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Negotiating the Hotel Management Contract

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THE MANAGEMENT AGREEMENT IS the single most important contract entered into by the hotel owner. Careful negotiation of this legally binding document is critical, as it sets the rules that define the long-term relationship between the owner and operator and is referenced routinely throughout the life of the contract. This chapter outlines the key steps in the process of negotiating the management agreement, beginning with the selection of an operator and setting the stage for negotiations through the introduction of the owner-operator bill of rights, which establishes the desired posture of the owner with respect to the salient terms of the agreement.

The present chapter was prepared based on the authors' experience negotiating hotel management contracts. We also draw on reference material from two leading authorities on the subject, James J. Eyster and Stephen Rushmore. Our intent is to provide an overview of the recommended process for negotiating hotel management contracts. The process described in the following pages is summarized graphically by the diagram appearing in Exhibit 1. For a comprehensive review of all the intricacies that surround hotel management contracts, readers are referred to the works of Eyster and Rushmore that are either referenced in the course of the chapter or presented in the bibliography at the end of the chapter.

The discussion that follows is limited to a treatment of management-contract negotiations for full-service hotels; the contract variations that may occur in select-service properties are not addressed. Further, the chapter focuses on agreements between an owner and a branded management company, omitting discussion of the model where contracts are negotiated separately with a franchisor and an independent third-party operator.

Getting Ready: The Pre-Selection Process

Whether the owner's objective is to engage a property manager for a new development or for an existing property, there are several factors that warrant careful consideration before the search for an appropriate operator begins. The following discussion provides selected points to consider at the outset of the process, as they will affect the brand and operator chosen.

Owner Investment Strategy

Before the search for an appropriate operator begins, ownership's investment objectives must be clearly defined. Is the intent to maintain ownership of the asset

Exhibit 1 Management Contract Negotiation Process



as a long-term investment, a medium hold (five to ten years), or a quick turn-around (one to five years)? What are ownership’s investment criteria and return expectations, including the minimum and target hurdle rates? Depending upon the strategy chosen for the asset, owners may need to limit or broaden their search for a suitable operator accordingly. For instance, most of the national branded operators are primarily interested in entering into long-term contracts and thus may not accept a contract provision that permits termination of the relationship upon sale of the asset. If a long-term management contract with no provision for termination on sale is in place, this could potentially limit the marketability of the asset. Therefore, a branded operator may not be a suitable match for an owner whose strategy is a quick disposition. However, there are some operators, typically not affiliated with a brand, that specialize in positioning assets for sale, should a

quick turnaround be the owner's strategy. Whatever the owner's objectives, to ensure a proper fit between owner and operator, a clear investment strategy must be developed and considered during all stages of the selection process.

Creating a Competitive Environment

As with the brokerage process, creating a competitive bidding environment from the beginning of the operator-selection process will yield a more favorable negotiation for the owner. The more competitive the bidding, the more flexible management companies will be with respect to the contract's key provisions. Assessing ownership's relative bargaining power before entering into negotiations will expedite the process by setting realistic expectations from the outset. The following factors affect the owner's leverage in the negotiation process:

- *Property Location.* Whether it is a resort on a Hawaiian island or a commercial hotel in downtown Boston, certain locations are deemed more desirable than others, particularly by branded operators, due to the high barriers to entry that exist. This is not to say that branded operators are not interested in managing a property located in a second-tier city or an outlying suburb, but they may be more flexible in the deal terms to obtain a brand presence in a highly desired location. Conversely, there may be a situation in which national brands are well represented in the market, precluding owners from obtaining a brand within the same market due to radius-restriction limitations contained in management contracts for existing hotels. In this instance, location may serve to hinder an owner's negotiating strength because it limits the pool of viable operators.
- *Property Profile.* Like its location, the profile of a property may influence the operator's willingness to compete to manage the hotel. The higher the profile of a property, the more interest owners will generate from prospective operators. Examples of high profile assets include larger-than-average hotels (1,000+ rooms), strategically located properties (e.g., a hotel connected to a convention center), and properties with historical significance.
- *Branded vs. Third-Party Management.* Owners have options when it comes to selecting an operator and branding a hotel. One option is to enter into a separate franchise agreement to secure a brand and engage an independent third-party operator to manage the hotel. Another option is to select a single company, often referred to as a "brand manager," to provide both the brand and the operational expertise to manage the property. Most major brands, with the exception of a select few (e.g., Hyatt, Ritz-Carlton, Four Seasons), offer both options; however, owners may have more leverage if they elect to go with a brand manager, primarily because brand managers' fees are higher in absolute dollars. For example, franchise fees generally range from four to seven percent of gross rooms revenue. On the other hand, management agreements are most often based on total revenue. Furthermore, there are several add-on fees associated with a management agreement that do not appear in the base fee, such as incentive fees, mandatory contributions to sales and marketing funds, and accounting fees, to name only a few. A management

