



**3rd  
edition**

**THE  
HMA  
&  
FRANCHISE  
AGREEMENT  
HANDBOOK**

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**Hotel Management Agreements  
& Franchise Agreements**

**for**

**Owners, Developers  
Investors & Lenders**

**JIM BUTLER**

Chairman,

JMBM Global Hospitality Group®

**BOB BRAUN**

Partner and Senior Member,

JMBM Global Hospitality Group®



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1st edition, 2011  
2nd edition, 2012



We wrote the book™ series:

- [The Developer's EB-5 Handbook for EB-5 construction financing](#)
- [The HMA & Franchise Agreement Handbook](#)
- [How To Buy And Sell A Hotel Handbook](#)
- [The Lenders Handbook for Troubled Hotels](#)
- [The ADA Compliance and Defense Guide](#)

This handbook is provided for informational purposes only.  
Legal advice should be based on your specific information  
and provided by a qualified attorney.

Dedicated to all the owners, developers,  
investors and lenders who deserve  
an even shake when they go up against  
experienced brands and operators.

We hope this will help level the playing field.

# What's new in the HMA & Franchise Agreement Handbook?

The 3rd edition of the HMA & Franchise Agreement Handbook includes a new title, eight new articles and a new chapter to deal with the important issues raised by franchise agreements, brands and independent operators.

## **The new material covers:**

- When should you choose a brand for your hotel?  
When should the brand manage your hotel?
- The myth that franchise agreements cannot be negotiated – eight things to negotiate in your next franchise agreement
- The importance of comfort letters in financing franchised hotels
- Brand franchise issues in hotel purchase and sale transactions
- Dual-branded hotels
- Beware the trap of "changing brand standards"
- Why all long-term hotel management agreements are now terminable
- Case Study: *Marriott v. Eden Roc*

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## Foreword by Jan A. deRoos

### *Why a Practical Guide is Relevant and Needed by the Industry*



Over the years, hotel owners and hotel brands (and independent operators) have developed important relationships based on the considerable value they provide to each other: one provides the real property and the other the intellectual property that together make a successful hotel.

Not surprisingly, a sophisticated and legally intricate system of management agreements (HMAs) and franchise agreements has evolved to govern how hotel owners contract with branded managers or independent operators who manage, brand and have long-term control of the hotel's assets.

Fortunately, *The HMA & Franchise Agreement Handbook* by Jim Butler and Bob Braun provides an excellent and invaluable guide to understanding the important and complex arrangements created by HMAs and franchise agreements.

The detailed discussion of HMAs and franchise agreements by Butler and Braun is refreshingly direct and candid. It is written for business people in easy-to-understand language. And it provides owners, developers, investors and lenders with the unique and pragmatic counsel that only comes from intense hands-on experience with hospitality matters – particularly HMAs and franchise agreements – representing many clients over a long period of time.

Today, the names of many hotel owners and hotel operators are recognizable throughout the investment community. But it is not necessarily the case that the party with the greatest market capitalization or success in other categories of real estate has the greatest power in negotiating an HMA or franchise agreement.



This handbook by Butler and Braun provides essential information that will help owners, developers, investors and lenders understand the far-reaching impacts of their HMAs and franchise agreements, and the important points that can, and should, be negotiated.

This version of *The Handbook* has been revised extensively to reflect a recent sea change in the hotel industry - the proliferation of franchise agreements, which have become increasingly negotiable. Hotel management agreements continue to be critical for luxury properties, resorts and larger properties. But for bread-and-butter hotels and the hot select service segment, owners and brands are placing more importance than ever on franchise agreements. This shift also raises issues of when to use independent operators, and the more favorable terms that may be negotiated with them.

The authors' objective of providing the keys for "breaking the code" to HMAs and franchise agreements is fully realized in this important work. In addition, by freely distributing this work via the Internet,\* they have committed to educating a broad audience with relevant and current practice. I commend Butler and Braun for their excellent and invaluable book.

*Jan A. deRoos*  
*Ithaca, New York*  
*March 25, 2014*

*Jan A. deRoos is the HVS Professor of Hotel Finance and Real Estate at Cornell University's School of Hotel Administration. He is co-author of The Negotiation and Administration of Hotel Management Contracts long considered to be the industry's leading reference on hotel management agreements. The current fourth edition (2009), co-authored with James Eyster, is available at through Cornell University at [general\\_books@cornell.edu](mailto:general_books@cornell.edu) or (607) 255-2933.*

\*The HMA & Franchise Agreement Handbook is available electronically through [hotellaw.jmbm.com/hma\\_handbook](http://hotellaw.jmbm.com/hma_handbook).



## Preface by Jim Butler

### *The HMA & Franchise Agreement Handbook traces its roots to the Hotel Law Blog*

*The HMA & Franchise Agreement Handbook* is drawn from articles which have appeared on [www.HotelLawBlog.com](http://www.HotelLawBlog.com) with edits required to keep them current.

Since the 1st edition of the handbook, hotel management agreements or HMAs have continued to be critical to the value of hotel assets, hotel franchise agreements have become more important than ever, and savvy investors are paying greater attention to getting better operators and better HMAs.

In this revised and updated edition, we've included a new chapter on franchise agreements, brands and independent management agreements. As more brands focus on franchising and limit their management to key strategic assets or flags, the relationships between brands, independent managers, lenders and owners has become more complicated and deserves special consideration. In this 3rd edition, we have also included two new articles on why all long-term, "no-cut," branded management agreements are now terminable.

All the hotel lawyers of JMBM's Global Hospitality Group® join me in hoping that *The HMA & Franchise Agreement Handbook* will be useful to you and your colleagues. Please contact us with any experiences or thoughts you would like to share. We always love to talk with our industry friends on "what it all means" and to see if there is any way that our resources and experience might help you accomplish your goals.

Jim Butler

Author of [www.HotelLawBlog.com](http://www.HotelLawBlog.com)

Founding partner of Jeffer Mangels Butler & Mitchell LLP

Chairman of JMBM's Global Hospitality Group®

Founder and Conference Chairman, Meet the Money®



## Introduction

*Why your hotel project needs hotel experience ...  
because hotels are different!*

Hotels are different. And so is dealing with them – whether in negotiating, litigating, or arbitrating hotel management agreements ... hotel purchase and sale, development, financing or refinancing transactions ... or in workouts, bankruptcies or receiverships. Hotels require different experience, strategies and documentation.

The lawyers of JMBM's Global Hospitality Group® are regularly surprised to see how badly world-class lenders or investors stumble with hotel assets. These players are often guided by some of the "best law firms in the country" – top Wall Street law firms with international reputations. These legal giants may be ideal for a complex real estate project or corporate finance project because they have more experience in these areas than other firms. But hotels are NOT real estate or corporate finance, and however good these firms may be in other areas of law, their lack of hotel-specific experience fails them – and their clients – when it comes to hotel transactions.

We continue to see value that is irretrievably lost, due to this lack of hotel industry experience at the outset in formulating the strategies and goals. Unfortunately, strategies and campaigns launched on the battlefield – whether in workouts, litigation, acquisitions, or financing – are too often irreversible. Once you have tripped past a decision point, you cannot go back!

*The HMA & Franchise Agreement Handbook* is intended to be a helpful resource for the friends and clients of JMBM's Global Hospitality Group®. But please listen carefully to this suggestion: If you don't have the hotel-specific experience you need for your hotel matters, then find a way to get it! We would be glad to discuss with you how the experience we have gained over more than 25 years and more than \$71 billion of hotel transactions might provide exactly the guidance or power you need to get the result you want.



## Getting started – terminology

Here is something of a Glossary for deciphering the coded terms used with HMAs and franchise agreements:

**Hotel managers and hotel operators.** In the hotel industry, the professional companies that operate hotels are interchangeably referred to as hotel managers, hotel management companies, hotel operators, or hotel operating companies. These terms have the same meaning, and for a little variety, we may use these terms interchangeably.

**A hotel brand, branded management and independent operators.** A hotel brand, however, may or may not be associated with a hotel management company. For example, Marriott, Hilton, Starwood, InterContinental and many other hotel companies own the trademarked intellectual property of one or more brand names. They can independently license the use of their brand name under a license or franchise agreement, or include the right to use the name in the HMA when they manage a hotel.

Hotel companies that own these trademarked brands are often called "the hotel brands" or just "brands." Some of these brands, such as Choice Hotels and Best Western, only license their brands and do not operate hotels. Other brands which offer hotel management services are often called branded operators or branded hotel managers – and they often will manage certain of their brands, but not others.

In contrast with branded hotel operators, a large number of hotel operators do not own or do not license any trademarked hotel brands to identify hotels to the public. Instead, they specialize in operating hotels (either branded under some other company's franchise or unbranded). This latter group of operators without brands are often called independent operators as they are independent of the traditional hotel brands.

**Hotel Management Agreements (HMAs) and their ilk.** Contracts between hotel owners and hotel operators controlling the management of a hotel go by various names. They are called hotel management agreements, HMAs, hotel management contracts or hotel operating agreements. For convenient refer-

ence, in this book, we will generally use the term "Hotel Management Agreement" or "HMA." Again, each of these terms means the same thing.

**HMAs allocate risk.** Whatever they are called, Hotel Management Agreements allocate risk between the hotel manager and the hotel owner. Many provisions in the HMA do this, including reimbursement obligations, termination rights, performance standards, indemnifications and subordination provisions. One type of "subordination" is an economic subordination, as where a manager agrees that all or a portion of its base or incentive fee will be subordinated (paid only after) to an owner's preferred return. Another type of subordination is discussed below under SNDAs.

**Franchise or License Agreements.** When brands grant the right to operate a property under a brand name, they do so under a franchise agreement, which is also often interchangeably referred to as a license agreement. Franchises are regulated by the Federal Trade Commission and, in many cases, registered with state regulators and are subject to a number of disclosure requirements substantive federal and state laws. Franchise agreements are traditionally less negotiable than management agreements, but as we discuss in Chapter 3, a number of very important terms can be negotiated.

**SNDAs.** SNDAs are agreements between a hotel operator and hotel mortgage lender governing the lender's right upon a foreclosure upon the hotel, including protection of the hotel manager's right to continue to manage the hotel after foreclosure. For our purposes the following three terms are identical in meaning and fully interchangeable in the context of hotel operating agreements: SNDA, Subordination Agreement, or Subordination, Non-Disturbance and Attornment agreement (from which the SNDA acronym is derived).

Subordination Agreements are frequently used with various types of real property when someone other than the owner is occupying or using the property secured by the lender's loan. So in the hotel industry, this arrangement involves the hotel owner, the hotel operator and the hotel lender. And because the lender's joint agreement is required, typically the HMA will specify that



these three parties will execute an SNDA (as a free standing agreement) prior to placing any lien on the hotel. The terms of the SNDA may be specified in the HMA, set forth in an attached exhibit, or required to conform to the requirements of the hotel operator.

SDNAs are potentially so important that we have devoted an entire article to them, and several articles refer to them. (See *SDNAs or Subordination Agreements affect the value, financeability, and collateral value of a hotel*, page 57).

**Comfort Letters.** Brands do not enter into SDNAs for franchised properties; however, they do enter into (and lenders typically require) "comfort letters," which are agreements that define the rights of lenders and the brand if the owner defaults under a loan secured by a franchised hotel. These agreements can have a meaningful impact on the terms that an owner may obtain from a lender, or on a lender's rights in the event of a default. Considerable care should be given to negotiating their terms. (See *The importance of Comfort Letters in financing franchised hotels*, page 79.)

HMAs and franchise agreements can dramatically affect the value, financing, operations, and marketability of a hotel.

*This HMA & Franchise Agreement Handbook* addresses a broad range of subjects on how to get a great operator and hotel management agreement, critical terms of a hotel management agreement, and how to terminate a bad hotel operator. It will also cover selecting the right brand, negotiating a franchise agreement, selecting an independent operator, and important comfort letter issues.



## About the authors

**Jim Butler** is one of the top hospitality lawyers in the world (Google™ "hotel lawyer" and you will see why).

Jim is the author of the Hotel Law Blog and Chairman of the Global Hospitality Group® at Jeffer Mangels Butler & Mitchell LLP (JMBM). For more than 25 years, Jim and his team have helped hotel owners, developers, investors and their lenders find business and legal solutions with their unequaled hotel experience gained over more than \$71 billion of hotel transactions, involving more than 3,800 properties all over the world.

Jim and his team are more than "just" great hotel lawyers. They are also hospitality consultants and business advisors who help clients unlock and preserve value in hospitality properties.

The hotel management agreement and franchise agreement are intertwined with virtually every legal and business aspect of your hotel. They are the keystone affecting the most crucial components of your hotel's success, including financing, ownership structure, value and profitability, day-to-day operations and guest perception.

JMBM's Global Hospitality Group® has negotiated, re-negotiated, litigated and advised on more than 1,000 hotel management agreements and hundreds of franchise agreements. We have current, state-of-the-art experience in successfully negotiating with virtually every major hotel management company and most of the independent operators.

A structural pillar of our hospitality power is our dominant management agreement and franchise agreement expertise.

Whether it is a troubled investment or new transaction, JMBM's Global Hospitality Group® creates legal and business solutions





for hotel owners and lenders. They are deal makers. They can help find the right operator or capital provider. They know who to call and how to reach them.

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**Bob Braun** is a transactional lawyer who has negotiated hundreds of hotel management, franchise and license agreements for owners, developers, investors and lenders. A senior member of the Global Hospitality Group® at Jeffer Mangels Butler & Mitchell LLP, Bob represents hospitality clients in both transactional and operational issues.

On a domestic and international basis, he is experienced in negotiating hotel management and franchise agreements, the purchase and sale of hotels, resorts, restaurants and other hospitality properties, providing counsel for a wide range of strategic and operational issues, and helping clients with troubled assets.

The agreements between the owner, brand and manager affect virtually every aspect of the hotel or resort property, and Bob brings to the negotiating table a wealth of experience in hotel transactions and a deep understanding of the day-to-day operating issues of hotels and resorts, and related operations such as spas, restaurants, retail, residential components, golf courses and more).

Bob's recent experience includes negotiating the management agreement for a number of dual-branded luxury, upper upscale, upscale and extended stay properties; representing a client in the management and branding of an iconic, adaptive reuse development; negotiating a management agreement for a mixed-use office, retail and ultra-luxury hotel property in a major metropol-



itan area; and facilitating the acquisition and branding of a series of hotels acquired by a lender in foreclosure. Bob has handled a transfer of management for a portfolio of 27 hotels to six separate management companies (and negotiated the related franchise agreements); represented the acquisition and assembly of a portfolio of 10 full-service and select-service hotels by an internationally recognized private equity group; and has overseen dozens of friendly and hostile transfers of brands and management of distressed hotel properties. Bob frequently advises clients on operational issues such as telecommunications, software, internet, e-commerce, data processing and outsourcing agreements, and counsels hospitality clients on national and international data security and information technology matters, particularly the mitigation of damages from data breaches and privacy violations.

Bob and JMBM's Global Hospitality team have decades of experience in helping owners preserve and enhance the value of their hotel properties through hotel management and franchise agreements. They are advocates who can level the playing field between hotel owners and hotel brands.

More than just great lawyers, the members of the Global Hospitality Group® are deal makers who bring solutions to every situation.

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# CHAPTER 1

## HOW TO GET A GREAT HOTEL OPERATOR



## Maximizing hotel value with management, branding and franchise

**I** imagine this: You are getting ready to start one of the most important processes in your hotel's "life cycle" - selecting the hotel brand and operator and getting them under contract. Even if you are a major hotel owner or developer, how many management or franchise agreements do you do a year? Two? Five? Ten? And with how many brands?

Or, maybe you are a very experienced real estate developer or investor, but you haven't done many hotel deals, and don't want to fall into the traps some other smart real estate investors have when they failed to realize that hotels are different. You need to know (or have a guide to) the players, the norms and customs, and the practices of the hotel industry. How can you do that?

With JMBM, no one will make a fool of you. Our experience will help you confidently establish what "market" is on management or franchise agreement terms. We will help you strike a good deal and a fair one.

What if you could make one phone call to solve your problem? One phone call to instantly tap into these resources:

**The "little black book" of hotel industry contacts** of a hotel industry insider, complete with relationships and credibility built over more than 25 years.

**A virtual data base of terms and deal points** gathered over **more than a thousand** transactions with virtually every brand and operator so you know when you are getting "market" terms.

**Top business advisory and legal** guidance and protection at every step.

These are precisely the resources you can access with the hospitality attorneys of JMBM's Global Hospitality Group®. We have negotiated, re-negotiated, litigated and advised on more than 1,000 hotel management agreements and hundreds of franchise agreements.



Hotel management and franchise agreements are intertwined with virtually every legal and business aspect of your hotel. They are the keystone affecting the most crucial components of your hotel's success, including financing, ownership structure, value and profitability, day-to-day operations and guest perception.

In fact, a branding and management agreement can easily create more than a 50 percent swing in the value of the hotel - and often much more! And, a long-term management or franchise agreement is difficult to "fix" once it is in place.

We can help you develop your own list of deal point priorities that you "must have," "want to have" and "would like to have." These may include a host of critical items, such as: performance clauses, termination rights, ramping up management fees, owner approval rights over operating and CapEx budgets, preferred returns for owners, and subordinated incentive fees for operators.

JMBM's Global Hospitality Group® has successfully negotiated with virtually every major hotel management company and brand. Our vast experience helps create value for your project.



## Three of the most important things you will ever do for your hotel

**T**hree of the most important things you will ever do for your hotel are selecting the right hotel brand, selecting the right operator, and negotiating a fair Franchise Agreement and/or Hotel Management Agreement.

At one time, virtually all of the upscale hotel brands were only available with a hotel management agreement. In this model, the hotel company grants the hotel the right to use its brand as part of the HMA that also gives the hotel company the sole and exclusive power to manage the hotel for a period of many years. There is no franchise or license agreement. In this arrangement, when you select the brand, you have selected the operator because there is a unity of brand and brand management. Although the power of the brand and effectiveness of operations are still separate considerations, ultimately the selection of one determines the other. This model of the so-called branded management agreement continues to be important today, particularly for luxury and upper upscale hotels.

But over the last 10 or 15 years, particularly with the success of select service product, the alternative of the franchise model has spread from its economy segment roots. In fact, it has become prevalent for significant segments of the hotel industry, including full-service and upscale hotels. It was once unthinkable that an owner could franchise a Hyatt, Westin, JW Marriott or the like, but such franchises are now growing more common by the day as the major hotel companies embrace the franchise model.

In this franchise model, the selection of brand is a completely separate process from the selection of operator. Separate agreements will be required – a franchise agreement to get legal rights to use the brand to identify the hotel and an HMA to get an operator for the hotel property.

The successful matching of the brand and operator with an asset and its owner is an important determinant to the success of a hotel project. Finding the right brand and operator for your project – and achieving reasonable terms in your franchise agree-



ment and HMA – can make a significant and positive impact in key areas: hotel value, financing, and operational success. And if you make a mistake, it is almost impossible to correct.

The terms of a branding and hotel management agreement can add – or subtract – a huge amount of value. As noted earlier, it is widely recognized that the business and legal terms of these arrangements – wholly apart from the operator's abilities – can create a 50 percent or more change in the value of your the hotel. That is huge! Take a hotel nominally worth \$100 million. By this industry rule of thumb, the hotel's value could easily swing \$50 million (from \$75 million to \$125 million) depending on the brand franchise and/or management contract terms.

In the last few years, we have seen several situations where the ability to terminate a long-term hotel management agreement added significant value. In one recent case we handled, it added \$41 million dollars to one luxury hotel. We have also seen cases where the ability to terminate would have added about \$50 million in one case, and \$65 million in another. We have seen a number of situations where the ability to terminate such a contract could have doubled the value of the hotel.

Aside from the right "marriage" partners, the terms of the franchise agreement or management contract tying brand and management together is critical, because it will likely govern the relationship for decades and is hard to change once cast.

## **Impact of brand and operator on financing**

Many lenders will not consider lending on hotels unless they are branded, and they may even have certain preferred brands and operators.

But a hotel management agreement can also effectively prevent financing or refinancing a hotel. Sometimes the contract requires operator approval for any financing, or prohibits leverage above certain specified levels. Sometimes a lender's inability to terminate the HMA on loan default will deter financing or otherwise raise the cost and adversely affect the terms of a financing.



Owners should not assume that operator approvals will be given if they are discretionary, and should not underestimate the impact a management contract can have on a lender or investor. Sometimes, the brand itself is not financeable.

## **Operators' and HMAs' effect on hotel operations**

Under most branded hotel management agreements, the operator will have almost exclusive control over all aspects of a hotel property and operation – hiring and firing, setting rates and policies, sales and marketing, renovations, capital expenditures, collecting revenues and depositing them into accounts controlled exclusively by the operator.

**Brand costs.** Maintenance of brand consistency and power often varies. Brands and their reservation systems ebb and flow in their quality and ability to deliver room revenues. Brands have great power unilaterally to impose changes in standards that all system hotels must meet – new computer systems and software, new signage and logos, new traveler loyalty programs, design requirements, promotions, and centralized services. Hotel owners frequently come to believe that the cost of these brand-imposed standards are simply not worth the benefit. Or they think the standards benefit the brand, but not the hotel.

**Owner approval rights.** The owner's ability to control runaway costs and require appropriate efforts to drive the top line, when necessary, largely depend upon "approval rights" over critical matters like annual operating budgets, marketing plans, capital expenditures, entering into union or other major contracts, personnel hiring and benefit plans, and operator self-dealing.

**New brands.** Over the last couple of hotel industry cycles, many brands and operators expanded too rapidly, lacking the procedures, systems, personnel, and expertise to manage properly all the new hotels brought under the flag. Or optimistic projections for brands reaching critical mass and economies simply failed to materialize. Sometimes regional offices were not staffed or have been closed. In some cases national sales and group marketing was either never well-developed or inadequately maintained.



**Brand changes.** We have seen many owners despair when the branded operators they signed up with subsequently changed their ownership, market position or strategies. Red Lion was once a very strong 4-star brand. RockResorts was founded as a chain of small luxury hotels that after initial growth, declined to only one hotel. Amfac was one of the fastest growing brands in the United States and was in the top 25 hotel management companies, until it sold and spun off most of its hotels to become a campground operator. Wyndham underwent dramatic changes when sold to Blackstone and later spun off, as did Doubletree when acquired by Hilton. Same with Le Méridien after the sale by Air France. Westin also went through a very rough period of several years before it was acquired by Starwood.

How would you like to be one of the hotels locked in under a long-term, no-cut branded management agreement with a "lost" or "drifting" brand in transition for several years, if not eternity?

### **It's almost impossible to fix a bad choice in brand, operator or contract terms**

Branded hotel management contracts tend to be very long-term agreements. While it depends on the brand and your bargaining power, 30-50 years is not uncommon, and some run to 100 years!

Sometimes it is possible to negotiate amendments or changes to a long-term HMA. A few operators might agree to amendments out of a sense of fairness when they are not able to deliver on promises made. But that is not very common. Usually, operators demand the strict enforcement of the contract terms unless there is some mutual benefit (such as additional investment by the hotel owner) or a trade-off of value for value.

