel reservations market in coming years. If the owner may want to establish its own Web page for reservations, this may diminish the manager's role in providing a flow of reservations. Will the manager cooperate? Will the manager's reservation fees go down if the volume of reservations drops, or are these fees tied only to the size of the hotel? The volatility of the Internet means that some of these issues may change radically over a short time.

■ **Additional Cash Requirements.** Older management agreements required owners to contribute cash to fund operating losses or capital requirements—with no limitation or ceiling. Today, an owner will look long and hard at any open-ended requirement to contribute additional funds to the hotel. The owner will regard any such obligation as inconsistent with the standalone nature of each real estate or hotel investment.

■ **Major Expenditures.** The management agreement should limit the manager's right to make major expenditures, whether of a capital or oper-

ating nature, and whether discretionary or required by new laws and codes. All such expenditures should require owner approval, to allow the owner to consider other ways to deal with any problem that may exist.

The manager will, however, legitimately want to know that the hotel will always comply with applicable law and the manager's bona fide operating standards. If an impasse over upgrade expenditures may cause the hotel to fall materially short of these standards, the manager may want the right to close the hotel temporarily, or at least temporarily remove the manager's brand name.

■ **Renovation Program.** If the owner is acquiring the hotel and plans to undertake a renovation program, the owner should obtain the manager's confirmation that this renovation program will satisfy the manager's product improvement requirements for the near- and medium-term future. The manager may want to impose fees for its role in the renovation program. Depending on the manager's role in the work and the other terms of the management agreement, such fees may be appropriate, but the owner will want to identify and control them.

■ **Rebates.** Any available rebates, discounts, and the like, whether from third-party vendors or from affiliates of the manager, should be credited back to the owner. Left to their own devices, managers can use rebates or intercompany payments as a subtle way to pull more money out of the hotel, in the guise of charging each hotel for cost reimbursements that include a profit element for the manager or its affiliates.

■ **Renovations.** Major renovations or upgrades should require the owner's approval. The management agreement should obligate manager to oversee those renovations once approved and set forth the compensation (if any) that the manager will receive in connection with this work. If no separate compensation will be provided, that should be stated.

■ **Manager's Expenses.** The manager will try to obtain separate reimbursement (above and beyond management fees) for as many expenses as possible incurred by manager. The management agreement should limit the extent to which these expenses can be reimbursed.

■ **Reserves.** The management agreement should provide for creation, funding, disbursement, and operation of reserve accounts for FF&E and for capital improvements. If any of these accounts ever exceeds a specified percentage of annual gross revenues, then the owner will want to suspend further deposits until the accounts have again fallen below that level.

Any agreement about reserves (or a separate letter agreement) should look forward to the likelihood that a lender will want some level of control over these accounts and involvement in deciding how the parties apply them. In the worst case, if the management agreement gives the manager too much discretion for the lender's tastes, the lender may insist on establishing a second set of reserve accounts that it can control more closely.

■ **Reporting.** An owner will require financial reporting procedures, including specific periodic reports, more extensive than might have been typical 5 or 10 years ago. An owner's "full reporting" requirements would probably never exceed what an individual hotel would already give its centralized chainwide management, so these requirements impose no real incremental burden on the manager.

The owner should think about requiring these reports to be provided in a specified machine-readable format. The owner should also determine, early in the process, what operational reports the owner's lender will require, to make sure those requirements do not exceed the reports the owner will receive from the manager.

■ **Budget Approval.** Any owner will want the right to approve the annual budget. The management agreement should describe the general content, scope, and level of detail required in any annual budget, and take into account whatever approval requirements the owner's lender will have. The agreement will also need to say what happens if the parties disagree about the budget. The hotel still needs to operate in compliance with the agreed level of quality.

■ **Budget Compliance.** The management agreement will require the manager to comply with the budget (subject to percentage variations for each line item or, suboptimally, category of expenditures) and will closely restrict the manager's ability to reallocate savings from one line item to another. The owner will recognize that wide-open reallocation rights and categorical overrun rights effectively deprive the owner of any control over the budget.

■ **Business Plans.** The annual budgeting process effectively forces the manager to develop an annual updated business plan for the hotel, a burden that goes beyond those historically assumed by a hotel management company.

■ **Audit Rights.** An owner will want the right to audit the manager's operations of the hotel. With enough negotiating strength, the owner may be able to negotiate that if the audit discloses an underpayment to the owner, the manager is obligated to pay not only the costs of the audit but also some multiple of the overpayment—a good incentive for the manager to avoid making mistakes with the owner's money.