contract with a brand manager is not always the investor's best choice, but owners negotiating with major branded operators are better able to appreciate their relative bargaining strength if they are aware that management contracts typically equate to more fees for branded companies than stand-alone franchise agreements.

- *Deal Structure.* Sometimes owners look to operators to provide a financial contribution to a deal, either in the form of an equity investment or through loans or loan guarantees. The benefits of operator financial contributions are that (1) needed financing is obtained and (2) the management company's financial commitment aids in aligning owner and operator interests. Despite these benefits, the authors believe that an owner is better off if the deal can be financed by sources independent of the operator, and the owner is thus well advised to observe the maxim "if you don't need the money, don't take it." Equity participation changes the relationship between the owner and operator significantly, and by accepting an operator as a partner, owners should be prepared to relinquish a considerable amount of control in the negotiating process and perhaps in the subsequent administration of the contract. In short, the cost of concessions that owners are forced to accept typically outweighs the value of the funds received up front. This is not to say that operator equity participation is not an option worth considering, but owners need to understand the ramifications of the operator's becoming a partner in the project.

Identify Key Players

During the pre-selection stage of the process, owners should begin to identify the senior-level executives within the business development departments of the operating companies they expect to pursue. As discussed in greater detail in a subsequent section, the choice of operators that an owner will pursue is largely dictated by the market positioning of the hotel and the availability of one or more brands within the subject hotel's local marketplace.

Now is also the appropriate time to identify and retain legal counsel, as well as a hotel contract negotiation consultant, should one be required. All individuals retained to represent ownership's interest in the complex process of negotiating a hotel management contract should be specialists because hotels are truly different from all other classes of real estate. The more experience the team possesses in hotel contract negotiations, the more favorable the outcome is likely to be for the owner. The brand operators with whom the owner's team negotiates do this for a living, and they typically have deep experience and in-house counsel to guide them. Owners need to balance the scales with competitive representation, ensuring an equitable negotiation process and ultimately a fair agreement.

Timing

Because the process is complex, selecting an operator and entering into the negotiation process takes a lot of time. Even in instances where an owner and operator may have a history together, including perhaps existing contracts for other hotels managed for the owner by the operator, the process may take three months or lon-

ger because each contract entails new and unique issues. For an owner with no experience in selecting an operator, arriving at the completion of the contract negotiation process will require closer to six months. However, considering the term of the contract binding the owner and operator—ten to twenty-plus years—the process is not one that should be rushed.

The Operator Selection Process

Having decided to develop or purchase a hotel asset, ownership's selection of a brand affiliation and operator becomes the most important decision influencing the outcome of the real estate underwriting. A hotel's brand and operator have a direct impact on asset value, and the owner's selection therefore requires careful consideration.

Research Viable Candidates

The first step in the selection process is to develop a pre-qualified list of potential branded management companies that will receive a Request for Proposal (RFP). In developing this short list, owners need only consider brands that represent an appropriate match for both the subject hotel and the market. While there are a number of qualified operators and numerous brands to choose from, the short list should be limited to six companies, a manageable yet sufficient number of candidates from which to choose.