Virtually none of the branded HMAs are terminable at an owner's option - unless you negotiated for that point. So the operator will have almost exclusive control over your hotel for many decades unless you can negotiate an amicable buy out or termination of the contract. Some operators may do this but it is unlikely to be cheap. And most operators will likely refuse to do anything to shorten their long-term contracts.



You have relatively few alternatives except to establish a material breach of contract or a breach of fiduciary duty by the operator. Of course you could always just breach the contract yourself and terminate the operator, but you will be liable to the operator for damages likely equal to the present value of the profit the operator would have received under the HMA for the remaining term. And, under appropriate circumstances, you might file bankruptcy and reject the HMA in the bankruptcy proceeding.

Like we said, HMAs with the branded hotel companies are very difficult or almost impossible to fix once they are in place.

So how do you get the right brand and operator for your hotel project ... and a deal you can live with?

There *is* a way to enhance greatly your prospects to get the best brand for your project and a fair deal on your HMA.

First, you need to avoid the five biggest mistakes hotel owners make in selecting operators and negotiating HMAs. (See page 9) Then, you need to understand and run a professionally guided HMA PRO™ to recruit a great operator while making the terms of the HMA one of the key ingredients in selecting the operator. The HMA PRO™ is described in the article that begins on page 18.

# The five biggest mistakes hotel owners make in selecting operators and negotiating brand HMAs

**W**e have found that hotel owners who get into bad situations with their operators usually fall into one or more of five traps for the unwary. The following are the five biggest mistakes owners make when seeking an operator or brand for their hotel, and the "famous last words" that accompany them:

## Mistake #1:

Focusing on just one brand and letting them know you "have" to have them.

## Famous last words:

I just have to have Brand X for my hotel. They are perfect for my project.

Even if Brand X is perfect for your project, the best way to get a great brand and a fair deal is to have a little competition, compare the results, and be sure each operator knows there is at least one other brand they have to "meet or beat." This process should not feel like an auction, but rather like the controlled, selective, competition that it will be. (See the articles on HMA PRO™ on pages 18 and 22.)

## Mistake #2:

Trying to do it yourself – the biggest false economy of all. You don't know what you don't know.

## Famous last words:

We met some operators at the recent hotel conference, and they really like our project. I think we can do a deal with them. Or ... maybe you can just give me a couple more phone numbers to call.

A casual or accidental process is not the best way to identify, recruit, and selectively draw out the best business and legal terms for your hotel management agreement. You will have already given up more than you know over cocktails or a round of golf in an undisciplined process. Hotel executives make their



living by negotiating hundreds of deals with people like you. Without identifying all your project's strong points at the outset and drawing the blueprint for your HMA PRO™ (the ultimate refinement of an RFP-like process for getting a hotel operator and fair HMA terms), your deal will get shopworn and tired before it can be properly positioned. And if you let the hotel companies guide the process, you may find yourself with a Letter of Intent (LOI) or term sheet *before* you have guided and shaped the hotel company's expectations. As a result, owners can lose big, important "deal points" that could have been accomplished if they had engaged in a disciplined process.

### Mistake #3:

Starting to get proposals from a brand or operator thinking it expedites the process and saves money.

### Famous last words:

Let me get the LOI signed first. It's 'non-binding' anyway. Then we will bring in the management agreement experts.

It is a false economy – usually a near disaster – to negotiate the LOI terms first, and *then* bring in your hotel management agreement advisors. By the time the LOI has been discussed, much less signed, it is too late to protect your interests. Although most LOIs say they are non-binding (except on exclusive dealings with only the one operator and on confidentiality), the custom of the industry is that you are "retrading" the deal if you try to change those "non-binding" terms when your experts try to un-ring the bells that you have set off. Yes, you could probably walk from the deal (after waiting out the exclusivity period), but you have now lost the ability to do a reasonable deal with the operator you thought would be best, and you have lost time and momentum. The operators are well aware of this, and they usually will not retrade.

## Mistake #4:

I will align the operator's interests with mine by getting the operator to invest in the deal. (Uh-Oh!)

## Famous last words:

We have the operator's interests aligned with ours. They are making an investment in the deal, along with us.

At first it is exciting. The operator thinks so highly of your project that this major institutional, experienced operator is actually willing to co-invest with you in your project. Be forewarned: the operator's money will be the "most expensive" capital an owner can get – not in terms of the return paid on the capital, but in the terms you will have to "give up" in the management agreement. The operator will still get its real money off the top before any return is paid to equity.

## Mistake #5:

Let the hotel operator take care of everything – HMA, design, budget ... They are the hotel experts and you can focus on the other important stuff.

## Famous last words:

I don't care about the hotel management agreement terms. I just need someone to take over the hotel aspects of the deal so I can do my retail/office/golf course/condos. I'm not a hotel guy.

Our typical client is very successful in business, perhaps even in real estate or development. But many of our clients are novices when it comes to hotel development, management agreements and operational issues. For these people, it is usually better to temporarily hire the team of experts needed than to turn the hotel issues over to someone in the organization who has neither hotel experience nor the same commitment to the project.

## How to avoid these mistakes

Hotel owners and operators need each other. Although some tension always exists in the push-pull of owner-operator relations, in many situations owners and operators share the same vision of what a hotel should be, how it should operate and how to make it a smashing success.



At the other end of the spectrum, there are miserable hotel owners who have great operators "locked in" on terrible 50-year, no-cut, operator-takes-all management agreements. Other unhappy owners have great management agreements with operators who cannot execute the business plan or deliver on financial or guest expectations.

How do you get the "Goldilocks" balance (not too hot, not too cold, but just right) of a great operator, a shared vision for the property, and fair management contract terms?

Over the years, we in JMBM's Global Hospitality Group® have developed our version of the hotel brand and operator RFP process. We call our optimized process the HMA PRO™ for Hotel Management Agreement Procedure to Recruit (a great) Operator. The HMA PRO™ is an organized, disciplined and highly interactive process. It's not about "putting your project out to bid." It's about strategically positioning your property to attract the right operator for you and your project. Here's how it works:

Based upon the owner's goals, the specifics of a project and its market fundamentals, we first identify an exhaustive list of possible brand and operator candidates. With the client, we review and prioritize choices, and compare alternative operator contacts and approaches, tailoring them to the individual project and operator candidates.

Unlike RFPs for many other purposes, we generally recommend that the owner plan to actively "sell" the merits of the project to the brand and operator candidates: Tell them why this is a great project that they want to have in their family of hotels. Clarify your vision of what distinguishes the project, how it will be successful, and why it may be strategically or financially important to their particular hotel company.

Careful planning and execution of the HMA PRO™ is one of the most important keys to finding a good hotel operator and brand and getting a fair agreement - and one you can live with for many years!

# How to get a great hotel operator and a fair hotel management agreement

## *Why hotel owners need HMA PRO™*

**E**veryone agrees that the choice of the right hotel brand and operator may be one of the most significant decisions affecting the financial success and value of a hotel. The right operator will add significant value to the property, both on a current basis through better operations, and by enhancing the long-term value of the property. At the same time, the wrong brand or the wrong operator will reduce the current earnings of the property and the value of the property, making it harder to finance and resulting in a lower sales price.

## **Successful hotel investment also requires a fair HMA**

Many owners discover too late that getting a great operator is only a part of the puzzle they need to solve. Investors also need a fair hotel management agreement or HMA. Without a fair HMA, the best operator in the world will not bring the expected benefits to the hotel investment.

The typical branded HMA is a terrible document for owners. Wholly apart from the fees and other economic terms, it is so one-sided that the operator has virtually total control of the hotel while making the owner responsible to maintain the operator's vision of its operating standards – without regard to the owner's needs.

We sometimes say that such an agreement gives the operator "all the benefits of ownership without any of the burdens."

## **Using HMA PRO™ to get both a great operator and a fair HMA**

We are convinced that the solution to getting the best hotel brand and operator – in terms of an HMA that is fair to all, including the owner – is a process we have refined to a new level and which we call the **Hotel Management Agreement Procedure to Recruit** (a great) **Operator or HMA PRO™**.



**HMA PRO™** is JMBM's refinement of the old standby Request for Proposal or RFP. We started with the typical RFP process still used by knowledgeable hotel consultants today. But we didn't like the passive nature of the RFP process, which suggests that the owner should just wait for whatever an operator might propose. And over a period starting more than 25 years ago, we made some critical changes to the typical RFP process that greatly enhance the outcome for owners and investors. We don't know anyone else who uses a unique process like ours, and we decided that our proprietary process needed a different name to distinguish it from what everyone else does. So we coined the phrase HMA PRO™.

## **When to bring in the hotel advisors**

The best time to bring in experts is at the very beginning of your project, when you are evaluating, planning and structuring. We are like the legal and business architects helping you develop the blueprint for your hotel transaction strategies. And everyone knows that you call in the architect before starting construction. You want the architect's experience to help develop concepts, test feasibility of certain approaches, and ultimately to prepare the blueprint to guide your very first steps.

## **Identifying the owner's goals and priorities**

Before recruiting a hotel operator, each owner must identify, evaluate and prioritize its goals and other considerations for a particular hotel. What does the owner want to accomplish with the property? How do relative advantages of alternative positioning compare? How do the ultimate ownership goals stack up against realistic alternatives? Each owner must consider its current and potential plans.

For example:

- Is this to be an iconic trophy property or a less attractive but perhaps more reliable cash generating machine?
- Must the profit and capital appreciation come from the hotel itself, or from greatly enhanced value in a resort, integrated mixed-use components or adjoining residential, office or retail properties?



- What resources and capital is the owner prepared to dedicate to the project?
- Is the investment horizon short-term or long-term? Is it driven by any particular events or by economic return or other factors?
- How does this property fit in with other investments in the owner's portfolio? And what is the cost-benefit analysis for alternative positioning?

### **Don't even start talking to operators until you have a grip on the 50-point comprehensive HMA PRO™ checklist!**

Before your first contact with a hotel operator, you should carefully identify all of your unique ownership priorities and goals.

We help clients accomplish this by walking them through our comprehensive HMA PRO™ checklist (See page 18). In almost every case, it changes the operators you want to approach, how you approach them, and what you want to accomplish from any exchange with operators.

It usually takes several hours of focused discussion to work through the business and legal points in the comprehensive HMA PRO™ checklist, and most clients find this time to be some of the most valuable in the entire process of recruiting a great operator. The checklist is a detailed list of 50 tier-1 and tier-2 business and legal issues which an owner needs to resolve prior to or during the earliest stages of negotiating the term sheet or letter of intent (LOI) with the operator. We call these matters tier-1 for "must have" deal points, and tier-2 for "really want to have" matters that perhaps are not as crucial, but are still extremely important. The tier-3 issues are more mechanical items that can be hashed out in the actual negotiation of the hotel management agreement itself, after the term sheet or LOI is finished.

People outside the hotel industry often don't realize that the owner's ability to negotiate for these tier-1 and tier-2 checklist items will be jeopardized or lost once the back-and-forth of the LOI negotiations have begun. They find themselves drawn into a



seductive process of negotiations with proposed operators, thinking no harm can come from getting a "non-binding" term sheet with an operator, and they will have the hotel experts look it over later on.

But beware! Once the first requests or comments are given by the owner to an operator proposal (even though "non-binding"), operators typically will say that the owner is "retrading" the deal if it then tries to raise these issues later on, and operators normally will not discuss these issues further even though they might have agreed to them if "properly" sequenced. What good does it do to have hotel experts look at the non-binding deal that cannot be changed on any important business or legal terms? You can basically "take it or leave it" on the non-binding deal you struck, but you will likely have lost an operator that would have been the best for your property.

While some operators may cut a little slack in this situation, most do not. And even with the more flexible ones, every deal point will be harder fought and more compromised. It is better to avoid being put in such a position of weakness.

### **How is HMA PRO™ different?**

We developed HMA PRO™ because we observed that the traditional RFP did not create a competitive, owner-oriented process. The name itself, RFP or "request for proposal," puts the owner in a passive position and does not encourage the owner to shape the proposals for its maximum benefit.

HMA PRO™ is a different and unique solution. It relies on early identification of the owner's key concerns, and then approaches a small handful of pre-selected candidates who are more likely to meet the owner's needs, rather than using a shotgun approach. It does not treat operators like fungible commodities. Rather, it recognizes that each operator brings different strengths and qualities to a management opportunity. We have found that this approach makes operators more willing to participate in HMA PRO™ than an RFP. An RFP often makes operators feel like they are wasting time and resources on an auction where they have little chance of success. HMA PRO™ lets each operator know it is special, encourages participation and focuses the parties on

critical elements, mutual expectations and terms, rather than platitudes and advertisements.

It is a better and more focused process that uses everyone's precious time more efficiently.

### **Seven basic steps in the HMA PRO™ process**

Our HMA PRO™ process has seven basic steps for identifying and contracting with the optimum operator:

1. Establish and prioritize the owner's needs and goals, and develop strategies and approaches to achieve them.
2. Identify the brand and operator candidates most likely to meet the owner's needs and goals.
3. Recruit the best brand and operator candidates by developing a package and approach to "sell" the merits of the project, generate operator interest with direct contact at the appropriate level, and gain buy-in to the HMA PRO™ process.
4. Draw candidates into a constructive, interactive process with on-site property inspections and mutual presentations by operator and owner. Elicit a proposal from each candidate that is responsive to owner's priorities.
5. Evaluate the business and legal elements of each proposal received to select the "finalists" for a "best and final" process.
6. Seek "best and final" proposals and analyze them to identify one party to negotiate with until a deal is reached (and if a deal cannot be concluded, move on to the first alternate).
7. Negotiate to conclusion and execute final agreements.



# HMA PRO™ Checklist

The following is our comprehensive HMA PRO™ checklist, and most clients find time spent reviewing this checklist can be some of the most valuable in the entire process of recruiting a great operator.

The checklist is a detailed list of more than 50 tier-1 and tier-2 business and legal issues which an owner needs to resolve prior to or during the earliest stages of negotiating the term sheet or letter of intent with the operator.

In addition, there are a variety of issues which can be specific to the transaction or the parties; however, the issues in this checklist are almost universally considered.

| HMA PRO™ CHECKLIST                                 |   |                          |
|--|---|--------------------------|
| Subject  | Provision   | ✓                        |
| <b>Term</b>  | Initial term  | <input type="checkbox"/> |
|  | Renewal terms   | <input type="checkbox"/> |
| <b>Fees</b>  | Base fee  | <input type="checkbox"/> |
|  | Incentive fee   | <input type="checkbox"/> |
|  | Fee caps  | <input type="checkbox"/> |
|  | Subordination of fees   | <input type="checkbox"/> |
| <b>Alignment of Interests, Operator Incentives</b> | Shared investment   | <input type="checkbox"/> |
|  | Credit enhancement  | <input type="checkbox"/> |
|  | Key money   | <input type="checkbox"/> |
|  | Net operating income or gross operating profit guarantees, guarantees against negative operating cash flow – guarantee, letters of credit or revolvers provided by operator | <input type="checkbox"/> |
|  | Joint venture structure issues  | <input type="checkbox"/> |

## HMA PRO™ CHECKLIST

| Subject                   | Provision   | ✓ |
|---------------------------|---|---|
| <b>Operator Duties</b>    | Detailed listing of operator duties   |   |
|                           | Limits on operator authority  |   |
|                           | Control over reimbursements (such as markups, overhead and travel) and complimentary rooms  |   |
| <b>Termination</b>        | Termination for cause   |   |
|                           | Termination on sale   |   |
|                           | Termination for failure to satisfy the performance standard   |   |
|                           | Termination for convenience   |   |
|                           | Termination for failure of brand to maintain: growth trend, critical mass, regional or national marketing   |   |
|                           | Termination for bankruptcy or insolvency of brand   |   |
|                           | Termination for deterioration in brand or public perception   |   |
|                           | Termination for brand's change-in-control or change in key personnel  |   |
|                           | Termination by owner for failure or inability to open, get financing, operate profitably, reopen after disaster if expenditure of more than \$xx is required) |   |
| Transition on termination |   |   |



## HMA PRO™ CHECKLIST

| Subject                       | Provision   | ✓ |
|-------------------------------|---|---|
| <b>Performance Tests</b>      | RevPAR test   |   |
|                               | Budget test   |   |
|                               | Owner's Return test   |   |
|                               | Two-prong or single prong test  |   |
|                               | Measuring period  |   |
|                               | Cures   |   |
|                               | Provision enabling owner to explore other operators at any time it is uncomfortable with operator, in its sole discretion (no interference or breach) |   |
| <b>Operating Standard</b>     | Fiduciary obligations, maximize net present value to owner, minimize obligation of owner to provide additional investment                             |   |
| <b>Budgets</b>                | Content   |   |
|                               | Timing  |   |
|                               | Operating budget approval   |   |
|                               | Capital budget approval   |   |
|                               | Budget compliance   |   |
| <b>Reports and Inspection</b> | Periodic reports, annual reports, detail and flash reports  |   |
|                               | Audited financial statements  |   |
|                               | Right of owner to inspect and audit both financials and operations  |   |

# HMA PRO™ CHECKLIST

| Subject              | Provision   | ✓ |
|----------------------|---|---|
| <b>Other Matters</b> | Who is the employer?  |   |
|                      | Union matters   |   |
|                      | Licenses and permits, including liquor license  |   |
|                      | Subordination, Non-Disturbance and Attornment agreements with lenders now and in the future                             |   |
|                      | Limitation on owner contributions to working capital  |   |
|                      | Right of first refusal  |   |
|                      | Non-Compete term, area, brands  |   |
|                      | Indemnification – what exclusions to owner's indemnifications of operator   |   |
|                      | Exculpation – limit liability of owner to its interest in the hotel   |   |
|                      | Sale of the hotel – operator's transfer of rights under the hotel management agreement – what restrictions or approvals |   |
|                      | Arbitration and expert resolution   |   |



## How to make your HMA PRO™ successful – a practical guide

**I**n selecting and signing up a branded operator, the first step is to recognize that this is a big event. Remind yourself of that every day.

Think about the magnitude of the opportunity ... and the hazard.

Once you are firmly focused on the importance of the task at hand, act accordingly. The next step is to round up and dedicate the necessary resources for this important job – internally and externally. You want experienced hotel experts who have been through the process hundreds of times to guide you through a process for identifying and recruiting the best operator for your hotel.

Selecting the right branded hotel operator is NOT something you do casually, quickly or without expert advice. It takes planning, strategy, analysis and game plan execution. The payoff is big. The consequences are severe.

### **HMA PRO™ is NOT a form – It is an interactive process**

We are sometimes asked by well-meaning friends or clients if we can just give them a form for an HMA PRO™. That is the tipoff that someone needs some more background information to understand what an HMA PRO™ really is and how to make it work. Here is what we tell them:

First, the HMA PRO™ is a process and involves some important documents. Both the process and the documents should be carefully integrated to address all the relevant business, legal and hotel industry issues. We don't pull it off the shelf because it needs to be customized to your situation after the all-critical business judgments are formed. (After doing more than a thousand of these, the documents are the easiest part of the exercise!)

The process and documents can look very different from deal to deal, and combine or separate important steps. The business,



legal and hotel aspects all have to be brought into focus, well before documentation. The hotel lawyers at JMBM don't just document the deal, we work to get you the best deal. And the HMA PRO™ process is a great strategy for positioning your project to get the best terms possible.

### **What happens in the HMA PRO™ process?**

How the HMA PRO™ process is shaped – i.e. how many steps are involved, how much information is provided (and when), and whether you "sell" the deal first to raise enthusiasm, and other elements – depends on the unique considerations in each deal. The process is likely to include these elements:

- Identifying appropriate candidates to brand and operate the hotel project
- Preparing a tailored presentation for owner to present to the operator candidates explaining the opportunity in general terms to gain interest and participation
- Soliciting an indication of interest in participating in the HMA PRO™ or discussions with the owner-developer
- Requesting a confidentiality agreement in order to receive further information
- Providing different levels of information to HMA PRO™ candidates in two or more stages
- Granting access to a "due diligence room" or providing a "book" of information and exhibits
- Marketing to potential HMA PRO™ participants to whet their appetites, create excitement for the project, and show them how much there is to gain if they reach to get the deal
- Collecting, reviewing and analyzing proposals



- Preparing comparative summary of key aspects of each proposal (the "matrix")
- Requesting clarifications of proposal deal points
- Running an interview process with selected finalists leading to a "best and final" proposal process
- Ultimately, negotiating and preparing final documentation with a selected candidate or two

Careful planning and execution of the HMA PRO™ process is one of the most important keys to finding a good hotel operator and brand and getting a fair agreement. Whether your project is a standalone hotel or a hotel mixed-use development – getting the right operator or brand, and a deal you can live with, is critical to the success of your project.

# How to negotiate an HMA

## *Ten tips for a smoother process*

**W**e get a lot of calls to help owners, developers, and investors negotiate new hotel management agreements. One of the first questions they usually ask is how the negotiation process works, since there are so many different parties involved, usually in different parts of the country (or the world).

So, this article will focus on the process of negotiating the hotel management agreement – how to effectively gather and coordinate the input from all relevant stakeholders and advisors, communicate the right message to the operators and drive the process to a timely conclusion with a good result for the owner and operator.

Or, put another way, how do you expedite a hotel management agreement negotiation, while maintaining stamina to win important economic and business points? The timing, direction and focus of the process can be critical.

## Ten Tips for negotiating hotel management agreements:

1. **Select your team and get access to a virtual data base of market terms.** You should identify the members of your group who will have the authority to make decisions and will be dedicated to the process. Just as importantly, you need to seek the outside advisors – lawyers and consultants – that can bring you the expertise and sense of market terms that you don't have in your organization. Our business and legal experience from more than 1,000 hotel management agreements and hundreds of franchise agreements provides the largest virtual database of hotel management and franchise agreement deal terms in the world.
2. **Identify and prioritize the issues.** There are at least 20 or 30 business issues that are tier-1 or tier-2



issues that need to be raised and negotiated in a term sheet or LOI. (See The HMA PRO™ Checklist, page 18) While term sheets and LOIs are usually nonbinding, the failure to raise these major issues at this stage will subject you to angry claims that you are retrading if you want to raise them later. It will certainly be harder to accomplish them later – if you can at all – and will delay your process.

3. **Control your own draft of the hotel management agreement.** Get the operator to provide you with a Microsoft Word copy of the form of HMA they propose to use. The operator may want to control the document revisions, but that's not realistic in an age of long distances and universal word processing, and we can often conform their HMA to the agreed-upon terms faster and better than they can. In any event, we need it for the process as described below.
4. **Shaping the form HMA to meet your needs.** We don't mind starting with the operator's form HMA. That is generally the accepted custom of the industry. However, after working with you to identify the most important business and legal points, we revise the operator's form agreement to meet your needs, using specialized redlining software that tracks all changes in the document. Usually, we will suggest the exact language to be used. Sometimes, we will just highlight issues or options for discussion.
5. **Making sure we are all on the same page.** Based on our earlier discussions about your priorities and goal, we then circulate a marked-up draft of the operator's form HMA showing all of our proposed changes. This draft only goes to you for your review, followed by a conference call (or, where we and the owner are local, a meeting) to discuss the agreement and any necessary revisions. We review the document with you, page by page, to get your input and approval for what we have suggested.