### OPERATIONAL

■ **Affiliate Transactions.** Owners recognize that managers often enter into favorable transactions with their affiliates, as described previously. A strong owner will not tolerate vague assurances that these contracts will be entered into, for example, "at arm's length and on competitive terms." While this language sounds nice, the owner will find it difficult or impossible to police or to prove noncompliance.

Instead, the owner will want prior disclosure, prior approval, and (for larger contracts or larger hotels) perhaps a bidding or other market testing process to confirm any contract with an affiliate is at market rates. On the other hand, in many cases owners will recognize that these arrangements create bulk purchasing power, particularly for insurance coverage, that may ultimately benefit both owner and manager.

■ **Pre-Opening and Design.** Design of the hotel and pre-opening activities are two areas where the manager will particularly try to persuade (or require) the owner to enter into contracts with the manager's affiliates (a "technical services agreement," "restaurant design agreement," etc.). The scope and terms of those contracts must be understood, identified, and negotiated as part of management agreement negotiations. Fees may need to be recalculated accordingly.

The owner should try to persuade the manager to include as many of these services as possible as part of the basic management agreement, for which the manager is already being compensated. To the extent that the owner cannot do so, the owner will still want to cap any other fees.

■ **Complimentary Rooms and Services.** The owner will want to limit the right of the manager to provide complimentary rooms and services to hotel employees and the manager's central employees. The management agreement may require owner approval for any such arrangements beyond a certain level.

Along similar lines, the owner will want to understand the treatment of "free nights" for the manager's frequent guest awards program. The owner may wish to limit the number of "free nights" made available at the hotel.

■ **Employees.** Although the manager will generally select, hire, train, and fire employees, the owner may want to control the general manager, director of sales, controller, and other key positions. To the extent that labor union negotiations arise, the owner may want to participate.

■ **Separate Employer Entity.** Sometimes a manager will want to use an affiliate to act as the "employer of record" for the hotel employees. In that case, the manager should expressly assume responsibility for the designated employer's acts and omissions and the management agreement should acknowledge the arrangement. Although the manager or an affiliate may be the employer of record for the employees, the owner of the hotel may still face liabilities under ADA, labor, tax, and other law, notwithstanding the language of the management agreement.

■ **Record-Keeping Systems.** The owner will ask the manager to maintain all proper hotel books and records—but ideally using an open and accessible system so the owner can obtain access to this information without being at the mercy of the manager's proprietary software system. At a minimum, the owner will want to know that data can (and, when necessary, will) be converted from the manager's system to a nonproprietary system, both periodically and when the agreement terminates.

■ **Location of Books and Records.** The management agreement should require books and records for the hotel to be maintained at the hotel, with limited exceptions. Upon termination, all books and records should be delivered to the owner. The manager should not keep copies except

as required by law or for other legitimate reasons.

■ **Standard of Operation.** The management agreement should set forth a specific standard of operation for the hotel. Because of likely market shifts in franchised brands, it may be dangerous to refer, for example, to a particular brand name, as the same name may imply a varying standard of quality over time. An owner may want to require the manager to operate to a standard comparable to at least the top third of hotels (by room rate) in the relevant marketplace. Any specific standard for operation of a hotel is very difficult to define and enforce.

■ **Liquor.** If at any time the hotel cannot serve liquor, this may impair profitability of food and beverage operations and very likely of the entire hotel. The owner needs to focus with particular care on establishing a liquor ownership and licensing structure that minimizes the likelihood of interruption of service. The "obvious" answer would be to have the owner hold all liquor licenses, but this structure: (1) may cause concern to a lender (for fear of problems in foreclosure); and (2) may expose the owner and its principals to unwanted regulatory burdens (fingerprinting, background checks, etc.).

Depending on the state, the owner may want the manager, or an affiliate of the manager, to hold the liquor licenses with appropriate arrangements to give the owner the benefit of the liquor income, to the extent possible under state law. Because of the regulatory overlay (i.e., long lead times) and the importance of liquor licenses to the success of a hotel, this issue will often need to be dealt with at the earliest stages of any hotel transaction.

## MISCELLANEOUS

■ **Lender's Agenda.** Because a lender often regards itself as an "owner in waiting," the lender will share many of the owner's concerns as outlined here. A lender will also have a number of concerns unique to a lender's position not addressed in this article.