Brand. A hotel should be positioned within the market to maximize its operating potential, and branding is a critical component of establishing the hotel's positioning. Because different brands set different expectations in the consumer's mind, the selection of a brand determines how the hotel will be perceived. The brand chosen will also directly affect the level of services and amenities offered, as well as the hotel's price point, competitive set, cost of development or conversion, and cost of operation. The brand selected must convey an image commensurate with the physical product. Several brands should be researched and considered. Not infrequently, an owner's first choice among brands may not be available, either because the brand is already represented in the subject hotel's market or because of radius restrictions present in the chosen brand's contracts with other owners. Similarly, owners should not exclude desired brands from the selection process simply because they may already exist in the subject market, as agreements may be expiring or hotels bearing the desired brands may be positioned for sale. Another compelling reason for owners to pursue multiple branding options is that, although base fees may appear comparable, the all-in costs of brand affiliations, after taking into account mandatory participation in centralized services and brand standards, can vary significantly across brands. Owners should be sure to pursue several branding options so as not to limit the pool of suitable operators.

Operator. Although the selection of the operator is sometimes dictated by the brand desired (e.g., Hyatt, Ritz-Carlton, Four Seasons), most brands offer franchising as an option. As noted earlier, the emphasis in the present chapter is on the process of choosing a branded operator. However, owners should also consider the

strategy of entering into a franchise agreement to secure a flag and employing an independent third-party management company to operate the asset. There are pros and cons to each approach, but some owners may find the reduced constraints of the franchise-with-independent-operator formula attractive. For example, as a franchisee, the owner may be able to opt out of costly programs offering little perceived value while the same programs are often mandatory for properties managed by the branded operator.

Request for Proposal

The request for proposal (RFP) serves three primary purposes: (1) it is a formal invitation from an owner to an operator to bid on the management of the subject hotel; (2) it is the means by which pertinent information about the subject hotel is communicated to prospective operators; and (3) it facilitates the gathering of the same information on all operators for the purposes of comparing and ranking responses.

Through the RFP process, owners ascertain the level of interest from the operators selected and obtain the information necessary to compile a decision matrix that serves as the basis for ranking each operator's qualifications and ultimately developing a list of finalists. From an owner's perspective, the most critical components of the RFP responses are projected operating results, as reflected in the operator's pro forma, and the cost, as reflected in the operator's proposed contract provisions and conditions. The pro forma is critical because it represents the operator's projection of the subject hotel's operating potential under its brand and management. The operator's proposed provisions and conditions are of equal importance in assessing the RFP responses because they convey the cost and the key expectations of the operator, such as the duration of the contract and termination rights. As a minimum, operators should be asked to provide proposed base and incentive fees, length of term, chain fees and charges, termination-clause language, and estimated conversion costs in the case of an existing hotel.

The quality of operator responses depends on the specificity of information on the subject hotel and its market contained in the original RFP, as well on as the extent of the detail requested from respondents to the RFP. The more experienced the owner's team is in preparing RFPs, and the greater the time commitment to the preparation of a thorough RFP, the better will be the information provided by potential operators, ultimately simplifying the selection process. Exhibit 2 provides a sample table of contents for an RFP soliciting bids and related information from hotel management companies.

The questions included in the RFP will vary according to the project because the objectives and circumstances surrounding each deal are unique. However, the following list represents some of the typical questions posed to prospective operators in the RFP:

- What are the fundamental strengths that differentiate your organization from others in the field?
- What would be your operational approach to achieving the level of service outlined?

Exhibit 2 Sample Table of Contents: Request for Proposal from Hotel Management Company

1. Introduction and Objective
a. Deal Highlights
b. Hotel Facility History and Description
c. Owner's Objectives
2. Property Overview
a. Summary of Salient Data
b. Photos
3. Overview of Subject Market
a. Area/Location Overview
b. Economic and Demographic Overview
4. Lodging-Market Overview
a. Competitive Supply
b. Demand
5. Analysis of Subject Operations (for existing property)
6. Requested Specifics of Submission and Time Line
a. Request for Proposal (specific questions)
b. Management RFP Timeline

Source: Capital Hotel Management.

- Provide the background and qualifications of your organization, providing particular discussion of those individuals who would be assigned to this asset.
- Provide a memorandum describing relevant proposed contract provisions and conditions, including the base and incentive management fee, term, centralized service fees, termination clause, etc. Include an estimate of expenses related to the transition.
- Provide a list of properties managed by your organization, giving particular attention to those similar in size and scope to the subject property. Address any similarities with your properties to the subject, if applicable. Please include examples of financial results achieved at similar properties under management, as deemed appropriate.