Most of the changes will be obvious as to their purpose and effect. Some will not be, and we will discuss these so we all agree to all proposed changes.

6. **Revise and confirm.** After our joint review of the document, we make revisions to reflect your decisions. If changes are minor, we may not recirculate to our team prior to sending to the operator. If there are major changes or there is a desire to see the revised language, we may recirculate to gain final approval before sending the document to the operator.
7. **Send the revised draft to the operator.** The next step is to send the proposed changes to the operator in the form of the marked up draft we have already cleared with our client. We jointly want to press the operator for a fast turnaround with its own indication of what changes the operator can accept or proposed changes to our changes. If at all possible, it is very much to your advantage to keep control of the drafts – our draft should be treated as the new basis for negotiations. If not, we can make it work, but the process is more laborious and time consuming.
8. **Set the all hands meeting.** The goal is to get the operator's markup or written response to our proposals, and then to arrange a "meet until the deal is done" meeting. This usually takes at least one, and perhaps two, working days. The biggest problem for you will be convincing the operator to make someone available for the entire time necessary. Otherwise, there can be a delay of days or weeks until the follow up meeting is scheduled and the negotiations can be completed.
9. **Location of the all hands meeting.** There is a benefit to meeting in our offices in terms of our ability to generate documents quickly, but we can meet at the operator's corporate offices, their



attorney's offices, the hotel or your offices. The availability of representatives with decision-making ability will probably drive this location, and you should be prepared to travel to meet the operator on their turf, if it means they will have the necessary people available. In some cases, the distances between the operator's and owners' representatives may be so great that a conference call may be the only way of expediting the review, but meeting in person is almost always the best, and we would try to find a "neutral," mutually acceptable location before settling for a conference call.

10. **Exchange and finalize.** After the all hands meeting, we will circulate revised drafts of the HMA reflecting the decisions. There may be a very small handful of "final issues" to be resolved that we hold to the very end before we give them up or trade them off. But there will be an exchange of documents reflecting the final decisions that should lead to an expedited signing of the HMA. If something goes awry, we will do another meet-until-we-sign meeting.

## **CHAPTER 2**

# **WHAT YOU NEED IN YOUR HOTEL MANAGEMENT AGREEMENT**



## What to do *before* you start negotiating your brand HMA

*Five tips for a successful relationship with your operator and a good HMA*

**I**n order to consummate any substantial business transaction, there are inevitably some challenges that must be overcome. Hotel management agreements are no exception: in part because of their complexity, and in part because hotel management agreements typically transfer effective control over valuable assets for several decades, and their terms can easily enhance – or diminish – the value of hotel by a staggering amount.

We have often seen hotel values depressed by *50 percent or more* from what the hotel would have been worth without the encumbrance of an onerous, long-term management agreement. The Global Hospitality Group® at Jeffer Mangels Butler & Mitchell LLP has compiled a comprehensive list of many milestones that mark the road to successful negotiation of a hotel management agreement. As in all journeys with high stakes, advance preparation – including mapping out the most advantageous route and hiring guides that know the terrain – is critical to success. In this instance, it's needed before you ever get to the negotiating table.

This is especially true for those new to the hospitality industry. Many sophisticated developers and investors have identified the rich potential that hotels offer – particularly in hotel mixed-use projects – and they regularly bring new vitality to the marketplace. While not new to real estate development, these players are new to the norms, customs, practices and business considerations of hotels. The intertwining of single-purpose real estate with an operating hotel business presents unique issues and opportunities – opportunities that we have seen the uninitiated leave on the table, simply because they were none the wiser. Developers and owners new to the hotel arena can avoid an expensive and painful learning curve by retaining experienced advisors that know the value of each component in the management agreement from both sides.



Here are our top five pre-negotiation milestones for helping owners achieve success and strike a fair deal on a hotel management agreement:

## **1. Get the right brand for your project**

Every project is unique, and all appropriate brands, identities and market positionings should be considered – along with the appropriate operators who will enhance project value. The right operator to optimize value may not be the branded management company that puts its name on your hotel. And it is important to note that the emergence of new "lifestyle brands" and "soft brands" can add great value to a project – "brands" that are not owned by traditional hotel companies and which many pundits fail to recognize for the value they can bring. Some of the new lifestyle brands are sponsored by the traditional hotel companies such as aLoft by Starwood, and Indigo by InterContinental, but others are the product of lesser known brands, such as the Valencia Group with its Santana Row and San Antonio Riverwalk projects or Miraval with its Miraval Resorts. And they provide some interesting alternatives to other great lifestyle or boutique hotels such as the Kimpton Group, Commune or Morgans.

Selecting the best brand and operator requires a careful business and legal analysis of the owner's needs, goals and resources – particularly for a hotel mixed-use project where the hotel is often the spark plug for the synergies of mixing uses. That's why we like to bring our knowledge and resources to the owner's team before the brand and operator candidates are even identified. We can help identify the right players, scope out areas of strength and weakness, and help our owner or developer client articulate and prioritize goals to be accomplished in an HMA PRO™ process. This kind of preparation can enable an owner to better gauge the strengths and weaknesses of each potential brand, find the optimal terms that the brands and operators are willing to extend, and facilitate an informed decision and a smooth negotiation with reasonable expectations on all sides.

## **2. Look for common perspectives**

Sometimes, we are brought in late on the hotel management agreement process – after the initial candidate consideration and



selection and perhaps into the Letter of Intent, or LOI, stage. When this happens, we too often find that the table has not been properly set. As deal terms and drafts begin to exchange, it can appear that owners and operators are contemplating two different projects ... because they are! The owner comes to the negotiating table with one set of financial projections and program elements, while the operator has its own. Set side by side, they would seem to describe different projects – different concepts for the hotel's target market segment and customers, its sources of revenues, costs of construction and maintenance, integration of the hotel with other project elements, and even the project's financial viability.

If the owner believes the project is highly profitable and the operator does not, the natural (and reasonable) result will be for the operator to try to protect itself by demanding higher fees and incentives, which will create a chasm between the owner and the operator. If the operator believes that the project requires substantial amenities and the owner does not – or if they cannot agree on how hotel mixed-use project elements will be integrated – it is more likely that the owner and the operator will be unable to agree on key issues, such as the total cost of the project and owner's required investment. (Remember that selecting the right operator, based on objective data, makes a meeting of the minds more probable.) The operator and owner must agree as to what the project will look like and what will drive its success.

### **3. Address the challenges early**

During negotiations, it may often make sense to defer certain tough issues for later resolution so that all the areas where agreement can be reached are understood, and the importance of the areas that require compromise are clear. However, there comes a time when the parties have to discuss the elephant in the room that they have been ignoring. Talking about the elephant sooner, and more directly, may allow both sides to create global resolutions. And of course there may be situations where owners and operators will not fully resolve certain issues, either intentionally or unintentionally. While it's true that parties cannot be expected to resolve each and every issue that might come up during the term of a management agreement – that would require the ability to predict the future – failing to address

known issues can be an expensive way to reach "agreement" because it leaves potentially messy disputes for the future.

#### **4. Know what's "market" and how it fits your goals**

While both owners and operators usually seek to negotiate agreements with market terms, every hotel property is unique. And, there is really no simple metric or checklist of market terms. There are ranges of what are considered market terms for particular types of properties or projects and specific brands or operators. For example, the terms for branding or operating a 2,000-room convention hotel are quite different than a 200-room full service urban hotel or a 120-room extended stay. And market is also defined by the competition for a particular set of brands or operators, which will vary depending on how desirable a specific hotel project is, and how important that location or property may be for the strategic and business needs of a brand or operator (e.g. to fill in a critical hole in its distribution system, maintain a presence in a key market, etc.). And, ultimately, a market deal is the deal you make.

These factors make it very valuable for an owner to have an experienced team who may know better what market is than the brand or operator – and will at least know what the operator has done in six recent deals and, just as importantly, what their three closest competitors are likely to offer on a sticky economic or business point. There are also a lot of trade-offs that make up a market package. In other words, it is a little like going to a smorgasbord buffet with \$100 worth of tickets, and you have to know the price of each item if you are going to get the meal you want. If you spend all your money on the caviar and dessert, you won't have any left for the main dish or the beverage. All items on the buffet are not of equal cost or value.

So, while there are some commonly accepted ranges for business and legal parameters for hotel management agreements, an owner needs to recognize that they can be broad, and owners may need to be flexible to accomplish their goals in a particular situation.



## 5. Bring the right team to the table

Negotiations don't occur between companies; they transpire between the people representing those companies - and it is essential to have a team with the comprehensive set of experience and skills to negotiate and document a successful hotel management agreement. Hotel management companies usually have a strong bench of experienced lawyers, dealmakers, financial experts and others who understand fully their goals and needs, because they are actually in the business of sourcing and negotiating management contracts and franchise agreements. Owners typically have not experienced the frequency or volume of hotel management agreement negotiations that operators have, and should retain experienced lawyers and advisors in order to level the playing field. But more than just arming oneself in negotiations, retaining experienced professionals will make the negotiations more productive for both sides.

Owners will want to draw on professionals who have had direct experience with the operator, as well as broad-based experience in the industry. A hotel lawyer and consultant who knows what a particular operator has done in other deals as well as what that operator's competition has done (and is likely to do again) is able to bring great value to the owner's side of the discussions.

Finally, it is essential that owners understand the critical importance of their own active participation in the hotel management agreement negotiations. While it may be expedient to leave the discussions to the professionals (and certainly portions of the discussions can and should be handled by attorneys or consultants), a lot of issues will ultimately be won or lost by the passion and conviction of the owner. "I am just not going to do that," goes a long way toward convincing the operator that a specific issue is too important to be compromised.

That is one of the reasons that we spend so much time with owners - particularly first time hotel owners and developers - to help them understand the real practical significance of management agreement provisions. It isn't rocket science, but it is understanding the business implications of hotel management agreement terms on the owner's goals and plans, and seeing what should be accomplishable that makes a difference.



Preparation to successfully negotiate a hotel management agreement starts early. It starts before you ever identify potential candidates and way before you ever start talking terms. The roadmap you establish - along with the practical experience of the professional team members you line up to structure and guide the process - can make a substantial difference in the outcome and long-term success of your entire project.



## Hotel management agreement performance standards and why they matter

**P**erformance standards matter because hotel owners and hotel operators do not always share the same goals. Most hotel owners want their hotels to be profitable, or at least run with a focus on optimizing long-term value. Others may want their hotels to operate at a specified level of luxury in order to provide the right "amenity" essential to other components in a hotel mixed-use project, or adjoining property. But even where luxury is important, owners always desire to accomplish luxury in a prudent and businesslike way.

Generally, hotel operators, and brand operators in particular, want to increase the number of hotels under management or franchise (their "distribution system"), burnish or enhance the brand image and its public recognition, bring hotels to a minimum level of standardization, and increase profits by making hotel owners absorb more of the hotel operator's corporate expenses, and extending their brands to other products (like time share, or residential products).

If individual hotels are not profitable, or are not operated at the desired level of service, the operator's other goals are not necessarily impacted. In addition, hotel operators typically receive a big portion of their compensation as a percentage of gross revenues off the top before operating expenses, debt service or any return to the owner. Their reservation and marketing systems, and other centralized services are also typically supported off the top by payments from the hotel in reimbursements or as percentages of gross revenues, so these factors incentivize growth of the system (with attendant recruiting, training and staffing challenges and costs) and increasing gross revenues whether any profit is falling to the bottom line.

The difference between the owner's goals and the operator's goals doesn't reflect a "right or wrong" situation, or a value judgment; it does mean, though, that owners and operators need to work together to ensure that their needs and goals are

adequately represented, and that the management agreement reflects a reasonable compromise.

One of the popular misconceptions of performance standards is that the purpose of the standard is to give an owner a "free" right to terminate an HMA without being required to pay a termination fee. That is not the purpose of a performance standard (although it can be the result, if the operator ignores its obligations). Owners only terminate management agreements as a last resort; the difficulty in finding good managers and the cost of changing managers or rebranding a property, among other things, means an owner is more likely to stay with an underperforming manager. Instead a performance standard, if negotiated carefully, establishes a meaningful measure of the operator's performance and aligns the interests of owners and operators.

But the power to terminate a hotel management agreement does offer an owner what may prove to be a necessary tool to gain the attention of the operator and some meaningful compliance, or readjust the terms of the HMA. In this way, the performance provisions can help ensure that the HMA remains in place, because the owner and operator know what to expect from each other and will have incentives to understand their respective obligations to one another and to avoid problems in the future.

### **What does an operator want?**

Put simply, the hotel operator does not want to be penalized for events and causes that are beyond its control. For this reason, a hotel operator will not want to be responsible for the profitability of the hotel, or where economic conditions reduce the hotel's revenues or profits, or when labor disturbances interfere with operations, or when the property is subject to unanticipated events, like the cancellation of a large convention. Because of this, most operators will see the ideal performance standard as one with as few teeth in it as possible. Remember, the profitability of the operator depends on it having as many long-term HMAs in place as possible. The longer the deal, the more the operator will receive in the form of management fees, licensing fees, and the like and the higher the market will value the operator. Therefore, it is in their interest to draft performance



standards in such a way that it will be very difficult to ever terminate the HMA for failure of performance.

## What does the owner want?

Owners are interested in many things. It may be prestige, amenity value for other parts of a project or related properties, or an efficient and well-run place for tourists or business people to stay. These are typically all the things that brand hotel development staff (the salesmen for the brand) promise over rounds of golf and nice dinners when courting the owner for the management contract. But if these perceived promises are not engraved into the terms of the hotel management agreement – including the performance standards – they will be difficult to enforce later on. So if prudent and efficient operations, building long-term value and profitability are important to enable the owner to pay lenders, investors and itself, they'd better be properly reflected in the documentation.

These concerns lead the owner to seek performance standards which provide incentive for the operator to operate the hotel at the required level of standards, to maximize profits in accordance with the performance thresholds, and to impose those tests consistently, whether or not the operator can control the results.

## Three guideposts for negotiating HMA performance standards

Here are three suggestions to follow in negotiating effective performance standards.

**Know thyself.** Recognize how important the HMA will be to the value of the hotel and treat it accordingly. Carefully define all of the important measures of success for your project, whether it be through profit margins, minimum revenue thresholds, or achieving specified levels of service or recognition (such as Mobil star or AAA diamond ratings). Unless you can explain your needs, you won't achieve your goals.

**Be realistic.** Understand your strengths and be aware of the operator's needs. Seeking unrealistic goals is likely to prevent you from gaining the agreement you want, and won't make your objectives any easier to achieve.





**Get help.** You need to understand the different ways you can achieve your needs. You need to know what operators have agreed to in the past and what they might agree to now, and for that, you need a legal and advisory team that negotiates management agreements every day, and has experience with all the brands and boutiques, both as to market terms at a given time, as well as alternate solutions to solve both parties' needs or find reasonable compromises.



## Hotel management agreement performance standards – the operator's take

**W**hat does a typical operator performance clause look like? Operators may propose an HMA without any performance standard. That would be in their interest, because a performance standard can only be used to their disadvantage – to reduce their income, subordinate their fees, or possibly terminate the management contract. And of course, the right to terminate is the right to re-negotiate the agreement as well. So failure of a performance standard does not mean you have to terminate the operator, but might be used as the basis to re-negotiate the allocation of financial and other risks.

The typical performance standard clause proposed by a branded hotel operator often looks something like this:

In addition to the other rights of termination in this Agreement, the Owner shall have the right to terminate this Agreement if, for any two consecutive Fiscal Years beginning after the completion of the third (3rd) Full Fiscal Year, both (a) the Annualized RevPAR for the Hotel for such Fiscal Year is less than 80% of the average Annualized RevPAR for the Competitive Set for such Fiscal Year (the "RevPAR Test"), and (b) the Gross Operating Profit of the Hotel is less than 80% of the Gross Operating Profit of the Hotel as set forth in the Annual Budget for such Fiscal Year (the "GOP Test") (the RevPAR Test and the GOP Test are collectively referred to as the "Performance Standard").

This provision is fairly short, but it contains a number of moving parts, and we need to discuss some of the key components.

### What is RevPAR?

RevPAR is the acronym for "Revenue Per Available Room." RevPAR is calculated by dividing the gross revenues for a hotel for a period of time by the total number of available room nights over the same period. The resulting number will tell you how

much money you are generating from each room in your hotel for a particular period. It is a way of combining the results of two other key factors – average daily rate or ADR and Occupancy. The ADR is included in the revenue component of RevPAR, and the occupancy is encompassed in the available room night component.

### **What is the competitive set?**

The competitive set is a group of hotels that are similar to your hotel. For example, a 100-room select-service hotel might be compared to a nearby Courtyard by Marriott, but not the local Ritz-Carlton which would be excluded. Picking the competitive set is a critical issue and something of an art. The data for the competitive set is provided by independent data sources, like Smith Travel Research (STR), which usually require a minimum of five different hotels in the set (in addition to your hotel) to ensure confidentiality and anonymity of hotel data participants.

### **What is the budget test?**

The budget test requires that the Hotel achieves a minimum percentage (most often less than 100 percent) of the profit that the operator anticipated in its budget for a particular year. This standard raises a very important issue for owners, since operators prepare the budgets for the hotel and therefore have the ability to propose a budget that is easier to achieve. While owners typically have budget approval rights (or at least they should), operators are in a much better position to forecast the potential profitability of the hotel. Even more importantly, the operator, by virtue of its management of the hotel, is in a position to manipulate the operations of the hotel to achieve the necessary level of performance. For example, an operator might choose to push certain expenses into a following year to meet the operating test or accelerate certain income.

### **Why is it measured over two consecutive years?**

Operators prefer to structure a performance test so that the operator only fails the test if it doesn't meet the minimum gross operating profit (GOP) level in two consecutive years. This helps protect operators, since the operator isn't in danger of being terminated if it suffers one bad year out of a series of good years. However, it also emphasizes one of the concerns that an owner



should have about the budget test – since it takes two years of failure to trigger the owner's right to terminate, the operator can, in the second year of a down cycle, revise its projections to make it less likely that they will fail, and also make it easier to maneuver the financial performance of the property and avoid termination. It also means that a hotel could perform poorly for several years, which reduces the value of the hotel and the ability to finance it.

### **Is this two tests, or one?**

The performance test usually proposed by an operator is designed so that the operator has to fail each of the tests in both years of the test period to be subject to termination – in other words, the operator might not achieve the necessary profits, but if it operates on par with its competitors, that year doesn't count as having failed the test. An operator wants this because it doesn't want to be penalized if the hotel doesn't make its predicted profits, but operates at least as well as its competitors; conversely, a hotel operator would not want to be subject to termination if it achieves anticipated profitability, even if other hotels in the area operate more profitably.

### **"Cures" and other parts of the performance test**

There are often additional components or matters that relate to the operator's performance test. For example, an operator performance provision will often provide that the operator can avoid termination if it "cures" the performance failure by paying the owner the difference between the actual profits and budgeted profits for the year. Should the operator have any cures if the performance standard is to be meaningful? If so, how many? Must the cure be made for the first year of performance test failure? If not, does the two consecutive year test completely reset or just need one more failing year? What is the right measure of a "cure" payment? Does the missed profit really cover all the damage? Certainly not!

Well, the details of a "cure provision" of a performance test are extremely prolix and cannot be treated here except to alert you to its importance. Additionally, don't forget that the operator will typically seek to be excused from the performance tests for any period of time that involves an event that qualifies as a "force

majeure." There are typically also "passes" from the test or "lockouts" from exercising any rights under it for an initial stabilization or lockout period that may run from 12 months to seven years, or longer, or during periods when the property is being upgraded.

And any breach of the HMA by owner claimed by the operator – such as failure to fund a big capital improvement program – may also excuse the operator from a performance test.

## **What should I consider when negotiating the performance test?**

*Every little thing matters.* The test looks simple, but every part of it is meaningful. For example, constructing the competitive set alone raises many issues:

- Are there really five hotels in your market that compete directly with your hotel? Many times it is difficult to find those hotels, and you have to consider adding hotels that are in different classes or different locations.
- What is the right percentage for the test? If the average RevPAR for the hotels in the competitive set is lower than your hotel, a target RevPAR of 90 percent of your hotel's projected RevPAR may be too low, making the test less than meaningful. A new hotel should significantly outperform an older set of hotels. Maybe your hotel should be at 120 percent of the competitive set.
- What happens when new hotels come into the market area, or existing hotels in the competitive set close, or when hotels are rebranded? Should that change the RevPAR test?

These are only a few of the most obvious issues, and given all the other issues in a complex hotel management agreement, a hotel owner needs expert assistance to ensure not only that the performance test itself is meaningful, but also that it works seamlessly with the remainder of the agreement and all of the parties' goals.



## Hotel management agreement performance standards – the Owner's Return test

**I**n the last article, we looked at a typical hotel operator performance clause and how it protected the operator interests. For the owner to have a termination right under such a clause, the hotel operator must fail both prongs of a two-prong test: the RevPAR test, which compares the RevPAR results of the subject hotel to those of a competitive set of hotels, and the budget test, which requires the operator to achieve profitability based on the operator's projections in a budget. We also pointed out some of the challenges posed by that test.

In this article, we will look at a performance test that takes better care of the owner's concerns and which raises some issues with operators.

### What is the interest that owners want to protect with a performance test?

The bottom line is that owners want to receive an adequate return on their hotel investment. Owners need the return because they are expected to pay debt service, provide working capital, fund capital expenditures and provide a return to their investors. If they don't get that return, owners should have certain rights. There are a variety of tests, but we believe the most effective, meaningful and fair test is an Owner's Return performance test.

The concept of an Owner's Return performance clause is rather simple: Unless the operator can manage the hotel to generate sufficient profit and distributable cash to provide the owner with a specified return on investment, the performance clause has not been satisfied, and certain consequences follow.

Normally, we use the Owner's Return test for two purposes:

1. **Create a viable investment.** Identifying the Owner's Return clarifies the expectations of the owner and the operator, and is an essential part of the "bargain"

between the owner and the operator. Ultimately, if the operator cannot fulfill its part of the bargain, the performance standard gives a hotel owner the option to terminate the hotel operator when the test is failed. Sometimes the ability to terminate an operator can be the only effective way to truly get the operator's attention and redirection to take care of the owner's concerns.

2. **Hurdle for incentive compensation and subordination of fees.** Independent of any termination right that may attach, no incentive fees should be payable to the operator in any year unless the performance test has been satisfied. Often, a portion of the operator's base fee - say anything over 1.5 percent of gross revenues, or perhaps anything in excess of half of the base fees - may similarly be conditioned on and subordinated to payment of the Owner's Return for the given year.

### How do I measure Owner's Return?

The required Owner's Return is determined by this formula, calculated annually:

$$\text{Owner's Return} = \frac{\text{Total investment in the hotel}}{\text{Agreed upon investment return}} \times$$

For example, if the total investment in a hotel were \$25 million, and the agreed upon investment return were 12 percent, the Owner's Return would be determined as follows:

$$\text{Owner's Return} = \$25 \text{ million} \times 12\%$$

or

$$\text{Owner's Return} = \$3 \text{ million}$$

### Total investment in the hotel

The first key to measuring the Owner's Return is to calculate the owner's total initial investment in the property, including all



costs associated with the investment, both debt and equity, and all hard and soft costs.