Those lender concerns, which quickly become quite difficult and tricky to deal with, could be reflected either in the management agreement itself or in a separate lender-manager agreement ("comfort letter" or "Lender's Consent") going beyond the typical "anchor tenant" type of documentation commonly used by hotel lenders. When negotiating any management agreement, the owner should require the manager to agree to provide documentation and other comfort of the type that a future lender may require.

■ **Lender's Involvement.** An owner may want to include the lender in discussions about the management agreement from the beginning. This way, the lender cannot decide, after the fact, that the management agreement is for some reason unacceptable.

On the other hand, a more confident developer in a strong market might negotiate the management agreement without the lender's involvement, and then present it as a fait accompli that the lender can either take or leave. If the then current lending environment favors hotel lending, a lender placed in this position may "take" the management agreement even if imperfect, so long as it is basically adequate.

■ **Legal Status.** An owner would prefer to limit the nature of the manager's interest in the hotel, making it clear, for example, that the manager is a licensee (at most) and not a lessee, and has no interest in real property.

■ **Agency.** A recent line of "agency" cases has held in essence that any owner can always terminate any hotel management agreement, regardless of its stated term. To try to negate the outcome of these cases, managers have started to add language to their management agreements saying managers hold an "agency coupled with an interest."

If an owner wants to preserve flexibility under the recent line of cases favoring owner termination rights, the owner should watch out for language about "agency coupled with an interest," which may sound like innocuous boilerplate. Instead, the owner should try to negate any suggestion that the manager holds an "agency coupled with an interest," and hence cannot be terminated.

■ **Allocation of Tort Risks.** An owner would ideally want the manager to pay for its own negligence, or any other act or omission that produced liability (e.g., employment-related acts and omissions). A manager will, however, try to avoid responsibility for these matters, arguing that garden variety negligence and employment-related claims are part of the cost of running and operating a hotel and they should be charged to operations.

As with most other risks of this type, the best solution is typically insurance, but residual uninsurable risks may remain. An owner will often allow the manager to charge these latter risks against operations so long as the manager met some objective standard of non-egregious behavior (e.g., good faith and reasonable exercise of diligence and business judgment).

■ **Sale of the Hotel.** Any sale of the hotel will require assistance from the manager, to answer questions from prospective purchasers and provide access to the hotel, copies of financial information, etc. Accordingly, the manager must cooperate. The owner needs comfort that the manager cannot somehow interfere with the owner's selling the hotel at the best possible price to the most attractive possible buyer on the most attractive possible terms (e.g., a transaction with a REIT).

An owner's concern becomes particularly acute if the manager has its own purchase option or other rights to buy the hotel or match outside offers. To the extent that the manager can frustrate an outside sale, this may give the manager an advantage in exercising its own purchase rights. The owner should also consider whether the nature of the manager's rights (e.g., a right to match an outside offer) will frustrate the owner's exit strategy (e.g., the aforementioned sale to a REIT).

■ **Radius Clauses.** The owner may wish to prohibit the manager from operating — or licensing its flag to — any other hotel within a specified radius of the hotel. In these cases, the owner should try to achieve absolute clarity in defining the geographical scope of the restriction, such as by attaching a map. And the owner should consider the wide range of possible transactions (management, acquisition, portfolio acquisition, new development, new brand names) that the owner may or may not desire to prohibit.

In addition to the hotel-specific issues discussed in this article, any management agreement will also raise the same issues that are part of any real estate negotiation, such as insurance, indemnities, taxes, operating requirements, general flexibility (e.g., change of use), representations, warranties, and compliance with law. The parties will also probably want to negotiate typical real estate issues of a more procedural nature, such as defaults, cure periods, materiality, consent rights, and the like. As in any other real estate negotiation, the outcome of every issue will depend on the marketplace, the parties, each party's leverage in the particular transaction, and the wide range of other forces that always make every real estate transaction, and particularly every hotel transaction, unique.

## NOTES

1 See J. Stein, "Lenders and Hotel Management Agreements," Real Est. Rev. 24–29 (Spring 1998).

2 In a hotel acquisition, the investor also needs to look more broadly at the overall scope of the hotel, and make sure the investor understands and is acquiring the entire asset. Similar issues that arise in hotel loan underwriting are discussed in J. Stein, "Hotel Loans: Underwriting, Structuring, and Lenders' Due Diligence," Real Est. Rev. 32–37 (Winter 1997).

3 See J. Stein, "When Is a Termination Right not Really a Termination Right?" Submitted for publication in *The Innkeeper* (hospitality law publication of the American Bar Association), Issue No. 2 (1999).