That initial investment should be increased each year by all of the owner's additional investments. We typically provide for the addition of three major items to the calculation of owner's investment in the hotel:

1. **Contribution to FF&E fund, when contribution is made.** Virtually all management agreements (and franchise agreements and loan agreements) require an owner to set aside a reserve to pay for regular replacements of furniture, fixtures and equipment (FF&E). These reserves reduce the cash the owner might otherwise retain from the operation of the hotel, and represent an additional investment by the owner.
2. **Capital expenditures not paid from the FF&E fund.** As a hotel ages, the FF&E fund may not be adequate for the maintenance of the hotel. Major upgrades to its soft goods, replacements of furniture, fixtures, and equipment, or other capital projects will usually be paid out of hotel revenues (that would otherwise have gone to the owner) or from additional investment by the owner. Unless these amounts came from the FF&E fund, they also represent additional investment by the owner.
3. **Any additional working capital contributed to the hotel, not otherwise included in the preceding items.** From time to time, working capital may be required for various reasons, such as seasonal business needs or operating deficits from disasters or business cycles.

## Investment return

After the owner's total investment in the property is calculated for a given year, the Owner's Return is derived by applying a percentage to that which must be paid out of profits to satisfy the test.



A common goal of owners is to achieve something on the order of a 12 percent annual return on their total investment in the hotel. Over the past 20 years we have regularly obtained a reasonable Owner's Return provision from almost every major brand – at least when they really want to manage the particular hotel.

Their willingness to give this kind of performance test is a much truer reflection of their enthusiasm for a project and their belief in its success than all the laudatory fluff shared in the process of selling the owner on hiring the operator.

### **What do operators think of this test?**

Operators understand the importance of a return to the owner, but often object to this test, particularly when it could allow an owner to terminate a management agreement. As we have pointed out before, hotel operators do not want to guarantee performance, and limit the tests of performance to those things that are within their control. Since operators cannot control the net income from the property, the owner's acquisition costs or continuing investments in the hotel, some operators will argue that owner termination for failure of this test is problematic.

On the other hand, if an operator can't manage a hotel to provide the owner with a reasonable rate of return, the owner should at least have the option to change things up.



## Five keys for good HMA budget provisions

**T**he budget provisions in the HMA provide the means by which the owner achieves efficiency and profitability, and the operator achieves brand integrity. While both are equally critical to the success of the hotel, operators are often able to drive the budgeting process to their advantage.

### Importance of budgets

It is difficult to overstate the importance of a meaningful budgeting process for a hotel. Ultimately, the budget represents the implementation of the owner and operator's vision for the hotel. It is the means by which the owner and operator achieve the qualitative goals we associate with the brand or style of the hotel, and the quantitative goals of achieving a well-run, efficient and profitable business. Moreover, it is often the means by which we judge the performance of the operator.

The approved budget is also key to many other provisions in the HMA. Often, the inclusion of a line item expense in a budget will constitute the owner's approval of that expense without further inquiry. For this reason, owners consider the budget process seriously and recognize that it will have far-reaching impact on the success of the property. Properly drafted, the budget process created by the HMA provisions can provide the owner its most significant ability to affect the operations, profitability and success of the hotel.

### Challenges

Owners face a significant challenge in the budgeting process. Simply stated, the operator has the upper hand for a variety of reasons. Unlike owners, operators create budgets all the time. Operators have entire departments of staff dedicated to budgets and have much greater experience with budgeting than owners do. This experience and capacity gap increases each year. Operators almost always dictate the form of the budget, giving them a benefit in presentation (and knowing in which three line-items an expense is buried). Moreover, operators have access to much more information than do owners, both as to the property

at issue and all of the operators' other properties. For these and other reasons, operators almost always have a big "home field advantage" when it comes to creating and evaluating budgets.

Owners face another challenge in that while operators spend many months preparing a proposed budget, owners have only a short window of time at the end of the year in which to evaluate and critique budgets. Some operators have told us that budgeting is, in fact, a year-round process. Given the reality of Thanksgiving, Christmas and the New Year's holidays, owners have only four to five weeks to evaluate and respond to the budget that operators have been preparing for months.

### Five key elements to a successful budget provision

Given these facts, there are five key pieces to crafting a good budget provision in an HMA that can add great value to the hotel and save a lot of grief when times get tough.

1. **Time.** The proposed budget must be delivered in time for the owner and its advisors to evaluate it carefully and thoughtfully respond – at least 60 days before the beginning of the fiscal year, typically November 1. Doing so will allow time for the necessary review, comments, redrafting and review that makes the budget process meaningful. If possible, the operator should provide preliminary budgets even earlier.
2. **Scope of review.** Some operators will attempt to limit the scope of the owner's review by stating that certain estimates, such as anticipated room rates or expenses necessary to meet brand standards, are not subject to owner's objection. This is wrong! The owner should have the ability to question everything in the budget. It doesn't mean the owner will always prevail, but the owner should have a say.
3. **Owner's approval; resolution of budget disputes.** Owner's approval rights of the budget must be similarly meaningful. It is not adequate to provide that the operator shall consider the owner's comments in good faith, and then shall be entitled



to make the final decision in its sole discretion or words to that effect.

- **Use of an independent expert.** If a dispute cannot be resolved between the parties, it should be handed to an independent expert who reviews the issues from not only the operator's side but also from the owner's side. We also like to provide a standard (other than just "brand standards") that governs how the expert will decide the dispute.
- **Baseball arbitration.** Often, it makes sense to be explicit and consider "baseball" arbitration as an alternative to "traditional" arbitration. In baseball arbitration, the arbitrator must adopt the position of either party, but cannot custom design his own random solution. Baseball arbitration tends to force each of the parties to be more reasonable (i.e. to narrow the gap) so that they don't lose everything they want. And it means that at least one party's vision will be implemented, instead of a cut-and-pasted collage of two different approaches.
- **CapEx should be sole approval of the owner.** There is one exception to an arbitrated resolution of budget disputes – capital expenditures. Capital expenditures beyond the regular, agreed-upon contributions to an FF&E reserve should be within the owner's sole control.
- **What happens if there's no agreed budget?** Hand-in-hand with the approval and dispute resolution process is a means of operating the hotel pending resolution of a budget dispute. Most agreements provide that when the parties cannot

agree on the budget (or any parts of it) the operator will operate in accordance with the parts of the budget that are agreed upon; for the other parts in dispute, the operator will operate under the prior year's budget with some kind of adjustments. While this is generally workable, adjustments should be considered where a prior year included one or more unusual transactions or events.

4. **Budget format.** While it should go without saying, budgets must be provided in adequate format and detail to provide real information about the operator's plans. Budgets should be detailed enough to include not only the line items, but clear narrative explanations of the assumptions underlying those line items. It is also essential that the budget process be integrated, so that operating, capital and marketing expenses are presented as a unified whole.

Budgets should also be zero-based, rather than just increased (or decreased) some increment from the prior year. The underlying assumptions and rationales of the budget need to be rethought and reanalyzed, so that owners are not presented with the repetition of prior years' mistakes and do not miss the changes in markets or technologies that move so quickly.

5. **Variances and amendments.** Most operators argue that budgets are a planning device but cannot be relied upon, and they should be authorized to stray from the budget. This results in a meaningless budget. We believe that the operator should be contractually required to adhere to the budget except for permitted variances which are carefully defined in the budget provision of the HMA.

Consequently, while minor variances can be tolerated, some basic guidelines should be followed such as those below.



**What goes up also goes down.** Operators often provide that expenses can increase when occupancy increases. That may be true, but operators should be held to the opposite as well. When occupancy drops, operators should work effectively to reduce expenses and maintain profit margins.

**Budget line items are not fungible.** Operators sometimes argue that savings in one part of a budget should allow for overruns in others. This merely makes the budget process ineffective. Each part of the budget should stand on its own.

**Back to the future.** Changes to the budget should not be imposed by the operator alone. If circumstances change, the operator should submit a new budget for review and approval on the same basis as the original budget.

**Don't be a stranger.** The budget should be considered along with the operating results for each monthly reporting period, and the operator should be required to report regularly on its budget compliance, the causes of variations, and how they are being addressed.

## Conclusion

Hotel owners who fully participate in the budgeting process can positively affect the operations and profitability of the hotel. The budgeting process can be time-consuming. But isn't it worth taking the time once a year, however inconvenient, to protect your investment? The budgeting process can also be contentious. But isn't it worth it to work through disagreements to find ways – one line at a time – to leverage your investment into greater profitability? And wouldn't it be great if you and your operator understood and respected each other's needs and were aligned in your commitment to owning and operating a great hotel?

## Indemnification provisions

**I**ndemnification is usually a payment (or sometimes a repair or restoration) made to restore a party to its condition or situation prior to some event. In the context of HMAs, it usually means that one party, typically the owner, will protect another party, typically the manager, from a monetary claim related to the hotel or its operations.

### Indemnification provisions in HMAs:

#### What's the fuss all about?

A simplified indemnification provision in an HMA might look like this:

Owner shall defend, indemnify and hold Operator harmless from and against any and all liabilities, fines, suits, claims, obligations, damages, penalties, demands, actions, costs and expenses of any kind (including legal fees) (collectively, "Claims") arising out of (i) any action or omission or course of action on the part of Operator in its performance under this Agreement; (ii) any obligation incurred by Operator, whether alone or together with Owner or by Owner alone, in connection with the Hotel; and (iii) Owner's breach of this Agreement; provided that this indemnity shall not apply to any Claims resulting from the willful misconduct, gross negligence or bad faith of Operator.

#### Why is an indemnification provision needed in an HMA?

Indemnification is usually included to deal with third party claims such as those brought by guests (for lost property or injury), governments (e.g., liquor license or fire & safety violations), or employees (sexual harassment or wrongful termination). It identifies when and how the owner will be responsible for a claim against the operator, and when the operator will be responsible for a claim against the owner.



## **What does it do that isn't in the rest of the hotel management agreement?**

It may alter or reverse the "normal" allocation of financial responsibility for third party claims.

For example, in about 80 to 90 percent of current hotel management agreements, the operator is technically and legally the "employer" for the hotel's employees – the hotel staff and management are on the official payroll of the operator or one of its subsidiaries, and the operator recruits, hires, fires, trains and supervises the employees.

If an employee filed a claim against the operator for discrimination or sexual harassment, the employer would normally be responsible for such claims. After all, it is the employer. But a common indemnification provision might say that the owner has to indemnify the operator against any employee claims. Many owners find this extraordinary, inasmuch as any wrongful action would most likely be caused by the operator.

The theory of such a common indemnification provision by the owner or the operator is that "the operator is not paid enough to assume this kind of liability." The operator feels that it is just acting as the employer as an accommodation to the owner, and the owner should pay for all employment cost, benefits, and even such legal claims.

Under the sample indemnification provision above, the owner would probably be liable for any such employee claims against the operator.

## **Why should the hotel owner care?**

When the owner has to pay the first \$5 million judgment for employment discrimination or sexual harassment by the operator – or has it deducted from the hotel's operating accounts – the owner will care, and will appreciate the importance of the indemnification issue (although it will be too late to change the provision for the duration of the HMA).



## What do hotel operators want?

Operators generally want to avoid paying any costs incurred in operating a hotel. They want to protect their base and incentive fees from any offsets or reductions, and want to be shielded from any claims incurred in the course of their operating the hotel for the owner. Operators do not want to guarantee any kind of performance or liability. They view the claims that are being indemnified as a normal and ordinary cost of doing business – claims that the owner would bear if it were operating the hotel itself.

The limited exception that operators are generally willing to make to their complete indemnification by owners, is for a claim that is caused by the operator's own gross negligence, willful misconduct or breach of the HMA. Operators are also increasingly unwilling to allow "attribution" – where the acts of hotel employees hired and supervised by the operator (which can include the general manager and key, high-level supervisory personnel) are "attributed" or charged against the operator.

In the operator's "perfect world," it has no liability for the negligence of its employees, including the acts of a general manager, unless the owner can show that the negligence was the result of corporate gross negligence or willful misconduct of the operator.

## What do hotel owners want?

Hotel owners want operators to manage their property as professionals and experts. They generally do not expect to pay for damages or losses caused by someone else's negligence, breach of contract or violation of law – much less gross negligence or willful misconduct. In fact, hotel owners want to be indemnified by the hotel operator if the operator causes losses for any of these reasons.

## What message is being given here?

The evolution of indemnification provisions mirrors the evolution of hotel management agreements in general. There was a time, not too long ago, when operators were responsible for their negligence and misconduct, not just gross negligence and willful misconduct. By industry custom and practice, operators – at least



the established branded operators (as opposed to many independents) - have reduced their obligations and their liabilities, making management agreements more valuable to them.

For branded hotel operators, this current state of the industry concerning indemnification provisions - like many other provisions of hotel management agreements - sends a difficult message to owners. While operators and owners should be aligned in their goals, this provision highlights the differences and the tension between the positions.

### **How can you resolve it?**

There is no simple answer; each situation is unique. The indemnification provisions cannot be viewed in a vacuum. You need to understand how these provisions relate to the entire agreement, and address indemnification as part of the overall relationship between owner and operator in the hotel management contract.

Unless you are handling hundreds of hotel management agreements a year so that you know all the ins and outs and current market trends, even professional or institutional hotel investors should not start the management agreement process (even in negotiating the LOI or term sheet) without veteran hotel advisory and legal counsel experienced in these agreements.

### **Putting it all in context...**

Hotel management agreements (at least such contracts with the branded hotel companies like Marriott, Hilton, Starwood, InterContinental, Hyatt, and the like) tend to be very long term, "no-cut" contacts. Entering one of these arrangements is a little like turning complete control of your asset over to someone on a 99-year lease, except the "rent," if any, depends on what is left over after the manager gets done operating the hotel to its standards. But in addition to that, *you* are responsible for all operating shortfalls and capital expenditures that are not covered by available cash from hotel operations. The terms of the hotel management contract are likely to govern the relationship of hotel owner and operator for many decades and are hard to change once cast.

## SNDA: Subordination agreements affect the value, financeability and collateral value of a hotel

**F**or our purposes the following three terms are identical in meaning and fully interchangeable in the context of hotel operating agreements:

- Subordination Agreement
- Subordination, Non-Disturbance and Attornment Agreement
- SNDA

Subordination agreements are frequently used with various types of real property when someone other than the owner is occupying or using the property secured by the lender's loan. So in the hotel industry, this arrangement involves the hotel owner, the hotel operator and the hotel lender. And because the lender's joint agreement is required, typically the HMA will specify that these three parties will execute an SNDA (as a free standing agreement) prior to placing any lien on the hotel. The terms of the SNDA may be specified in the HMA, set forth in an attached exhibit, or required to conform to the requirements of the hotel operator or hotel lender.

### What are the three prongs of a typical SNDA?

An SNDA typically has three prongs, as follows:

**Subordination** (the "S" in SNDA). The hotel manager agrees to subordinate its hotel management agreement and any other interests in certain respects to the lender's lien. Most lenders insist on having some kind of subordination from a hotel operator as a condition to making a loan, and the inability of an owner to compel the delivery of subordination in a form satisfactory to the lender may jeopardize the financing.

**Non-Disturbance** (the "ND" in SNDA). The lender typically agrees not to disturb the manager's enjoyment and control of the property, and not to attempt to terminate the hotel management



agreement executed by the owner/borrower or to remove the manager if the lender becomes the hotel owner as a result of foreclosure. While this makes sense as long as a loan is performing, it can seriously diminish asset value and flexibility after a loan default by the owner/borrower.

**Attornment** (the "A" in SNDA). The manager agrees to recognize the lender, or its successor in interest, as the new owner having the right to enforce the hotel management agreement after the lender forecloses or acquires the hotel by deed in lieu of foreclosure.

### What does a subordination provision look like?

While the terms of an SNDA will undoubtedly depend upon the operator's and lender's relative sophistication and bargaining strength, a typical hotel management agreement is likely to have something like the following provision:

**Subordination.** Owner shall ensure that all existing and future Mortgagees and lessors provide Operator with non-disturbance agreements in form and content reasonably acceptable to Operator, which agreements shall preclude the termination of this Agreement absent the uncured breach of this Agreement by Operator, and shall further preclude the conveyance or leasing of the Hotel (whether on foreclosure, deed in lieu thereof or otherwise) to any Person to which Owner could not assign this Agreement without Operator's consent.

### As an owner or lender, do you know why the SNDA is so important?

As one critical part of a long-term hotel management agreement that may govern the parties' rights and liabilities for decades, the SNDA controls how each party's interests will be served or thwarted. In other words, the SNDA will strongly affect the owner's ability to finance or refinance the property, and possible liability on loan default. Similarly, the SNDA will control vital aspects of the lender's flexibility on loan default and in workouts, receiverships, foreclosures, bankruptcies, or deeds in lieu. The SNDA is also likely to have a dramatic impact on the

value of the hotel, and how many bidders are interested in buying the distressed property.

## What does each stakeholder-party to the SNDA want?

**What does the hotel operator want?** The hotel operator typically wants the option to continue to manage the hotel for the full contract term (with extensions) with a solvent owner – even when the hotel fails to produce enough cash flow to service debt and the owner is faced with foreclosure.

The principal motivations of the operator are purely economic. Long-term management contracts are assets for the hotel operator. They are somewhat like bonds or annuities, creating streams of inflation-adjusted income for many years. The present value of these income streams represents a significant asset. Anything that could result in an early termination of this income stream is a problem for the operator, including the ability of a lender to terminate the operator on foreclosure (or sale by a receiver, deed in lieu or bankruptcy court).

The hotel operator also wants to control the transfer of the property, even on foreclosure, to be sure that the proposed transferee is suitable from its perspective. For example, the hotel operator wants to know that the new owner will not be a competitor, has adequate resources to meet the owner's obligations under the HMA, and get appropriate assumption agreements whereby the new owner agrees to the terms of the old HMA, or renegotiates a new one.

Operators would say that they want to protect their "distribution system." They do not want their brand going up and down on properties, confusing the public. They want the property to continue shouldering its share of system costs (reservation, centralized services, marketing, and support of national and regional offices) and they want to continue managing the property and earning their fees.

**What do lenders want?** Initially, most lenders really want their borrowers to perform according to the loan documents and pay off at maturity. That does not always happen.



So lenders need both certainty and flexibility. They would like certainty that a capable, professional hotel operator is running the property to maximize cash flow and preserve the value of the asset securing their loan. Operators initially gained their bargaining power from the insistence of lenders and other investors that the branded operator be "locked down" for 50 or 100 years, so the lenders and investors would not have to worry about the promoter (or managing partner) taking over the property and destroying its value. The brands were happy to accommodate being "locked down" as long as the property met their brand standards, and the owner funded all deficits in operating cash flow.

Normally, lenders would like the brand and operator to stay in place even when loans go into default or foreclosure. They do not want the asset to lose professional management, reservation systems, or to suffer the significant cost and disruption of re-branding. But to maximize the value of the hotel collateral, the lenders would like for a potential hotel buyer (or the buyer at any of the distressed sales) to have the right on closing the purchase, or thereafter, to terminate the hotel operator.

Why would the lender want the ability to terminate the hotel management agreement, or give that right to a buyer of the distressed property?

**Hint:** A review of all the individual hotel purchase and sale transactions over the past 20 years – which transacted for \$10 million or more per property – shows that in 80 percent of the transactions, the buyer was either a hotel management company or a joint venture of a capital source with a branded hotel management company. What happens if the long-term management agreement cannot be terminated on foreclosure or bankruptcy sale or on a deed in lieu sale, and 80 percent of the typical buyers for the hotel don't bid because they cannot substitute their management? What is the impact on value?

In fact, when our hotel workouts team worked with major lenders in the late 1980s and early 1990s, including acting as RTC counsel for many bankrupt hotels, the typical lender swore that it would "never again" agree to an SNDA without the option to terminate the operator on loan default or distressed sale. And

that determination was strong ... at least for a few years until people forgot about what happens in the bad times. They are starting to remember "why" again.

**What do owners want?** Hotel owners usually have the simplest goal. They want reasonable freedom to get attractive financing for the purchase, construction, improvement or equity take-out of the hotel. They don't want to find that lenders are spooked by their hotel management agreement, or that the terms of financing are adversely affected. They want the hotel operator to give the lender whatever is necessary to facilitate the financing and don't want to be "held up" by the hotel operator when the lender needs some accommodation.

And lending standards can change dramatically over relatively short periods of time, at least when compared to long-term management agreements.

### **What are the challenges?**

Negotiating the subordination provision in a hotel management agreement is challenging.

In a new development deal, the hotel owner frequently has to get the operator before meaningful negotiations with the lender take place, and therefore the HMA with the subordination provision is usually in place long before talking to a lender. Also, many owners and their advisors do not understand the importance of this issue or ignore it until it is too late. Many owners are lulled by the manager's assurances that the manager has great influence with lenders, that lenders will be attracted to the project because of the manager, and that a deal has never been held up because of this provision. The last might be true, but that's only because the borrower bears the cost!

Lenders' standards are constantly changing. As lenders underwrite loans during times of easy credit, they are more likely to accept some terms from managers that they will not during challenging economic conditions. But since management agreements can have terms of 20, 30, 40, even 50 years or more, owners have to anticipate that they (or their buyers) will need to approach lenders many times over the course of the agreement, not just when the agreement is executed. The burden a subordi-



nation provisions places on financing will undoubtedly affect the value of the hotel through many transactions over the life of the property.

### **What is the answer? How can you resolve the conflicting interests?**

There is no simple answer. Each situation is unique. You need to understand how subordination provisions relate to your interests, the entire agreement, the lending environment, and address it as part of the overall relationship between owner and operator in the hotel management contract.



## Exculpation clauses – protecting the owner's assets

**T**his article briefly reviews the benefits to hotel owners in including a provision in hotel management agreements limiting the liability of the owner to its interest in the hotel property. This kind of provision is commonly referred to as an "exculpation clause," because it exonerates someone from blame or liability. While this clause is in many ways basic blocking and tackling, it is important to remember as acquisitions in the hotel sector increase and as owners renegotiate agreements with brands and independent managers.

And if you like the idea of both a belt and suspenders in any part of your financial dealings or business life, please note that you will never see an exculpation clause in a draft HMA from a hotel management company. In fact we have not seen them in very many HMAs drafted by others.

Why take a chance?

### **Limiting the hotel owner's liabilities under the HMA**

Most hotels are owned in a special purpose limited liability company or other entity designed to facilitate financing, and to also limit liability to the assets of the hotel and its related business. Sometimes operators will seek the personal guarantee of individual owners or investors so that they will stand behind the ownership entity's promises in the HMA, but most owners won't consider that. And if there is any kind of reasonable equity investment in the project, and appropriate insurance, personal guarantees should be out of the question.

### **Limitations on liability in management agreements**

Over the past several years, many hotel managers have gotten more aggressive in limiting their liability for operating hotels. These limitations include the indemnification provisions that typically require the owner to indemnify the operator for all losses or damages arising out of the hotel, unless it was caused by the operator's gross negligence, willful misconduct, or breach of the HMA. In other words, they are indemnified for their negligence.



Some brands have also added limitations on claims to a fixed amount (such as half the basic management fee), or "actual damages," preventing the owner from making any claim for consequential damages, punitive damages or other "extraordinary" remedies.

These clauses are designed to protect operators, but rarely does the operator's draft of the HMA contain any protections for the owner. We have almost always been successful in making the limitations mutual, and, in addition, we have successfully demanded protection for our owner clients from unwarranted liabilities through an exculpation clause.

### **What does the owner's exculpation clause look like?**

While each situation is different, a typical exculpation clause looks like this:

"Notwithstanding any other provision of this Agreement to the contrary, the liability of Owner arising out of or in connection with this Agreement and the transactions and obligations contemplated hereby shall at all times be limited to the interest of Owner in the Hotel, and in any litigation or any other dispute, neither Manager nor any other party shall seek or have recourse to any other asset of Owner or to Owner's partners, members, associates, agents, executives or Affiliates. Without limiting the foregoing, neither Owner nor any party associated with Owner shall have any liability in excess of Owner's interest in the Hotel for any act by Owner, including liability for the gross negligence, willful misconduct (either prior to or during term of or after the expiration or earlier termination of this Agreement) or breach of this Agreement by Owner."

### **What does the exculpation clause do?**

The purpose of the exculpation clause is to ensure that the liability of the owner and its principals to the manager and any other entity making a claim under the management agreement is limited to the owner's interest in the hotel property itself. The clause extends this protection not just to the owner, but to its

principals and affiliates, and covers not just direct claims under the management agreement, but any claim arising out of the management of the hotel. The limitation is important and meaningful – owners build or buy an expensive asset and invest significant sums in its equity. A manager should be satisfied that the substantial equity investment is adequate to secure performance by the owner.

### **Why an exculpation clause?**

It is generally possible to negotiate with a manager so that the limitations on damages are mutual – that is, both the owner and the Manager are limited in their claims. Moreover, hotels are typically held in single purpose entities, which limits their liability. Why is it preferable to include an exculpation clause?

While there are several answers, the key issue is that holding an asset in a single-purpose entity, and limiting damages and causes of action, does not prevent a manager or another party from "piercing the corporate veil" and pursuing claims against the principals of the owner. This is particularly the case because the clause should include not just contract actions, but other claims which are more easily brought against the principals of the owner.

Owners should also be aware that the asymmetry of the owner-manager relationship militates toward ensuring, through all possible means, that the owner is protected. The owner should not lose sight of the fact that claims by an owner against a manager may be difficult to prove. They often depend on subjective measurements of quality, and often relate to matters where the manager has more leverage. The manager, on the other hand, typically seeks monetary damages based on fee calculations, which are transparent (particularly where the manager has been keeping the books)! Strictly defining the owner's potential liability is, therefore, key to balancing the relationship.

# CHAPTER 3

## ABOUT FRANCHISE AGREEMENTS, BRANDS & INDEPENDENT OPERATORS

**New**

# Decisions about brands and management

*Branded vs. unbranded hotels, and branded vs. independent operators*

**W**hen should you brand your hotel and when should you leave it unbranded? How do you know when the benefits justify the costs? And if you decide to brand, should you go with brand management or an independent operator? What are the considerations?

Few decisions are more important. Here are some insights garnered by our Global Hospitality Group®'s experience in helping clients with more than 1,000 hotel management agreements and hundreds of franchise agreements.

## Why hotel branding and management decisions are so important

One of the first decisions in the hotel development or acquisition process can have a lasting impact on the success of the project: whether the property should be branded, and whether that brand should manage the property. The hotel's brand will be a defining part of the profitability, image and value of the hotel, and there may be no other decision which has a greater effect on the future of the property. Similarly, the management of a hotel can enhance the value of the brand, protect the owner, or detract from the value of the hotel – by as much as a 50 percent swing.

## The three fundamental questions

While a hotel owner will live with these choices for years – if not decades – owners and developers often fail to ask three key, threshold questions:

1. Should the hotel be branded?
2. If it is branded, which brand?
3. And if it will be branded, should the brand manage the property?



We recognize that there are many voices in the decision. Lenders or other investors may be more comfortable when a hotel is branded, and may feel that a brand manager will better operate the hotel. Some investors may be predisposed to one brand or another (often based on personal experiences as a guest, rather than an owner), and may have preconceptions of the ability of hotel ownership to operate the property. However, even where these strong voices have input, the owner or developer should consider the pros and cons of brands and brand management.

## Four options available to hotel owners for branding and management

At the outset, there are four basic choices available to an owner:

- Management by the brand, where a single firm will agree to operate the hotel under a specific brand, and the owner essentially hands the property over to the manager with oversight rights and obligations defined in a management agreement.
- A franchise with a third party manager. Here, the owner enters into two agreements, one of which is a license agreement with the brand, giving the owner the right to operate a hotel under a specific brand, and a second with a third party manager who will actually operate the property.
- A self-managed franchise. In this case, the owner obtains a license or franchise to operate under the brand, but manages the property itself.
- Finally, an unbranded hotel, operated either by a third party manager or by the owner.

## Why a brand?

**Brand standards and support.** Brands provide many benefits. The major brands establish standards, which are intended to be consistent across all operations so that guests are better assured that they will receive the level of service and amenities they desire and expect, wherever the property is located. Along with standards, brands provide operating manuals, which are

intended to provide a "turnkey" approach to the operation of the property. This is intended to reduce the number of mistakes and help ensure that the property is, in fact, operated pursuant to the brand standard.

Importantly, brands provide services that drive occupancy, such as reservations systems, websites, brand marketing, loyalty programs, and quality control. While they are often cited as important reasons to affiliate with a brand, they can be costly to establish and maintain, and the direct benefit to the property is not always apparent.

**But are the benefits worth the cost?** There are, however, a number of reasons not to use a brand. The most obvious reason is cost. Brands charge a variety of fees – management, royalty or license fees, loyalty program fees, marketing fees, reservations fees, training fees – the list can seem endless. Moreover, many of the fees are unrelated to the brand's actual performance. Base management or license fees and marketing fees are paid on gross revenues, regardless of the source of the revenues. Thus, the brand is compensated for occupancy even if the brand was not responsible for it.

Similarly, brand standards, while benefiting the property in some ways, come at a cost. These standards are designed to benefit the brand, not a specific property. Even if a standard does not add value to a property, the owner is obligated to adopt it because it is a brand standard. Brand standards are generally inflexible, and impose added costs on owners.

**Ill-conceived programs?** More than that, some hotel programs are ill-conceived. Over the past 25 years, we have seen brands adopt programs to centralize sales, accounting, quality control and other functions only to revert back to the prior regime of decentralized services when they do not provide the benefit promised. The cost of these programs are borne by hotel owners, and the cost is multiplied over the development of the plan, its implementation, the struggles to overcome flaws, and finally dismantling the plan. Brands have the luxury of experimenting because they do not have to foot the bill.



**Are expensive loyalty programs worth the cost?** There is also a big controversy as to whether loyalty programs actually benefit hotels. A recent study by Deloitte calls their effectiveness into question ("A Restoration in Hotel Loyalty: Developing a Blueprint for Reinventing Loyalty Programs"). Again, the owner must consider whether their benefit is worth the extra cost, both in terms of contributions to the loyalty program and redemptions by guests. These programs are not optional.

**Issues with long-term commitments.** Owners need to recognize that both brand management agreements and brand license agreements require a long-term commitment, measured in decades. Brand affiliation agreements make it difficult, if not impossible, for an owner to terminate for bad performance of the operator. This lack of control can seriously depress the value of the hotel at sale, or even lead to financial failure and foreclosure.

In addition, owners must take into account that the terms of these long-term agreements do not protect owners from the possibility of brand dilution or decline. There are a number of brands that, over the years, rode a roller coaster of changing target markets and ability to deliver on owner expectations. Many left owners without expected support for years or declined in value. Nonetheless, the owners were obligated to support expensive brand standards and programs that did not deliver expected benefits. (Amfac, RockResorts, Red Lion, Wyndham Resorts, Doubletree, JW Marriott, Westin and Sheraton to name a few). Some brands recovered to varying degrees over years. Others did not.

## Why not be independent?

Given that branding a hotel carries with it costs and burdens, some owners consider whether it would be advantageous to go it alone. Those who do cite a number of advantages:

- No license or system fees – at the outset, the owner will save in the neighborhood of 10-15 percent of gross revenues that it would otherwise pay to the brand for the right to operate under the brand name and mandatory services.



- Greater flexibility to meet the market. While unbranded properties don't have the support of system standards, they also do not have to take the good with the bad, and can structure a hotel standard that perfectly meets their market. Moreover, they can experiment and change, which can be difficult, if not impossible, in a brand's regime.
- Don't pay for what you don't need. There are some instances in which a brand simply isn't needed. For example, a hotel adjacent to a university hospital might not need a brand affiliation. The location of the property itself will put heads in beds and drive a high occupancy.

Owners need to be aware, however, that taking the independent route has its drawbacks as well.

- Unbranded hotels lose the benefit of a brand's support system, including detailed operating manuals and procedures, training, access to best practices, and perhaps most importantly, the bench strength and human capital that can make the difference between a successful and unsuccessful hotel. Many independent operators do, however, have excellent support systems.
- Not having a brand also makes the owner rely on its own resources and that of its on-site manager. Placing the success of the hotel in the hands of the wrong third party manager can be a risky venture. Nonetheless, the right independent operator can often bring better and more focused resources.
- An unbranded hotel will not have a dedicated reservation or marketing system. While there are a number of generic options available, they are not necessarily designed to the specific needs of the hotel or, conversely, require increased investment by the owner to create an effective reservation and marketing program. However, the online travel



agencies (OTAs) and other viable alternatives are now available to independent operators.

- An unbranded property is vulnerable to marketing programs by larger, branded operators. With larger marketing budgets, a branded property may be able to compete more effectively with an unbranded hotel. However, the saving in brand costs may be more than adequate to provide more marketing in the hotel's relevant markets.

## Who should manage the property?

Once the decision is made about whether the hotel should be branded or unbranded, the owner must address whether to have the brand itself manage the property, or whether to seek a third party manager (or self-manage).

**Brand managers provide a number of benefits.** They are closest to the standard and how it is implemented; the brand cannot argue that its own manager is failing to meet the operating standard (unless the owner interferes with the process or fails to provide capital). Some owners also see brand managers as being the most efficient alternative, since typically only a single management fee is paid, instead of a franchise or license fee and a separate management fee. And in many cases, the brand manager will have the deepest bench – the brand is likely to have more experienced personnel who can parachute in to the property to fill a vacancy temporarily, or to provide specific expertise on a problem.

**Brand management also comes at a cost.** While the nominal fees might seem to be less, brand operators are more likely to emphasize the highest interpretation of brand standards and be less concerned with achieving economies in operation or even maximizing revenues. The primary concern of a brand operator is the presentation of the brand, regardless of its economic impact on the owner. To put it directly, the loyalty of the brand manager is to the brand, not to the property. And to exacerbate the issue, brand managers are difficult and expensive to oversee. Since they have full access to and control of the hotel, even



understanding where their operations might be improved can be difficult.

**When is it appropriate to engage the brand to manage the property?** First, brands reserve the exclusive right to operate certain of their flags. For example, Ritz-Carlton, Four Seasons, W and other flags are exclusively operated by their corresponding brands, since they are flagship properties and the brands protect those standards jealously. It is the right choice because there is no other choice.

In addition, certain types of properties, such as large, convention hotels, require skills and expertise – and national group sales offices – that have been developed by only a small circle of operators. While there are a number of independent operators that can operate larger hotels, the staffing, systems, and resources of a branded operator will normally benefit hotels with more than 600 rooms, significant meeting space, and multiple food and beverage outlets.

## Conclusion

The decision to brand a hotel, the selection of the brand (if any), and the selection of the manager are all interrelated and essential decisions for the hotel owner. The outcome of the decision will have a lasting impact not only on the current income and success of the hotel, but on the ultimate value of the property.



# The myth that franchise agreements cannot be negotiated

## *Eight things to negotiate in your next franchise agreement*

The main purpose of this article is to debunk the myth that franchise agreements are not negotiable. Franchisors, given the proper motivation, are more willing to negotiate franchise agreement terms than in the past several years. So, throw away your old conceptions!

As a "starter kit," we have listed eight areas that are frequently the subject of negotiation in franchise agreements today. But there are many more. And, you are missing out if you don't get advice on what and how to handle your next franchise negotiation.

### **The ascendancy of hotel franchise agreements.**

Branded hotel franchise agreements continue their rise to dominance in the hotel landscape. Branded hotel management agreements are not dead, but the advantages of having a hotel operator independent of the brand have been widely recognized and continue to propel the franchise model. (The considerations of branding and using branded – versus independent – management are discussed at length in the previous article.)

Franchisees are told by the brand that the franchise agreements are not negotiable, but then they hear that someone else has been able to negotiate at least one or two contract terms. Potential franchisees don't want to waste time chasing something they cannot get, but the contracts seem so one-sided, and they want to get as much substantive relief as they can.

### **The most common question we hear from clients is, "What's really negotiable in a franchise agreement?"**

Based on our experience with hundreds of hotel franchise agreements, JMBM's Global Hospitality Group® knows that there is wiggle room to get some important concessions if you

know what to go for and don't waste your effort where it won't do any good.

We have listed a few areas where we have been able to help owners improve their contract terms. Depending upon your circumstances, there may be other significant opportunities.

But, a word of caution! One of the biggest mistakes we see is owners trying to negotiate the franchise terms themselves. Their lack of experience shows that they are amateurs, and the brands quickly realize that they don't have to give much by way of concessions.

### **Setting the context: Understanding the competing interests**

Most branded hotel properties are operated under franchise agreements which are long documents with lots of fine print. They are usually presented to owners as "non-negotiable." This brand position is justified on the basis of need for uniformity in agreements and insuring that hotel guests will have a consistency of amenities, operations and experience in all hotels bearing the same flag.

However, hotel owners seeking a franchise also have legitimate interests, and there needs to be some recognition of these needs and the unique circumstances of every situation. In fact, our experience shows that, within certain limits, some provisions of these franchise agreements can be negotiated to address franchisee concerns. Franchise agreements are not nearly as negotiable as hotel management agreements, so owners are well advised to understand what can and cannot be negotiated in order to realize the greatest value from their relationship with the brand.

We have negotiated hundreds of franchise agreements with every major traditional brand (and most of the others), and based on our experience, we believe there are key franchise agreement terms that hotel owners should normally be able to accomplish.



## Eight things to negotiate in your next franchise agreement

Here are eight of the most common franchise terms we are seeing negotiated today:

1. **Franchise and royalty fees.** While it's unlikely that franchise fees will be reduced for the entire term of the agreement, a "ramp up" in fees over the initial years of the agreement, particularly for a newly built hotel, can often be achieved. While other chain fees are more difficult to negotiate, it can be possible to get some temporary relief there as well.
2. **Area of protection or non-competition.** Hotel owners are properly concerned about the brand opening a competing hotel within their property's market area. If it's not offered, a franchisee should ask during the negotiations for a geographic area of protection or non-competition. The duration and area of protection of the restriction varies, but some protection is usually granted.
3. **Ownership transfer.** Most franchise agreements are still based on a simple ownership model, contemplating a single owner (or investment group) of a single hotel. Our experience is that more complicated owners (including REITs, private equity groups, real estate funds and other institutional investors) are increasingly focused on hotel investments. As a result, the transfer provisions should consider the structure of the owner and flexibility for transfers to certain related parties. In that regard, while a sale of a hotel often precipitates a property improvement plan (PIP), the owners should not trigger a new franchise agreement negotiation, set of franchise application fees and PIP when the transfer is to a related corporate entity or to another family member or trust set up for estate planning purposes.

4. **Independent management and changes in management.** The essence of franchise structure is providing the power of a brand with the greater flexibility and responsiveness of an independent operator (i.e. an operator unrelated to the brand). A good independent operator can provide an owner with a valuable buffer to the brand's demands for operating and capital expenditures, implementation of new and expensive brand standards, property improvement plans, and certain brand programs that may not make sense for a given property. While brands are, understandably, concerned that an operator must have the experience to run the property, the management company should be the owner's choice, and should have primary loyalty to the owner, not the brand. Thus, it's important to prevent a franchisor from having veto power over change in management of the hotel.
  
5. **Liquidated damages.** Liquidated damage provisions in the franchise agreement give the franchisor the ability to collect damages on the early termination of the franchise agreement. They can be a key inhibitor to the owner's ability to maximize the value of the property on sale, because liquidated damages have ballooned in recent years to as much as five times the average combined franchise fees and reimbursements paid to the franchisor. There are usually ways to both reduce the amount of the damages as well as restrict the potential transactions that might trigger payment.
  
6. **Capital investments.** Franchise agreements usually give the brands the ability to require substantial additional capital investments by owners to meet new physical brand requirements. There are a number of ways to reduce an owner's exposure, including restricting time periods and clarifying the types of capital improvements that can be required. This is particularly the case for a newly built property or an acquired property that may have recently undergone renovation.



7. **Personal guarantees.** Most franchisors require guarantees. Owners should seek to eliminate, or at least restrict the scope of, guarantees. As more and more owners are institutional, this requirement is less and less meaningful.
  
8. **Key money.** For the last several years, many brands have been willing to provide key money as a means of securing franchise agreements. While owners are typically excited about the prospect of getting additional funds, they should remember two things: First, key money is typically only paid after the hotel opens; it doesn't provide funds for construction. Second, and more importantly, key money is probably the most expensive money an owner will get; in return for key money, brands typically will be even less willing to negotiate important franchise agreement provisions.

While there are limited areas that an owner can expect to successfully negotiate with a brand in a franchise agreement, changes in these limited areas can make a big difference in the value of the brand to the owner. Our expertise in understanding how to implement these changes, and what other changes might be appropriate in particular circumstances, has achieved significant value for our clients.



**New**

## The importance of comfort letters in financing franchised hotels

**I**f you are buying, building or refinancing a hotel, you'll almost certainly be looking to a bank or other lender to finance it. When you do, you'll need to negotiate dozens of documents, some long, some short, but all of them necessary to get your loan. In other articles, we have talked about the importance of subordination, non-disturbance and attornment agreements (SNDAs). SNDAs are used in the context of a hotel management agreement - usually only long-term branded HMAs - to define the rights of lenders vis-à-vis the hotel operator in the event of the owner's/borrower's loan default, breach of the HMA, foreclosure by the lender or a deed-in-lieu of foreclosure.

But what about franchised hotels? Lenders who take security in a franchised property will want a "comfort letter," an agreement between the lender and the franchisor defining the rights of the lender with respect to the franchisor if the hotel owner defaults on its loan obligations, the franchise agreement or other related arrangements. In other words, lenders seek SNDAs to deal with their rights and obligations with respect to HMAs. They use comfort letters to deal with their rights with respect to franchise agreements.

### What is a comfort letter?

A comfort letter is, essentially, a form of assignment of the franchise agreement for the hotel brand. It governs the ability of a lender to operate a hotel property under a brand name after a foreclosure, receivership or other loan default.

### Why do lenders want a comfort letter?

Lenders make loans on branded hotels because they believe that a hotel is more valuable if it can be operated (and sold) as a branded property. If the hotel franchise agreement is terminated, the value of the property could drop significantly. Even where there is no foreclosure, the lender may want the ability to be able to "step into the shoes" of the borrower and continue to operate the property under the existing hotel franchise agreement. More



than that, a lender will want to be able to sell the hotel after foreclosure (or in connection with a receivership or similar action), and may believe that transferring the franchise to a buyer will increase its recovery. This, of course, requires the consent of the franchisor/hotel chain.

## Who writes the comfort letter?

Most hotel brands have a standard form of hotel comfort letter and, as a practical matter, brands will insist on negotiating from this form. When parties ask a hotel brand to use a new or different form of comfort letter, the brand may refuse or, at best, it will delay loan closing until the negotiation over the form of comfort letter is concluded. While the lender's rights under the comfort letter are limited, most institutional lenders have been willing to accept the comfort letter as providing the lender with sufficient "comfort" that it will have the ability to maintain the franchise relationship and the value of its collateral in the specified events of the owner/borrower default.

## What's in the comfort letter?

While each hotel chain's form of comfort letter differs to some extent, most comfort letters have the following provisions:

- The lender wants the brand to give the lender notice and right (but not obligation) to cure any default by the borrower under the franchise agreement prior to a termination of the franchise agreement.
- The lender wants the ability to assume the franchise agreement and avoid the payment of the application and other initial fees charged to franchisees. Hotel chains will often charge a lender a "processing" or administrative fee, which is less than the initial fee usually charged to a new franchisee.
- The lender wants the ability to have a receiver operate the property under the terms of the existing franchise agreement, at least for a short period of time during the foreclosure phase. Most hotel brands are generally willing to allow the receiver to operate the hotel under the "franchise flag" for a

relatively short period, provided: (a) any monetary and non-monetary defaults are cured promptly; (b) the hotel continues to maintain the insurance coverage required by the franchise agreement; and (c) the lender guarantees the obligations of the receiver under any short term license issued.

- If the lender acquires the hotel property as a result of foreclosure, it will typically want to sell the property quickly. As a result, the lender wants to obtain some assurances that the purchaser can also obtain a franchise agreement with the hotel chain.
- In addition, most lenders would like to be released from liability under the franchise agreement once it sells the hotel to a third party purchaser. Most hotel chains are willing to agree that, in the event of a sale of the hotel to a third party that party can apply for a franchise agreement and that such application will be processed in accordance with the franchisor's then existing requirements and procedures.

### **What's the challenge?**

Comfort letters, while a key requirement for most lenders, are challenging to borrowers because they require the lender and franchisor to come to agree on matters that have no immediate effect on them (or on the borrower!), but can prevent the closing of critical financing. Moreover, the lender and franchisor may have a different agenda than merely facilitating the closing of the owner's/borrower's financing transaction. For example, the lender may have other issues with the borrower, and the borrower may still be in the throes of finalizing the franchise agreement. Even in the best of situations, the borrower's counsel is often saddled with the task of negotiating a comfort letter that his or her client has little interest in, and trying to mesh the sometimes incongruent interests of the lender and the franchisor. The ultimate payoff to the borrower, of course, is the making of the loan by the lender.



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## Brand franchise issues in hotel purchase and sale transactions

*Key issues in hotel purchase agreements for buyers and sellers of branded hotels operating under franchise agreements*

**B**uying or selling a hotel operating under a brand name requires special attention. Typically, the existing franchise agreement will be assumed, terminated or modified in some way, and the new branding arrangements will usually have a significant impact on the value and profitability of the hotel. The JMBM Global Hospitality Group® has represented buyers and sellers of hotels with all the major hotel brands, and has developed practical solutions to achieve a smooth transition of the franchise from the seller to the buyer, or to change the franchise if that suits the buyer's goals. Knowing when and how to work with the franchisor as part of the transaction can save both parties a lot of money, avoid major disruptions of hotel operations upon the sale and increase the value of the property itself.

In this article, we discuss some of our experience dealing with a few key hotel franchise issues that need to be addressed during the hotel purchase and sale agreement negotiation and during the transition process.

### **The first thing you need to know: The franchise does not follow the property. It terminates on sale.**

Some hotel buyers and sellers believe that the hotel brand can be sold along with the hotel. That is not true. Virtually all franchise agreements currently used by the major brands provide that the seller's existing franchise agreement terminates when the hotel is sold. The buyer will need to enter into a new franchise agreement if the buyer wants to retain the brand. This leads to two key concerns.

First, unless a franchisee (the seller) has negotiated otherwise with the franchisor, the sale of the hotel will cause the termination of the franchise agreement, obligating the seller to pay a

significant termination fee. While most franchisors will waive the termination fee when an approved buyer enters into a new franchise agreement, the transaction documents, conditions and timeline must deal with this reality.

Second, the new franchisee (the buyer) must make independent arrangements with the franchisor to continue to operate the hotel under the same brand (if it chooses to do so), starting on the day the transfer takes place.

The hotel purchase and sale agreement should address these concerns. For example, the seller might include provisions in the hotel purchase and sale agreement to require that the buyer receive approval from the franchisor and a new franchise agreement from the franchisor before the closing of the transfer. If the buyer intends to change the franchise, then the seller needs to take into account the termination fees that the franchisor will charge for termination of the franchise, and the seller may want to increase the purchase price or negotiate terms with the buyer that reflect the seller's payment of any franchise termination fees. The parties' respective obligations to effectuate the transition should also be spelled out.

### **The hotel purchase agreement must allow enough time to complete the new franchise approval**

Hotel franchisors have an application process, which requires detailed background and financial information from the prospective hotel buyer before they will accept the buyer as a new franchisee. The seller will want to find out how long the franchisor will take to review the buyer's franchise application. The buyer needs to be prepared to file a franchise application and submit the necessary background and financial information to the franchisor as early as possible. A franchisor can take several weeks to review a franchise application from a new franchisor. Less time may be required for a buyer who already operates other hotels under the same franchise, but the buyer will generally still need to submit a new application and obtain franchisor approval.

The franchisor may also require the buyer to commit to upgrades of the hotel as a condition of approval (more about that next).



The buyer will want to review the franchise agreement presented by the franchisor, and perhaps negotiate a few modifications. The seller and buyer need to provide time in the transaction process for the buyer to go through the approval and negotiation process with the franchisor before the closing. Once the buyer and the franchisor have agreed to the terms of the new franchise agreement, it may take additional time for the buyer to receive the signed franchise agreement from the franchisor. It is prudent for both the seller and buyer to wait until after the buyer has a signed (new) franchise agreement before closing the sale of the hotel.

### **For the buyer: How to deal with PIP requirements**

Almost every hotel franchisor will require a new franchisee to undertake a property improvement program or "PIP" as a condition of receiving a new franchise agreement. If the hotel has not been upgraded for several years, the franchisor may require the buyer to make a substantial investment in property upgrades. If, on the other hand, the seller has recently made upgrades, the buyer may be able to reduce the required improvements, and/or to negotiate a longer time period after closing for the buyer to complete property improvements.

The buyer will want to start the discussion process with the franchisor early in the purchase transaction, so that the buyer can determine the costs of the improvements being requested by the franchisor, and be prepared to discuss a timeline with the franchisor to manage the costs and operating disruptions that will be required for the upgrade. Inexperienced buyers will want to engage knowledgeable consultants to help review and evaluate the franchisor's requested improvements, and suggest "value engineering" modifications to the franchisor's property improvement plan to reduce the buyer's cost.

### **For the buyer: How to negotiate with the franchisor for better terms in the franchise agreement**

Although many of the terms of a franchise agreement will not be negotiated by a franchisor, there are some provisions that are negotiable. Some of the most frequently negotiated provisions include:

- Lower initial franchise fee rate, with a ramp-up in franchise fees over time
- Include or expand an area of protection or restricted area within which the franchisor will not issue new franchises for the hotel brand
- Permit transfers to certain of buyer's internal affiliated persons or entities and to accommodate certain financial arrangements
- Eliminate any of franchisor's right of first refusal, right of first offer, or right of first negotiation
- Eliminate or reduce termination fees for the future sale of the hotel by the buyer
- Establish some protection or standard before the franchisor can require the buyer to make future renovations

Another major issue for negotiation will be the guarantees that the franchisor requires from the buyer and its affiliates. Buyers should be aware that there are different forms of guaranty, and it is possible to negotiate a guaranty that will reduce the potential liability of the guarantor. For additional recommendations on Hotel Franchise Agreements, see *The five biggest mistakes hotel owners make in selecting operators and negotiating brand HMAs* at page 9.

### **For the seller: How to deal with liquidated damages**

Most hotel franchise agreements require an owner/seller to pay a termination fee or liquidated damages on termination of a franchise. Often this amount will be a multiple of the average annual franchise fee earned by the franchisor over the prior years. The franchisor may also charge the seller other fees, such as charges for the hotel signs that the franchisor leases to the seller for a fixed term. The seller will want to ask for a waiver of all liquidated damages, which the franchisor will often grant, as long as the buyer enters into a satisfactory new franchise agreement with the franchisor. The seller should not allow a buyer to close on the hotel purchase before the seller has



obtained a waiver from the franchisor and the buyer has obtained a new franchise agreement from the franchisor.

Unless there is a specific condition in the contract, even if the buyer is obligated by the purchase agreement to execute a franchise agreement after the closing (and does so), the franchisor has no obligation to waive termination fees. And of course, if the buyer does not enter into a franchise agreement after the closing, the franchisor can demand that the seller pay all of the termination fees and charges.

Often times, such termination fees and related charges are secured by the personal guaranty of the owner/seller, which means that the franchisor can sue the owners directly for these amounts. Therefore, it is critical to the seller to obtain the waiver of termination charges by the franchisor before the closing.

### **For the buyer: How to coordinate a de-branding if the hotel is changing flags**

If the buyer intends to change the hotel flag, the process of removing the old name and replacing it with the new name will require coordination and timing. This is typically done by the buyer immediately following the closing, in accordance with a pre-arranged schedule. The buyer will want to coordinate with the franchisor, because hotel brand signs are often leased, rather than owned, by the seller. In addition, all items with the old hotel brand name and logo will need to be removed from the hotel and replaced.

In addition, a change of hotel brand will likely also mean a change of reservation systems. This may necessitate replacement of existing technology at the hotel to accommodate the new reservation system and training of personnel who are not familiar with the new system. The buyer will want to be in a position to immediately turn on the new reservation system when the old one is turned off, to avoid a disruption in bookings. If the hotel does a significant amount of group business, the buyer will want to discuss existing group bookings with the franchisor, and if possible obtain a commitment from the franchisor to leave the existing group bookings in place without





soliciting the groups to move to another hotel within the franchisor's system.

At the same time, buyers should be aware that franchisors often steer bookings away from properties when those properties change brands. Thus, the buyer needs to start marketing the property as soon as possible to avoid unreasonably low occupancy when the hotel opens under new ownership and brand.

### **For the buyer: Obtaining approval of the hotel manager and the right to change managers**

The hotel buyer will often bring in an independent hotel management company to manage the hotel under a hotel brand franchise agreement. Since the hotel franchise agreement will include a provision that requires the franchisor's approval of any third party manager of the hotel, the hotel buyer will need to confirm early in the transaction that the franchisor will approve the buyer's choice of hotel manager. For future flexibility, it is also wise to negotiate for the ability to change hotel managers without the franchisor unreasonably withholding its consent.



# Dual-branded hotels – what every owner or developer should know

## *The growing trend of dual-branded hotels*

**D**ual-branding of hotels in a single structure or complex is quite a trend in the hotel industry and has been picked up by the popular press.

The hotel lawyers in JMBM's Global Hospitality Group® have been working on dual-branded hotels for some time, so we thought we would share some our observations on the pros and cons of this approach.

### **One building – two brands: Two sides to the dual-branding coin**

*USA Today* has reported that hotel chains are increasingly offering owners and developers a "two-for-one" deal – a single building housing two separate hotels. While this is not entirely new (hotel companies have been placing multiple brands adjacent to each other or sharing facilities for many years), the trend of "dual-branding" appears to be accelerating. JMBM's Global Hospitality Group® has worked on a number of these projects, and see both benefits and challenges in this trend.

Here are a few of the considerations that we have noticed.

### **Benefits of dual-branding hotels**

Probably one of the most appealing parts of a two-brand, one-building approach is the ability to maximize the value of land, which is one of the biggest costs of developing a new hotel property. Hotel brands typically provide for a range of room sizes and configurations in any single hotel. By effectively putting two hotels on a single parcel, a developer can increase the number of guest rooms and provide a greater variety of guest room types to maximize the revenue from that property.

Different brands from the same brand family can also appeal to broader range of guests. For example, Hyatt Place and Hyatt House properties are often co-located, making it possible to offer

both a select service hotel and an extended stay property. And at LA Live in Los Angeles, Marriott International has combined a Ritz-Carlton and a JW Marriott Hotel on the same property. In a separate building across the street, Marriott will co-locate a Courtyard by Marriott and a Residence Inn. That gives Marriott four Marriott-family brands to offer guests in two buildings!

Locating two hotels in a single property may also permit more efficient use of space. The two hotels sharing a building may be able to share costly parking, pool, fitness center facilities, meeting space, restaurants, retail areas and engineering facilities which would otherwise have to be duplicated.

Just as important as maximizing the efficiency of physical space is the cost savings that may be achieved in operational efficiency. It may not be effective to have a full time chief engineer or accounting staff for a single, 100-room hotel, but it may work if they service two co-located hotels with a total of 250 rooms. Similarly, having more hotel rooms operated in the same building by the same brand has some potential for greater flexibility and scalability with other personnel (housekeeping, maintenance, front desk and so on), and thus can reduce employment costs and increase efficiency.

## **Challenges of dual-branding hotels**

While there are clear advantages to putting more than one hotel in a single property, there are a number of challenges as well. One of the key challenges an owner will face in a dual-branded property is that different brand families will not mix. It is virtually impossible to imagine two different brands would agree to operate hotels in the same building. So even if the owner felt that a Hilton hotel and a W hotel would be the perfect mix, if they ever did both occupy the same building, they would never share operating space, facilities or personnel.

Even mixing two brands from the same brand family can be tricky when the two brands are far apart in typical guest profile – the amenities of a luxury hotel would be compromised by sharing space and personnel with a limited service hotel. For that reason, most of the dual-branding efforts have been with brands that are fairly close on the brand family chain scale. At the same



time, putting two very different brands together can muddy the differences between different offerings.

Owners should also consider financing issues. Financing lenders may want to aggregate cash flows from the two hotel operations for debt service coverage ratios and other benchmarks for internal credit purposes. At the same time, they would normally also want separate legal parcels for each hotel for remedy purposes. This adds a few complications (generally not insurmountable) to negotiations and transaction costs, that should be more than set off by cost savings and efficiencies of dual-branding.

In the typical dual-branding situation today, the properties would normally both be managed under a single management agreement, or at least by a single manager so as to achieve the greatest operating efficiencies. Under a single agreement, the manager would combine the financial results of the properties together, and would apply a joint performance test. While that would avoid some of the problems of running two separate hotels in one building, it would also tend to hide the actual performance of the individual hotels. It would also mean that if the owner wanted to terminate the manager of the non-performing hotel, it would also have to terminate the performing hotel. These issues can all be dealt with in management agreement negotiations if an owner or developer is well-advised.

At the same time, if the dual-branded hotels operated under franchise agreements, they would require two different franchise agreements. Franchise agreements and operations for dual-branded hotels have not evolved to become common place. As a result, you will probably need to craft customized approaches, contact provisions and operating procedures to optimize the benefits of dual-branding.

New

## Five things to keep in mind when you look for a hotel operator

### *Setting the record straight on HMAs*

Over the past several months, a lot has been written about what hotel management agreements should or should not say. The Global Hospitality Group® at Jeffer Mangels Butler & Mitchell has been negotiating, re-negotiating, litigating, arbitrating and advising clients for more than 25 years on more than 1,000 hotel management agreements and hundreds of franchise agreements. Our experience extends to virtually every brand and every significant independent manager, as well as many less well-known players.

Based on that experience, we thought it would be helpful to set the record straight on some key issues that owners need to consider.

1. **Owners and managers are not partners.** One of the common statements we hear from owners and managers is that the management agreement "aligns the interests" of the owner and the manager, and that the manager is "just like a partner" in the hotel. While the interests of the owner and manager can be reconciled, they are not aligned - even when the operator makes an equity investment in the hotel. Managers are focused on maximizing their portfolio and overall revenue, while hotel owners are concerned about the value and income of a single property. Managers can "sacrifice" the profitability of a single property so long as the value of their portfolio is enhanced and they get their money off the top from gross revenues, whether or not the hotel is profitable. Owners expect to profit from each property.
2. **Managers are NOT taking ownership risk.** While it's true that hotel managers take on some costs and risk in managing a property, the fact is that in almost all cases, their risk is dwarfed by the owner's



risk. Owners are responsible for funding all of the costs of the hotel, regardless of its profitability; managers are not. Those who raise funds for charities often refer to the difference between "involvement" and "commitment." And they like to make an analogy to a ham and egg breakfast, where they say the chicken was involved, but the pig was committed. In the world of hotels, managers are "involved," but owners are "committed."

3. **The hotel management agreement is important.** Many commentators, including those with experience in the industry, argue that the manager's track record is more important than the management agreement. We agree that an owner should verify the manager's track record before making a commitment. However, the track record alone is not enough. First, while every management company has a list of highly touted successes, every management company also has a less-publicized list of disappointments – the track record goes both ways. Beyond that, a hotel management agreement is a complex document that identifies the expectations of parties for a period of five, ten, twenty, fifty years or more. Over that period of time, a good track record can turn into a disappointment, and relying on decades-old assumptions may be disastrous.
4. **Owners need meaningful approval rights.** All of these factors lead to a key conclusion – owners need to have a meaningful say in hotel operations. While owners hire managers to operate properties because of their expertise, resources, personnel and reputation, the relationship between owners and operators is "asymmetrical," and the goals of the two differ. While managers like the idea of a 70s style management agreement, where the owner simply hands the keys to the manager and hopes for the best, today's owners are vitally interested in operations. This means that owners should have clear oversight and approval rights over budgeting, expenditures and key operating decisions. They

should not be dissuaded from exercising those rights because of an operator's track record.

5. **The gap can be bridged.** Despite the differences between owners and managers, the gap can be bridged, but to do so requires expertise and experience in the options and alternatives available to the parties. From the owner's point of view, an attorney that understands what managers need and how their requirements can be met, is essential. Just as important is bringing to the table advisors that can recommend meaningful and practical compromises, and who are known to be credible players in the industry.

## **CHAPTER 4**

# **HOW TO TERMINATE A HOTEL MANAGEMENT AGREEMENT**



## Why is hotel management agreement litigation on the rise?

**H**otel lawyers will tell you that there are always disputes going on between hotel owners and operators, and that most of them are resolved at without any legal action.

Some disputes advance into litigation with the filing of a complaint, and others go to arbitration. The choice between litigation and arbitration is normally determined by the terms of the management agreement. Operators prefer arbitration and they have pushed to create a trend to arbitrate. The arbitrations are "private," tend to be missed by the press and are conducted in secrecy.

But the number of owner-operator battles has really escalated over the past few years. This is not just a matter of these disputes getting more media attention. There are a lot more disputes. What you see in the press is just the tip of the iceberg.

### The root cause of owner-operator disputes

While each dispute has a specific cause or issue, at the heart of the matter you will find the belief that the operator is not operating the hotel in a satisfactory manner and is treating the owner unfairly.

Operators don't want to give up their lucrative management agreements and many of them can't or won't change their actions to satisfy owners who bear all the financial risk of the hotel investment. In times like these, owners may find themselves dipping heavily into other funds to meet negative operating cash flows or mortgage payments. Many face foreclosure – and loss of their entire investment – with the operator's sub-par performance. They feel cheated when operators continue to take all their money off the top (from gross revenues) and the operators won't cooperate to improve the situation.

### The role of the economy

Clearly, bad economic times create a lot more friction between hotel owners and operators. When everyone is making lots of money, most people don't feel desperate to correct every wrong.



When hotel operations hit the skids, and owners have to write checks to keep the doors open, they want fast and responsive cooperation on critical issues.

Recovery from the Great Recession has been one of the slowest in history. Recovery in the hotel industry has been very uneven depending on the hotel's location, property type, market and other factors. Where hotels are performing better, friction between hotel owners and operators tends to ease. But for many, the improvement is neither big enough nor fast enough to quell the owner's dissatisfaction over operator shortcomings. As a result, we see the trend of hotel management agreement disputes continuing and increasing for quite a while.

New

## Why all long-term hotel management agreements are now terminable

*Major legal development on terminating hotel management agreements – Marriott v. Eden Roc*

**U**nder a New York Appellate Division court decision issued March 26, 2013, virtually all hotel management agreements are now terminable at will by owners. And this result will prevail even against the Marriott-style management agreements that seek to avoid an "agency" characterization of the owner-operator relationship.

The decision was rendered in the case of *Marriott International v. Eden Roc*, reversing the November 7, 2012 decision of Judge Melvin L. Schweitzer – who had granted Marriott's motion for a preliminary injunction, halting the owner's ouster of Marriott for poor performance.

In reversing the lower court decision, the Appellate Division succinctly stated that hotel management agreements giving full control to operators are personal services contracts and cannot be enforced by injunction. The court said:

The parties' detailed management agreement places full discretion with plaintiffs to manage virtually every aspect of the hotel. **Such an agreement, in which a party has discretion to execute tasks that cannot be objectively measured, is a classic example of a personal services contract that may not be enforced by injunction** [citations omitted and emphasis added].

### Termination may (or may not) be free

Please note that this decision has not addressed the question of damages that an owner may owe the operator for termination of a hotel management agreement under such circumstances. We should assume that unless there is adequate legal justification for the owner's termination, that the owner will be liable to the operator for damages. In a long-term, no-cut contract, these damages could be substantial unless the operator has materially



breached the contract. In the latter case, the owner might be entitled to terminate the contract without cost – in fact, the owner might be entitled to recover damages from the operator.

## **Why *Marriott v. Eden Roc* is particularly important for hotel owners**

For some unexplained reason trial courts are notorious for rendering the wrong legal answer on termination of hotel management agreements. The lower court had to be reversed in the *Eden Roc* case. The same has been true in many other well-known cases such as *Woolley v. Embassy Suites* (cited by the decision), *Marriott v. Pacific Landmark*, and others.

About the same time we successfully terminated the Fairmont management agreement for the Turnberry Resort last year(see *How to terminate a hotel management agreement: A Tale of Two Hotels – Marriott's Edition Waikiki and Fairmont's Turnberry Isle Resort*, accessible at [go.jmbm.com/ATaleofTwoHotels](http://go.jmbm.com/ATaleofTwoHotels)), the owner of the Honolulu Edition lost a similar suit in the New York Supreme Court and filed bankruptcy to avoid reinstating Marriott as manager of the hotel.

If the lower court in the Edition case had followed the law as determined by the federal court in our *Fairmont v. Turnberry* case or the law as clarified by *Marriott v. Eden Roc*, there would have been no need for the Waikiki Edition hotel to file bankruptcy.

## **What it all means: All long-term hotel management agreements are terminable**

Under one of two theories, hotel owners can now terminate their long-term hotel management agreements if they feel there is no satisfactory way to work with their operators. They may be liable for substantial damages for breach of contract unless the termination is justified, but they can take back their properties.

We believe the best way to resolve differences with an operator is through a dialog and a process of give and take to resolve the differences. But we have seen a number of cases where patient owners have tried everything they know how to do and are still frustrated by non-responsive operators.

Thus, when all else has failed, owners may be able to terminate the hotel management agreement and take back the operation of their hotels. This will usually be in the face of a contract that contains many paragraphs in all capital letters, stating that the contract is not terminable and that the owner waives all of its rights to terminate.

Notwithstanding this contractual boiler plate, virtually every hotel management agreement either creates an agency relationship between the owner and the operator, or establishes a personal services contract for the hotel operator's services.

Despite any provision to the contrary in such contracts, in most jurisdictions, there is such a strong public policy developed over more than a century that the non-termination provisions will be struck down. Except in unusual circumstances, an owner always has the power to terminate an agency or a personal services contract. If the termination is wrongful, the owner will be liable for damages. But the law simply will not enforce the agency or personal services contract against the owner.

A full copy of the *Marriott v. Eden Roc* decision is available at [go.jmbm.com/MarriottEdenRocDecision](http://go.jmbm.com/MarriottEdenRocDecision).



## **Case Study: *Marriott v. Eden Roc* – what it all means for terminating hotel management agreements**

*Hotel owners: How the appellate decision in Marriott International v. Eden Roc can affect your hotel*

**A**s we mentioned in the previous article, a New York Appellate Division court made it possible for the owners of the Eden Roc Renaissance hotel in Miami Beach to oust Marriott as its operator – despite the long-term hotel management contract between the two, which would have lasted another 43 years. (See *Why all long-term hotel management agreements are now terminable* at page 97.)

### **Setting the stage: owner-operator disputes over hotel management agreements**

The relationship between a hotel owner and hotel operator is complex. While the owner bears the financial risk of the hotel's success or failure and its gain or loss in value, the operator has the exclusive right to manage the owner's business and is paid off the top, whether the hotel is profitable or not. The contract between the owner and operator – the hotel management agreement – typically transfers control of the hotel's assets to the operator.

Hotel owners nationwide are keenly aware of both the benefits and impediments of long term hotel management agreements with branded operators (and nearly all such contracts are long term, often running 40 or 50 years). On the upside, the brand can provide stability, consistent standards, a reservation system, marketing expertise and professional staffing. But the downside can be hard for owners to live with – brands can rigidly incur needless expenses, be unresponsive to market conditions and impervious to the owner's need to run a profitable business and protect its asset.

While the majority of hotel owners and operators work hard to achieve a balance that is a win-win for both parties, it is easy to understand how things can go badly, fast.

## Background: The Eden Roc-Marriott dispute

On March 30, 2012, Key International, the owner of the 631-room Eden Roc hotel in Miami Beach, terminated Marriott as the hotel's operator "following years of mismanagement of the property and a failure to maximize the Eden Roc brand," according to its news release. But Marriott refused to acknowledge the termination or vacate the hotel. In October 2012, Eden Roc attempted to remove Marriott from the hotel's premises, but Marriott refused and obtained a temporary restraining order barring the hotel's owner from trying to oust it as Eden Roc's operator.

The owner appealed the decision and on March 25, 2013, a New York appeals court issued an order that vacated the lower court's injunction. Key International was free to terminate Marriott as Eden Roc's operator.

## What the Eden Roc decision means to hotel owners

Now that an appellate court has ruled that a hotel owner can terminate a hotel management agreement with its operator - the second time an appellate court has done so - owners are asking, "Does this mean I can terminate my hotel operator, even if I have a long term contract with them?"

The short answer is, "yes." Hotel owners can regain control of their hotel property when they see fit. This is good news for hotel owners.

But there are a number of very important caveats that will help frustrated hotel owners determine whether this is the best course of action when they are unhappy with their operators.

## The "power" vs. the "right" to terminate a contract

The *Marriott International v. Eden Roc* decision establishes that an aggrieved hotel owner can get rid of an operator despite the terms of a long-term, no-cut hotel management agreement that may run for 50 years or more.

But this is not necessarily a "free" termination (although it could be, depending upon all the facts and circumstances). Hotel owners need to understand that there may be serious consequen-



ces to pay if they terminate a hotel management contract, in terms of liability and cost.

*Eden Roc* reaffirms the "power" (i.e. ability) of an owner to terminate a hotel management agreement and to regain control of its property for any reason.

However, if the owner did not have the "right" to terminate the agreement – adequate legal justification such as a material breach by the operator – then the owner will be liable to the operator for damages resulting from terminating the contract. Those damages may be very substantial, and no owner should undertake a termination of a hotel management agreement without expert advice on alternative approaches, as well as the potential consequences of the action.

## **The hotel management contract is a personal services contract**

In *Marriott International v. Eden Roc*, a unanimous panel of the Appellate Division, First Department of New York agreed that the hotel management contract "is a classic example of a personal services contract that may not be enforced by injunction."

At first blush to someone outside the hotel industry, this case might seem unremarkable. It restates and affirms legal principles that have been used throughout the United States for more than a century as to the rules applicable for a mandatory injunction to enforce a personal services contract.

However, the fact that the *Eden Roc* decision is based solely on the inability to use an injunction to enforce a personal services contract is novel in the hotel industry. To date, all other lawsuits where terminating the hotel management agreement is at issue have also involved the use of "agency" principles.

In *Marriott International v. Eden Roc*, the court did not rely on agency principles at all. In fact, the court stated that it found no agency relationship, but the court still found the owner could terminate the agreement and Marriott could not enforce it by injunction.



By the way, as noted below, we disagree with the court's determination that there was no agency relationship under the management agreement, but that is a different issue for another discussion and another case.

## What's all the fuss about agency?

After a few high profile lawsuits over the termination of hotel management contracts (see the *Woolley*, *Pacific Landmark* and *Skopbank* cases with citations at the end of this article), most operators accepted that under the typical hotel management agreement the operator would be the "agent" of the owner, with all the attendant implications of fiduciary duty. Many sought expanded waivers of certain fiduciary duties, such as the duty not to compete, and the duty not to take undisclosed kickbacks on purchases, but most operators did not fight the basic concept that they were agents, and as such they were subject to the "cardinal rule of agency" restated in *Woolley* that a principal (the owner) always has the power to terminate his agent (the operator).

However, Marriott and a few other operators took a different track. And with zealous focus, they sought to strip their management contracts of any "agency" overtones or language, while retaining complete control over hotel operations. These contracts apparently confused some of the lower courts into thinking that because they purported to be non-agency contracts, they must be so, and therefore could not be terminated under traditional agency principles.

The *Eden Roc* court noted in a one-sentence conclusion that the hotel management agreement did not create an agency relationship. We do not believe that this was a correct conclusion, or that it will withstand the test of time when the question is brought before an appropriate appellate decision, despite all the attempts of Marriott and certain other operators to avoid an agency characterization.

But in denying the agency relationship, the *Eden Roc* court gave owners a tool that is potentially even more powerful than the agency relationship when it comes to the power to get control of a hotel back from an operator. And it certainly destroyed the



value of Marriott's elaborate attempts over many years to avoid this result by seeking to avoid an agency relationship.

## What about breach of contract and damages?

It is important to understand that the *Eden Roc* decision did not deal with the issue of damages for a possible breach of contract. This lawsuit was about a battle for control of the hotel, and a determination of whether Marriott had the right to continue operating the hotel against the hotel owner's wishes. The court ruled that Marriott did not.

The issue of damages between Eden Roc and Marriott will be left until a later date.

## New York, Florida and California agree on this result – what about other jurisdictions?

The appellate court's ruling firmly establishes that hotel owners have the power to terminate management services agreements with their operators and regain control of their properties.

Although the *Eden Roc* court is interpreting and applying New York law, the same rule is pervasive throughout the United States. When our hotel lawyers handled the *Fairmont v. Turnberry* case in Miami, which also involved terminating a hotel management agreement, our research indicated the same legal result under both New York law (the law governing the *Turnberry* contract) and Florida law (which a Florida court might refer to in a conflict of laws analysis).

An appellate court in California concluded the same thing in a lawsuit involving Doug Manchester's hotels in San Diego in the *Pacific Landmark Hotel, Ltd. v. Marriott Hotels, Inc.* litigation, another instance in which an appellate court voided Marriott's attempt to continue to control a hotel where the owner acted to terminate it.

In other words, although the outcome of the legal question decided by *Marriott International v. Eden Roc* could theoretically vary if governed by different state law, at least in California, New York and Florida the law is pretty much the same. We think this will hold true throughout most of the United States, but

hotel owners with contracts governed by the laws of other jurisdictions would be wise to analyze this carefully before terminating a hotel management contract.

In fact, an owner should not take any action in an owner-operator dispute involving a hotel management agreement without advice from experienced counsel at every critical stage of the process, starting at the earliest possible time.

### **How will the *Eden Roc* decision change disputes between owners and operators?**

This case provides an important reaffirmation of principles that will be critical for a few owner-operator disputes. If you are in one of those disputes, it may change the entire course of your situation – and for those parties, it will be a watershed event. We are frequently involved in these kinds of events and we never underestimate the impact it may have for those affected.

However, we do not see any wave of terminations being inspired by this decision. Most owner-operator relations are amicable and satisfactory. And even when they are not, the best solution is always a mutually workable result. Most difficulties are resolved at the negotiating table in a good faith exchange of viewpoints and business alternatives.

But when disputes cannot be resolved by discussion, *Marriott International v. Eden Roc* will be an important case in the litigation dynamics between owners and operators.

### **Will *Marriott International v. Eden Roc* change how hotel contracts are written?**

This case is the second time Marriott has gotten a bloody nose trying to avoid the result that equity demands – namely that no operator can force its agency or its personal services on another if that party wishes to terminate.

Lawyers for the brand operators will continue to write contracts that are favorable to the brand and lawyers for hotel owners will negotiate hard to level the playing field and achieve a contract that is fair to the owner. That's what lawyers do. But no amount of contractual acrobatics or gobbledygook will avoid the



inevitable result – that owners have the power to terminate the personal services of the operator.

The sooner operators accept this, the sooner operators and owners can get back to the real business of working together to provide great lodging for guests, consistent brand standards that make sense, and efficient operation of hotels that satisfies the legitimate needs of operators and provides a fair return to owners and their capital partners.

## Important legal decisions on hotel owner-operator relationship

For our friends who want the legal citations for some of the important legal decisions referred to above, here are the details, as well as the common names for referring to refer to these cases:

- *Woolley v. Embassy Suites Inc.* ("Woolley"), 278 Cal. Rptr. 719 (Ct. App. 1991)
- *Pacific Landmark Hotel Ltd. v. Marriott Hotels Inc.* ("Pacific Landmark"), 23 Cal. Rptr. 2d 555 (4th Dist. 1993)
- *Government Guar. Fund of the Republic of Finland v. Hyatt Corp.* ("Skopbank"), 95 F.3d 291 (3d Cir. 1996)
- *FHR TB, LLC v. TB Isle Resort, LP* ("Turnberry" or "Fairmont v Turnberry"), 865 F. Supp. 2d 1172 (S.D. Fla. 2011)

# Importance of fiduciary duties in disputes between hotel owners and hotel operators

**W**hile there are always disputes simmering between hotel owners and hotel operators, the past few years has witnessed a big increase in the number of disputes ripening to litigation and arbitration.

As we so often note, many of these disputes pivot on the fiduciary responsibilities of the operator. This is an important legal concept for hotel owners to understand. Generally, a hotel operator is the "agent" of the owner. Every agent is a fiduciary.

## So what if an operator is a fiduciary?

In a typical contract between two parties – say you and a contractor putting in a concrete driveway for your home – neither party is a fiduciary to the other. You are each free to act in your own best interest within the terms of the contract.

In contrast to the typical business contract, the hotel management agreement creates a completely different type of legal relationship between the hotel owner and the hotel operator. It has repeatedly been held by the courts to create an "agency" relationship. Operators originally crafted this relationship because they wanted total control of the hotel without ever having to get approval of the owner. They got this control by being designated the owner's agent to hire all employees, set up all bank accounts, enter into all agreements for the hotel, set marketing strategies, and so on.

## Fundamental rules apply to every agency and fiduciary relationship

Over hundreds of years, the English common law developed fundamental legal principles that will apply in every agency situation. For example, an agent is a fiduciary. A fiduciary has many duties such as a duty of loyalty, full disclosure, and noncompetition. Some of the rights and duties that come with an agency relationship can be waived by a fully informed written consent, and others cannot be waived no matter what.



## **Every hotel manager is the agent and fiduciary of the owner**

We believe that virtually every hotel manager is the agent of the owner, no matter what the hotel management agreement says. Some operators like Marriott try to avoid the "agency" label in their management agreements. Other major brands usually acknowledge they are agents and deal with their obligations in a different manner. But it is very common for any knowledgeable party to look for and to assert that the hotel operator is an agent.

## **Morals of the marketplace versus fiduciary duties**

If the operator is an agent, then as a matter of law, the operator assumes fiduciary duties (except under the law of Maryland, which Marriott had amended to remove the universal common law provision). These fiduciary duties go beyond the terms of the hotel management agreement and are more strict than the so-called "morals of the marketplace" that govern typical commercial contracts. Again, it is common for knowledgeable hotel counsel to assert and seek to enforce these fiduciary duties.

One of those fiduciary duties is the obligation of the agent to prefer the principal's interests (i.e. the interest of the hotel owner) over its own. This is certainly not a novel claim in agency law, but has not been that common in hotel management agreement litigation to date.

## **Hotel Management Agreement Audit™**

Establishing the existence of the agency relationship and the corresponding fiduciary duties is best done by a careful examination of the terms of the hotel management agreement and all the other facts of the relationship to assess these rights and duties.

It is not uncommon for operators to put provisions into hotel management agreements that are void and unenforceable. The key is to know when fiduciary duties created by operation of law – and without any express provision in the contract – may provide valuable rights to an owner and how they can actually trump contract boilerplate to the contrary.



At JMBM, we help people understand all their rights and obligations under a hotel management agreement. We do this with a diagnostic tool we call the Hotel Management Agreement Audit™. This is not a financial audit performed by accountants and auditors, it is a legal and business analysis performed by experienced lawyers and hotel advisors.

How can you evaluate your options unless you really know where you stand?



## Case Study: Turnberry Isle

### *How to terminate a hotel management agreement*

Over the years we have spent a lot of time on the subject of getting a great hotel operator and terminating bad ones. Owner discontent seems to erupt when operators continue to deliver disappointing results and ignore owner's requests to drive the top line and manage costs. Then the operators wonder why owners are upset.

Two significant hotel takeovers that started at virtually the same moment in August 2011 both settled in the same week of July 2012. One is the little-publicized takeover of the Turnberry Isle resort in Miami and the other is the widely-publicized takeover of the Waikiki Edition in Honolulu, discussed in the next article.

The comparison between the Fairmont case and the Waikiki Edition case is particularly interesting, given that two unrelated hotel owners seized control of their hotels from their operators at virtually the same moment on Sunday morning, August 28, 2011.

The owner's takeover was validated in the Turnberry Isle case, while the owner's takeover in the Waikiki Edition case was not. Independently commenced at the same time, both cases have now independently settled – within a week of each other by the end of the first week of July 2012. In both cases the owners terminated long-term, "no-cut" hotel management agreements with major hotel brands.

JMBM's Global Hospitality Group®, together with local counsel Dennis Richard of Richard and Richard, P.A., represented the owner of the Turnberry Isle Resort in a major victory over Fairmont Hotels & Resorts, by preventing Fairmont from re-taking the hotel. For reasons discussed below, that result is noteworthy when compared to the result in the case between Marriott and the owners of the Waikiki Edition in Honolulu, Hawaii.

In October 2011, a Miami Federal District Court dashed Fairmont Hotels' hopes of regaining management control over the Turnberry Isle Resort & Spa, in Aventura, Florida (near Miami).





The Court's order denied Fairmont's request for a preliminary injunction to be reinstated as the operator of the hotel. Fairmont's management agreement would have allowed it to operate the hotel for up to 50 years.

There are many important parts to this opinion, but one major theme is summed up in this statement by the Court:

"The notion of requiring a property owner to be forcibly partnered with an operator it does not want to manage its property is inherently problematic and provides support for the general rule that a principal usually has the unrestricted power to revoke an agency."

The Court's full decision can be downloaded by visiting <http://go.jmbm.com/FairmontvTurnberry>.

### **Factual background of the *Fairmont* case**

The Turnberry-Fairmont relationship at Turnberry Isle failed, but they were stuck in a purportedly 50-year contract. That was when Turnberry came to JMBM's hotel lawyers to help evaluate options, devise a plan, and execute it. The plan worked.

Founded more than five decades ago by Donald Soffer, Turnberry Associates' signature properties include Aventura Mall, Fontainebleau Miami Beach and Porto Vita in South Florida, Turnberry Place and The Residences at MGM Grand in Las Vegas, Union Station hotel in Nashville, Tenn., and Destin Commons in Florida's Emerald Coast.

Over the weekend of August 28, 2011, the owners of the Turnberry Isle in Aventura, Florida took control of their hotel and terminated their relationship with Fairmont Hotels.

The resort was created by the Soffer family's Turnberry Associates in the 1970s, and reacquired in 2006. Turnberry recently completed a \$150 million renovation. The hotel was operated by the Fairmont chain until Sunday, August 28, 2011.

Turnberry Hotel Group president C. Scott Rohm said, "We've had a long relationship with Fairmont Hotels and thank the company for its efforts." However, he said it was time for a



change. "Turnberry Hotel Group is re-emphasizing the glamour, personalized service and experiences that reflect the iconic resort's unique history and character."

In a statement, the company said that nearly all Turnberry Isle staff members were invited to stay. The management change did not affect existing reservations or scheduled events.

Paraphrasing the Fairmont opinion: Turnberry Hotel Group engaged in a bold, surprise takeover ousting Fairmont as the operator of the resort and terminating the management agreement without any advance notice. Turnberry demanded that senior hotel management immediately appear at the hotel on short notice on that Sunday morning, informed them once they arrived that Turnberry was de-branding the hotel and resort, and directed them to immediately leave the hotel property under the escort of an outside security team. Turnberry then changed the branding of the hotel, from napkins to marquees, retained employees loyal to Turnberry, switched to a different room reservation system and website, and removed all references to the Fairmont name.

Two days after the takeover, Fairmont sought emergency relief in federal court to get back into the hotel. The Court summarily denied Fairmont's request. Fairmont followed that with a request for a preliminary injunction seeking the same relief. After a trial on the matter, complete with testimony from top executives of Fairmont and the hotel owner, as well as industry experts, Magistrate Judge Jonathan Goodman, issued his Report and Recommendation that Fairmont's motion be denied.

Then Judge Donald L. Graham, having himself conducted an independent review of the record, found that Fairmont failed to meet its burden of persuasion on each of the four requirements for a preliminary injunction.

On October 14, 2011, Judge Graham issued his decision which "AFFIRMED, ADOPTED AND RATIFIED" Magistrate Judge Goodman's Report and Recommendation. As a result, Turnberry Hotel Group maintained control of the operations of the hotel and Fairmont was not reinstated.

## **Turnberry v. Fairmont decision is likely to become a frequently cited case**

We believe that this 71-page opinion, written by Magistrate Judge Goodman and adopted and reaffirmed by Judge Donald L. Graham, is destined to become one of the most cited cases in the area of hotel management agreements. Infallibly grounded on legal precedent – going back hundreds of years in English common law, a landmark U.S. Supreme Court case by Chief Justice John Marshall, and a well-known line of hotel cases – this is one of the best-written, most thoroughly researched and comprehensive decisions in the area.

The *Fairmont* court had a clear grasp on extremely complex and difficult legal issues. Both federal judges in the case – Judge Graham and Judge Goodman – independently came to the same conclusion: Turnberry had the power to terminate the 50 some year agreement, despite its express provisions to the contrary.

## **Some interesting comparisons of Turnberry v. Fairmont and Waikiki Edition v. Marriott**

The victory for Turnberry in the Fairmont case is particularly noteworthy when compared to the highly publicized litigation involving Marriott and the Waikiki Edition hotel.

- Both long-term, no-cut hotel management agreements are governed by New York law.
- Unbeknownst to each other, both takeovers occurred on Sunday morning, August 28, 2011. While Turnberry took control of its hotel at 8:00 am Miami time, some 6,000 miles away, the owner of the Waikiki Edition seized control of its hotel "in the middle of the night" at 2:00 am Honolulu time. Given the six hour time difference, the takeovers occurred at virtually the same moment!
- In contrast to Turnberry's successful takeover from Fairmont, however, the unfortunate owner of the Waikiki Edition was ordered, within days of the takeover, to return the control to Marriott.



- To forestall Marriott retaking control of the hotel, the Waikiki Edition owner then filed bankruptcy in January 2012. In the first week of July 2012, Marriott agreed to settle the case. The amount of the payment was not disclosed; however, the bankruptcy court judge had ruled in early June that a reasonable estimate of how much Marriott should be paid for lost management fees and expenses was \$20.7 million. Marriott had sought \$72 million for what it contended was an unjust breaking of a 30-year management contract. With the settlement announced on July 6, 2012, Marriott has withdrawn its competing plan in the bankruptcy and its objection to M Waikiki LLC's plan. Marriott also has agreed to drop the New York litigation.
- Turnberry moved on from Fairmont, without a bankruptcy, and on June 28, 2012, the Court dismissed Fairmont's pending lawsuit for damages based upon a confidential settlement reached by the parties.

## Case Study: Waikiki Edition

### *An owner's HMA dispute with Marriott*

I was interviewed a while ago by Jason Freed of *HotelNewsNow* (a division of STR) about several high profile lawsuits in the hospitality industry.

The first case we discussed was the lawsuit filed by the owner of the 353-room Waikiki Edition against Marriott and Ian Schrager. As the hotel's owner, M Waikiki LLC asked the New York Supreme Court to terminate its 50-year, no-cut hotel management agreement with Marriott on its \$250 million Honolulu hotel, and to award damages for misrepresentation and breach of contract.

This is an interesting lawsuit, so first let's look at the background facts and then let's see what the claims and the implications are.

You can download a copy of the complaint by visiting <http://go.jmbm.com/MWaikikivMarriott>.

### **Background of the Marriott Waikiki Edition litigation**

The owner acquired the hotel in 2006 for \$112 million, and then spent an additional \$138 million in renovations, including those required to be an "Edition" branded hotel. It thus has a total investment in the hotel of \$250 million.

After acquisition, the owner sought to evaluate whether to brand the hotel or operate it as an independent unbranded hotel.

In June 2007, Marriott announced its arrangement with Ian Schrager to create a new boutique hotel brand - "Edition." Extensive plans were announced including that 22 gateway cities would be the first locations for Edition hotels. Marriott announced that it expected to have five Edition hotel deals by the end of the year and 100 Edition hotels within 10 years.

The complaint then alleges that Bill Marriott and his team launched an aggressive campaign to convert the owner's hotel to an Edition, promising that Marriott would devote its considerable resources to make the hotel a success from the day it opened



its doors. Marriott presented rosy projections, showing that in its first year of operation the hotel would earn more than \$14 million in profit on \$53 million of gross revenue, and that the hotel would have an occupancy rate of 68 percent with an average daily rate (ADR) of \$400.

The complaint also alleges that Ian Schragger promised he would be personally involved in the design and operational development of the hotel. The owner says that Schragger promised his personal involvement in key design meetings would ensure that the hotel had the style elements necessary for the hotel to be a success.

The owner claims that the hotel is performing at only 37 percent of its competitive set. The hotel is branded with Marriott's new Edition flag – a brand with few other properties and little name recognition.

### **What went wrong at the Waikiki Edition?**

What went wrong? The facts in the complaint show that just about everything that could go wrong did go wrong, including Marriott's failure to develop and support the brand, Ian Schragger's turning a cold shoulder on his promises of personal involvement, and ultimately the apparent abandonment of the brand by Schragger and Marriott.

On top of that, the operating results at the hotel were abysmal. Marriott should have been ashamed to operate a hotel with these numbers. The complaint says that the hotel, which had a major \$138 million renovation, performed at only 37 percent of its competitive set.

Starting in August of 2009, Marriott began reducing its projections of profit for the first year from more than \$14 million in profit on \$53 million of gross revenue to a net operating profit of \$6.5 million on gross revenues of \$37.5 million, with an occupancy of 62 percent and ADR of \$319. A month later revised projections continued to project less, and so it continued.

Needless to say, the owner has suffered millions of dollars of operating losses under Marriott's management, and has received no return on its \$250 million investment in the Waikiki Edition.

## The two main prongs to this complaint

1. The first prong goes to the manager's failure to drive the gross income or gross revenue (bring in paying guests who spend money for rooms, food & beverage or other accommodations), and reduce or hold down expenses when the hotel is operating at a greatly reduced capacity. The essence of this claim is the one we have talked about at length: less than 30 percent occupancy, the failure to generate enough income, and the reduction of expenses caused \$6 million of operating losses (negative cash flow) instead of an operating profit of \$14 million as originally projected. That is before mortgage payments or other debt service.
2. The second prong goes to the "Edition" brand. The complaint suggests that there were representations that the hotel owner would be joining an existing chain of at least nine hotels, commitments to build the brand rapidly, and other promises of making the owner's hotel profitable. There are also references in the hotel management agreement to the hotel being operated as part of the "chain" of "Edition" hotels. The essence of this claim is that there is no "chain" of hotels and that the brand was not developed as promised.

## The tension between hotel operators and owners

When hotels operate at a loss for a sustained time, the tensions between operator and owner increase greatly. Operators are in virtually complete control of the hotel. They have complete control over all the activities that might generate income from the talents and skill sets of the people they hire at the property and corporate level, to what marketing programs they develop, and how they tap into corporate or other resources to develop business at the hotel. They also control (or fail to control) the expense side of things, determining what restaurants to keep open, hours of concierge service, the prices or charges for everything at the hotel, and staffing levels.



Under these circumstances, owners feel helpless and often seek cooperation from operators to change the way they are operating to reduce losses and create a profit or break even. When the operator is in control of everything, who is to blame for sustained bad results? Often owners do not feel that operators are doing enough, and may want to force some kind of change in operations or even a termination of the relationship, feeling that almost anything has to be better than what they have.

Operators tend to feel that they are doing the best they can under difficult circumstances. They have their own profit situation to monitor and their own shareholders to satisfy. But they also feel that they have to maintain the integrity of their brand, and that compromises for short term profit management may cause long-term damage to the value of their brand. They often say that they made a deal with owners and the owners should live by the agreement and provide whatever capital it takes to ride out the downturn or other difficulty.

## **How common are these hotel management agreement disputes between owners and operators?**

The tension between owner and operator is ever-present, but exacerbated in difficult financial situations. The wrestling over approving budgets and forcing compliance is the same, and often depends upon the terms of the HMA. Some HMAs give owners no right to approve any budgets, while others give limited rights, but usually leave the operator in control while disputed line items are arbitrated. Too often there is no standard for how the arbitrator is to decide whether to allow the disputed budget item except for the operator's "brand standards." And who is likely to win when the branded operator says the budget item is necessary to maintain its standards?

While the arguments are common – if not ubiquitous – over budgets, revenue generation and expense control, a relatively small proportion of these arguments result in lawsuits or arbitrations. There are few lawsuits because most HMAs require the disputes to be solved by binding arbitration. And a relatively small proportion of arguments are arbitrated because operators make them a war of attrition – very expensive and difficult to



win. Plus, if the owner loses, he is stuck with the operator which is still in complete control of the hotel and the operator may now carry a grudge. Those monthly review meetings may have a very chilly or even hostile feeling.

## **What happens in the hotel management agreement lawsuits? What do the cases say?**

Trial court proceedings are not reported cases, so the decision may be brief and difficult to find. Only cases that are appealed and decided by appellate courts result in reported decisions, which become part of our case law and precedent for other cases.

Arbitrations are private. There are no court reporters. They are often subject to confidentiality provisions. And arbitrator decisions, where they are to be found, often tend to be informal and sketchy.

That said, the reported case decisions on owner terminations of operator management agreements are virtually all favorable to owners on why the HMA creates an "agency relationship," why the agency is not "coupled with an interest," why there is an absolute right of the owner to terminate such contracts (though the owner may be subject to damages), and that this agency creates fiduciary duties imposed on the operator.

None of the decided cases has specifically focused on whether the acts of the operator were sufficient breaches of contract to justify the termination without liability, although the *Woolley v. Embassy Suites* case originated with the owner's claims that the operator's problems with the budget were grounds for termination.

There is no way to know how many unreported lawsuits or arbitrations may exist on this matter. From our own experience, I would say the claims are not uncommon, though most are resolved or settled prior to decision.

## **What is "special" about the Waikiki Edition lawsuit?**

The complaint's claim for the defendants' misrepresentations about and failure to develop the brand and the chain are NOT the typical type of claim we have been discussing and are less



common because a new brand is involved in fewer situations. There have certainly been similar claims made by owners over the years involving brands such as RockResorts, Amfac, Red Lion, Wyndham, Doubletree, Le Meridien and others as the brands changed direction overnight and disappointed owners. Some were successful in terminating the HMA. Others were not. Several involved the claim that the operator was no longer a "chain" and/or was incapable of providing "chain services." Others were based upon other factors. In all cases, the very specific language of the HMA, and the skill of the advocate developing the case, are critical to the success of the claim.

## **Marriott lost control over half of its trendy Edition chain in the pre-dawn hours**

On August 28, 2011, in the early hours of Sunday morning, the owners seized their hotel by installing new management and changing the signs and locks on the hotel to reflect the new name, the Modern Honolulu. As Marriott's Edition chain only had two hotels – the one in Waikiki and one in Istanbul, Turkey – Marriott lost half of its Edition hotels with this takeover. This has to be a big blow to the struggling new brand.

### **What does this mean for the Edition brand?**

In our opinion, the public litigation against Marriott and Schrage for breach of contract, fraud and mismanagement has to be a big black eye. Whatever the legal outcome, operating a functionally new and redesigned hotel at 31 percent of the competitive set is a dismal record for anyone, much less Marriott.

A lot of people have wondered who would want to invest in an Edition hotel with all this terrible publicity. Apparently, Marriott is worried about that too, and the *Wall Street Journal* reports that Marriott is investing \$400 million of its own money in Edition locations in London and Miami Beach, which will open over the next two years or so. We think the problems with the Waikiki Edition leave unanswered questions that will continue to haunt Marriott's efforts.

### **Other issues raised**

Terminating a bad operator is a little like worrying about the barn doors after all the horses are out of the barn. Sometimes you

get your horses back. Sometimes you don't. But it is always easier to make sure the barn doors are closed first.

With hotel management agreements, the first thing to check is that you have the right brand for your hotel, and then that you have a great operator with a fair HMA that protects your critical interests. If you have to wait 50 years until the contract expires or sue your operator, you have already lost.

## **Waikiki Edition lawsuit against Marriott – What Marriott's General Counsel says**

Our write-up of the Waikiki Edition lawsuit became one of the most read articles in the history of Hotel Law Blog. We got a lot of feedback on the article from people, who said it helped them understand what was going on there. We also received a letter from Ed Ryan, Executive Vice President and General Counsel of Marriott International, which took quite a different tone.

Although I disagree with many of Ed's points, the letter is thoughtful and well written. Ed encouraged me to publish it so people could see the other side of this issue. And in the interest of airing another view, I have done just that.

Read Ed's letter on the following page. Then, you be the judge.



**Marriott  
International**  
10400 Fernwood Road  
Bethesda, MD 20817

Edward A. Ryan  
Executive Vice President and  
General Counsel

August 18, 2011

James R. Butler, Jr., Esq.  
Partner  
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Los Angeles, CA 90067

Dear Jim:

I read with some dismay your blog about the Waikiki Edition lawsuit and what, in your view, it all means. Admittedly, there are a few points we agree on. You are correct, for example, when you say that it is important for owners to choose the appropriate operator and brand, and I also agree it is in everyone's interest to carefully negotiate a contract that reflects a business arrangement we all are satisfied with and will live with. But some of your comments were simply wrong, and I write in the hope you will correct them.

With respect to the Waikiki Edition lawsuit, you refer to the "facts" in the complaint. But the complaint does not state facts - it makes allegations. I won't discuss the specifics in this letter, but I am attaching our recently-filed Motion to Dismiss to ensure that you have a clearer picture of the facts and the law. It will suffice for here to say that Marriott remains committed to the success of the Waikiki Edition hotel, which has won rave reviews from the media. Marriott likewise is committed to the development of the Edition brand, although, ironically, the publicity the plaintiff created by filing the Waikiki

lawsuit, as well as the current economic downturn, has rendered that task more challenging.

Second, I want to help give you a better view on the landscape of owner/manager dispute resolution. To begin, courts and arbitrators do not find that management agreements create an agency relationship that can be terminated at will. Quite the contrary. The Embassy Suites case you refer to was decided back in the early '90s, and since that time, management agreements have changed radically to make clear that no agency relationship is being established. As a result, more recent cases go the other way. In two very recent decisions, for example, a New York court and an international arbitration panel both found that Marriott and Ritz-Carlton were not agents of the owners. The New York decision was rendered just last year in a case litigated by K.C. McDaniel on behalf of the owners of a Marriott property in Manhattan. We received the decision of the arbitration panel in April of this year in a case litigated by William Bosch of the Steptoe firm on behalf of the owner of The Ritz-Carlton, Jamaica. I've attached both decisions.

I think you will find the Jamaica decision particularly interesting, because it considers in great detail the owner's multiple claims of breach and finds them to be unfounded. The panel refused to find any default and refused to allow termination of the agreement, and instead required the owner to pay several million dollars of Ritz-Carlton's attorney's fees.

This leads me to my next point. To be honest, I'm offended by your statement that operators make litigation a "war of attrition." Of course operators vigorously defend lawsuits that are brought by owners; we have to, because our management agreements are key assets of our business. But typically the burdens of discovery fall far more on the operator than on the owner, because it is the operator that possesses most of the documents relevant to the operations of the hotel. We do not want to be involved in litigation and



certainly have no interest in making the process any more difficult than it needs to be. Unfortunately, it sometimes seems that owners are enticed by plaintiffs' lawyers into trying to solve their economic problems with litigation - an approach that, in the end, only benefits the lawyers. We understand that difficult economic times can place a strain on the relationship between owner and operator, and both suffer. But as we saw in the most recent downturn, we do our best to operate efficiently in such times and to maintain margins and flow through. We all know about cycles, and the approach of some to use litigation as a crutch to address a bad economy is simply counterproductive.

I hope this information proves useful, and you should certainly feel free to print this letter in its entirety if that seems appropriate.

Thanks,

Ed Ryan

# Terminating hotel management agreements when things don't work?

*Not easy, but not impossible either*

Updated March 15, 2014

**W**hat is one of the nicest acknowledgements of professional accomplishment a hotel lawyer might receive? In my book, being recognized by the *New York Times* as an expert in a core aspect of my legal and advisory practice is pretty close, and that is what happened May 2009 in a *Times* article by Jonathan D. Glater about the increased friction between hotel owners and operators now erupting into litigation in the case of the Four Seasons Aviara and the Fairmont Turnberry.

As I said in in an April 2009 *New York Times* article by Martha C. White, we are facing the prospect of hotel bankruptcies and foreclosures reaching levels not seen since the last big downturn of the 1990s.

And indeed, it is in difficult times like these when hotels fail to meet debt service - or even operating expenses - that owners and lenders become very frustrated with operators that prefer their own interests to those of the hotel. And that is why Jonathan Glater's article was looking at two high profile emerging battles where owners are standing up to operators and saying, "I'm mad as hell, and I'm not going to take it anymore."

## Hotel management agreement hell

Sometimes desperate owners prematurely jump to the conclusion that a hotel management agreement should be terminated. Without the correct analysis, this is like the old joke about "fire, ready, aim." Do your analysis first. But more about that in a moment.

Struggling to carry an underwater hotel with a bad operator and an onerous agreement is "management agreement hell." We know.



Twenty years ago, it seemed like anyone who knew anything about hotel management agreements was on the operator side, so we started helping lenders and owners terminate or renegotiate long-term, no-cut hotel management agreements that purported to run for 50 or 100 years.

We have seen it all: operators who insist on keeping five restaurants open 24 hours a day even though they are empty and losing a fortune. Overstaffed executive and line staff that inflate payrolls and sometimes are used to make your hotel a training ground or retirement center. Branded operators delivering only five percent of the hotel's business through its reservation and marketing systems. Operating standards that may maintain a brand image but don't contribute to profitability. Pricing rooms and services to maintain "rate leadership" in a market for the brand's perceived position, instead of getting a fair share of the available business for the hotel.

### **Does this sound familiar? Operators that are ineffective or fail to respond to critical needs**

Most owners become very frustrated when they feel that their operator is not responding to a critical situation. The aggravation level escalates when the operator isn't proactive in driving business, cutting costs and better managing capital expenditure issues. Sometimes the operators seem to tell you anything they think you want to hear - month after month - but do nothing, despite repeated promises. Whatever the reasons, bad financial results can severely wound owners and lenders who feel they are entitled to expect results from operators who proclaim their expertise and take their money off the top - as a percentage of gross revenues, or through markups, purchasing fees, reservation fees, frequent traveler charges, and the like. They are dismayed when the operator is unable or ineffectual at getting results.

The operators run your hotel, hire and fire your employees, set the pricing and standards, and tell you when they want you to write checks to upgrade the carpet and pool furniture, make payroll or pay their fees.



That is the background that led to my quote in the *New York Times* article about how hotel management agreements structure the relationship of owner and operator:

"It gives the operators all the benefits of ownership with none of the burdens," said James R. Butler Jr., a lawyer at Jeffer Mangels Butler & Mitchell in Los Angeles. "It pushes to the owner all of the costs – the capital costs of buying, maintaining and operating the property – and lets the managing companies take most of their money off the top."

## **Why not just terminate a bad operator? What can you do?**

Most branded hotel management agreements run for decades. They are not terminable at will or just because the hotel is underperforming. And they usually have very tricky procedures requiring notice of perceived breach with one or more opportunities for the operator to "cure" the default. So it is not usually easy to terminate a hotel management agreement. But if you terminate and do not have proper justification, you will be responsible for damages for breach of contract, which could amount to the present value of the income stream the operator would have received for the remainder of the contract term. This could be very expensive.

Of course there are other reasons not to terminate a hotel management agreement without due consideration. For example, although it may be convenient to blame the operator, a hotel's difficulties may not be the operator's fault at all. Even if an owner could terminate an agreement, it might not be the wisest thing to do. Maybe the present brand is the best brand and management for a property. The costs (and loss of momentum) of rebranding can be substantial. To do so if unnecessary would be very counterproductive. Besides, most brands will make a termination effort very expensive and time consuming unless they see it your way (and they probably won't without a lot of professional guidance).



## When your hotel fails to perform, what should you do? The SAVE™ program

When things are not going well at your hotel, the first thing you need to do is find out why they aren't going right. We have developed some very effective tools for dealing with long-term hotel management agreements that are no longer working for the owner. We call this collection of tools the SAVE™ program. "SAVE" stands for Strategies and Approaches for Value Enhancement."

The reference to "value enhancement" relates to the fact that while the right management agreement can add a lot of value to a property, in times like these, a long-term, no-cut, hotel management agreement can be a big "encumbrance" on value. In fact, we have seen a number of real-life situations where the hotel is worth up to twice as much without the branded hotel management agreement.

Along with the operational analysis, we give careful consideration to the operator's performance. What can be done cooperatively with the operator to improve results? Is this the right operator or just difficult times for everyone?

Has the operator breached either its express or its implied covenants under the hotel management agreement? Can the management agreement be terminated for any other reason, such as an operator's breach of the fiduciary duty of the agency relationship created by almost all hotel management agreements?

Is there some win-win for all parties other than termination?

## Terminating a hotel management agreement – where to begin

**T**he love-hate relationship between hotel owners and operators is as old as the institution of hotel management arrangements (going back to the 1970s). We have seen a lot of eager owners anxious to sign up with a big hotel brand, thinking that was the end of their worries. Often it is. More often it is not.

But hotel owners don't come to hotel lawyers to tell them how happy they are with a hotel operator. They either come to hotel lawyers to get help in signing up a hotel operator, or to complain about the unbearable financial pain caused by the incompetence, dishonesty and arrogance of their hotel operator. Sometimes the complaints are well-grounded and justify the termination of the long-term hotel management agreement, and perhaps even millions of dollars of compensatory and punitive damages as was the case with the Ritz-Carlton Bali we handled.

How is it possible to terminate a hotel management agreement? Particularly one that purports to be a 30-or 50-year "no-cut" management contract? We have a few ideas.

### Hotel lawyers – our perspective

We are not "hotel operator bashers." This is a very small industry. We know and work with all the operators – branded and independent – and they are an invaluable part of the puzzle of successful hotel operation in most cases. We have never failed to get a deal done for a client that wanted it done – after the client understood the likely effects.

So why would JMBM's Global Hospitality Group®, as an integral part of the hospitality industry, ever take on the operators to terminate a hotel management agreement?

Because sometimes they deserve it.

Our clients do what all business owners do when their contractual agreements are broken – they call their lawyers. And we are hotel lawyers that represent the interests of owners, developers and lenders. We have no conflicts taking on the traditional



brands. That is really how we started our practice in the late 1980s – breaking long-term, no-cut hotel management agreements.

## **Getting started – Is it time to terminate?**

First, termination is not always the right answer. Often, simple discussions or renegotiation of the management agreement are more appropriate. Who wants to re-brand, unless it's really necessary?

Second, you really have to look at each individual client's goals. Again, termination is often not the answer. But one does need to recognize the available options in making intelligent decisions. Sometimes, you just can't get the brand's attention or cooperation, and termination is the answer.

We like to think that we help clients identify and evaluate the options and select the right one. This is the benefit of understanding hotels from a business standpoint in addition to a thorough understanding of the legal issues.

The critical starting point is understanding two things:

1. It is possible to terminate a long-term, no-cut hotel management agreement, and,
2. That a hotel operator is an "agent" of the owner in most cases. This is an important issue for hotel owners, developers and lenders and its implications are discussed elsewhere.

## **Six ways to terminate a long-term HMA**

Terminating a long-term, no-cut hotel management contract is very difficult, but not impossible in the right circumstances. There are no "silver bullets," but there are a number of technical legal tools that may be available in the appropriate situation.

It is important to understand the potential that can be achieved by using these tools – and also, the cost benefit analysis.

There are at least six ways to terminate a long-term, no-cut, hotel management agreement – other than pursuant to express terms

of the contract, such as permitted terminations on expiration of term, termination on sale, or termination windows or options.

In general, the six ways to terminate an HMA are as follows:

1. **Negotiated termination.** Talk to the operator and see if they will walk away as a matter of honor, or fairness, or possibly a trade-off of value.
2. **Breach of contract or breach of fiduciary duty.** Where applicable, the owner can terminate the HMA for a material breach of contract or of fiduciary duty created under agency law principles noted below. These are subjects far deeper than one might initially suspect, and really are the subject of a whole different discussion.
3. **Agency law principles.** Terminate the hotel management contract under agency law principles implied by law. In short, the hotel operator is almost certainly the "agent" of the owner – despite any disclaimers in the contract. A cardinal rule of agency law says that the principal/owner always has the power to terminate his agent. There is a limited exception for agencies that are "coupled with an interest" but this exception usually does not apply in most HMA cases, and provisions to the contrary in the contract are generally not effective. However, unless the termination is sufficiently justified, the owner may be liable to the terminated agent for damages (generally present value of lost profit).
4. **Personal services contract.** Terminate the hotel management agreement as a personal services contract. Many cases have discussed the ability of either party to a personal service contract to terminate the contract at will (subject to potential liability for damages). A number of the important agency cases discussed the inability of an operator to enforce performance of its management contract. But the New York appellate court directly reaffirmed these



principles in a major case when the owners of the Eden Roc Hotel terminated Marriott International. See page 100.

5. **Rejection of HMA in bankruptcy.** Terminate the hotel management agreement by "rejection" in owner's bankruptcy. A management agreement will almost always be an "executory contract" as defined in the bankruptcy laws. Such contracts can be rejected, as a matter of law, in bankruptcy by a borrower, and on rejection, the injured party (i.e. the management company) becomes an unsecured creditor in the bankruptcy. Where the value of an asset is less than the amount of the senior encumbrance, the hotel operator stands in line with all the other unsecured creditors and receives nothing or whatever amount is negotiated to facilitate the bankruptcy. By this process, potentially tens of millions or hundreds of millions of dollars of potential damages are converted to nothing (or pennies on the dollar).
6. **Rejection in receivership.** Terminate the hotel management agreement by rejection in a receivership under applicable state law principles related in concept to those discussed in the bankruptcy rejection above.

No hotel owners should consider termination of their hotel operators without getting sound legal advice from experienced hotel lawyers who have evaluated, advised, structured and successfully execute multiple terminations. This process is complex and a misstep can be very costly.

## Epilogue

**H**otel management and franchise agreements, and the relationships between owners, managers and brands, is an evolving world – the final chapters of this book remain to be written.

JMBM's Global Hospitality Group® is committed to providing hotel owners, developers, investors and lenders with resources and programs that keep them informed of current issues and trends in the industry, through The Hotel Law Blog, Meet the Money® National Hotel Finance and Investment Conference, our *We Wrote the Book* series and other publications, and our work in the field.

See [www.HotelLawBlog.com](http://www.HotelLawBlog.com) and [www.MeetTheMoney.com](http://www.MeetTheMoney.com).

But most of all, we want to hear from you. We are an enthusiastic part of the fabric of the hotel industry and enjoy discussing what matters to others in our world or about to join it.

*So please contact us to discuss any of the issues raised in the HMA & Franchise Agreement Handbook, or other topics that concern you.*

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# About HotelLawyer.com

## The Hotel Law Blog

### Meet the Money®

[HotelLawyer.com](http://HotelLawyer.com) provides resources and information that are critical to hotel owners, developers, investors and lenders. On the website, you will find all the handbooks in our *We Wrote the Book™* series, timely presentations from industry experts, and the portal to our popular Hotel Law Blog. You will also find our Global Hospitality Group® [Brochure](#), which describes how we help clients with their hospitality projects, as well as our team's [Credentials](#) which lists hundreds of clients we have represented and more than 3,800 properties that have been the subject of our representation. On HotelLawyer.com, you can access free downloads of our books, presentations, brochure and credentials.

[The Hotel Law Blog](#), is written by the most experienced legal and advisory team in the industry. HotelLawyer.com is the site, and many of the blogs are now available in Mandarin Chinese as well as in English. Launched in 2006, the Hotel Law Blog is a great source of information on the many areas of law that impact the industry. Most importantly, the articles are written in plain language and answer the questions, "What's it all about? How does it affect my business?" [Subscriptions](#) are free.

[Meet the Money®](#) National Hotel Finance and Investment Conference is presented annually during the first week of May in Los Angeles. At Meet the Money®, there is time, atmosphere and availability for meaningful meetings and making deals. It's the conference that is big enough to attract heavy hitters, but small enough to mingle with them. Find out about our conference on [HotelLawyer.com](http://HotelLawyer.com) or [MeetTheMoney.com](http://MeetTheMoney.com).

The hotel lawyers of JMBM's Global Hospitality Group® are aggressive and passionate advocates for hotel owners, developers, investors and lenders, and we are committed to providing powerful resources to the industry.



\$135.00

# THE HMA & FRANCHISE AGREEMENT HANDBOOK

**T**he *HMA & Franchise Agreement Handbook* is a valuable new resource for hotel owners, developers, investors and lenders. It is written in plain language for business people who don't have full-time jobs negotiating hotel management agreements every day, but want the kind of legal and business advantages and insights they would get if they did.

Drawing on practical experience gained over more than 25 years, more than 1,000 hotel management contracts and hundreds of hotel franchise agreements, Jim Butler and Bob Braun are hotel lawyers and veteran advisors who can help you quickly sort out what is important and what is not.

Branded hotel management agreements continue to be very important, but they are no longer the dominant format for branding or operating hotels in the United States. Owners and brands are placing more importance than ever on franchise agreements, and these agreements are increasingly negotiable. This shift also raises issues of when to use independent operators, and the favorable terms that may be negotiated with them. This version of *The Handbook* appropriately marks this sea change in the hotel industry.

In the Foreword to *The Handbook*, Jan deRoos, HVS Professor of Hotel Finance and Real Estate at Cornell University's School of Hotel Administration says, "The authors' objective of providing the keys for 'breaking the code' to HMAs and franchise agreements is fully realized in this important work."

## About the Authors



**Jim Butler** is the author of the Hotel Law Blog ([www.HotelLawBlog.com](http://www.HotelLawBlog.com)), a founding partner of Jeffer Mangels Butler & Mitchell LLP (JMBM), Chairman of JMBM's Global Hospitality Group®, and founder and conference chairman of Meet the Money®. He has been quoted as an expert on hospitality issues in *The New York Times*, *The Wall Street Journal*, *Los Angeles Times*, *Forbes*, *BusinessWeek*, *TIME Magazine*, *USA Today*, *Hotel Business*, and other publications.



**Bob Braun** is a corporate and finance lawyer who has negotiated hundreds of hotel management and franchise agreements for owners, developers, investors and lenders. A partner of Jeffer Mangels Butler & Mitchell LLP and senior member of JMBM's Global Hospitality Group®, Bob represents hospitality clients in both transactional and operational issues. His articles have been published in the *Hotel Law Blog*, *Law360*, *Hotel-Online*, *Hotel News Resource*, [ehotelier.com](http://ehotelier.com), and [4hoteliers.com](http://4hoteliers.com).