Review RFP Responses

The next step in the selection process is to review the responses to the RFP submitted by the operators. During this step, the owner must consider many factors reflecting the strengths and weaknesses of the respondent operators to determine those that will advance to the next round of the competitive process. The goal at

this stage is to evaluate quickly the responses of each operator, assembling a short list of finalists that will proceed to the interview stage. The most efficient and effective method of conducting a review and comparison of the respondent operators is to create a decision matrix that permits the owner's team to organize responses to all pertinent questions and rate them accordingly. Stephen Rushmore, founder of HVS International, has developed the "Hotel Management Company Initial Selection Rating System" that appears in Exhibit 3. Using Rushmore's rating system, a specific weight is applied to each company's response to questions contained in the RFP, thus resulting in a numeric score that quantifies the responses and ranks the suitability of each management company under consideration.

Although decision matrices must be customized to reflect the unique aspects of individual deals, operator responses to the RFP can be generally categorized as either corporate or project-related. Corporate responses reflect decision factors such as the relative experience and suitability of the branded operator to the hotel asset in question. Project-related responses address specific questions concerning the project at hand, such as the proposed contract provisions and conditions, projected financial results and, if applicable, the operator's willingness to contribute financially to the project. The following list presents examples of both corporate and project-related factors typically weighed in the decision matrix.

Corporate Factors

- Size of managed hotels
- Size/experience of management company
- Brand recognition
- Distribution
- Management experience (turnover)
- Specialization/niche (e.g., resort, distressed property, secondary cities)
- Historical performance
- Corporate operating strategy (to test consistency with owner's vision of hotel's operation)
- Level of completeness/professionalism in response to the RFP
- Owner's instinct or "gut feel"

Project-Related Factors

- Proposed management contract provisions and conditions
- Projected operating pro forma
- Chain services and charges (*all* costs from conversion to operating should be enumerated)
- Brand value (for comparison to cost of chain services)
- Financial resources/willingness to invest (if desired by ownership)

Exhibit 3 Hotel Management Company Initial Selection Rating System

Comparing the size of the hotels managed by the operator to the subject, most are:		Management company's ability to generate profits (based on actual performance):	
Larger	-1	Normal—competent management	0
The same size	0	Better than average	+5
Smaller	-1	Exceptional operating ability	+10
Comparing the chain affiliations of the hotels managed by the operator, most are:		Management company offers:	
Same affiliation	1	Ability to obtain specialized identification	+2
Similar affiliation	0	Ability to obtain financing	+4
Dissimilar or no affiliation	-1	Feeder city representation	+2
If the operator manages other hotels in the same market area, are these considered to be:		Track record of success	+2
Directly competitive	-4	Management company has exceptional expertise or offers specialized services in the following areas:	
Somewhat competitive	-2	Centralized reservation system	+2
Non-competitive	1	Centralized sales and marketing	+1
Experience of the management company:		Regional sales offices	+1
New company	-1	Convention and group sales	+1
Moderate experience	0	Frequent traveler program	+1
Established	2	National advertising program	+1
Management company's financial resources: ability to invest funds in the property:		Top-level personnel	+1
Limited	-1	Financial systems and controls	+1
Moderate	0	Other specialized services	+1
Strong	2	Personnel relations	+1
Operator shows willingness to invest funds in the property as a loan (double amounts if funds are contributed as equity)		Development capability	+1
Initial inventories	+1	If management company has the following deficiencies:	
Working capital	+1	Poor references	-3
Pre-opening expenses	+2	Loss contracts (deduct for each loss)	-1
FF&E	+3	Limited home office structure	-1
Debt service guarantees	+3	High management turnover	-2
If the management company appears to be flexible in accommodating the following specialized needs:		No growth plans	-1
Short-term contract	+2	Excessive growth plans	-1
Termination buy-out provision	+2	Will not subordinate incentive fee	-3
		Unwilling to provide restrictive covenant	-3
		Fee based entirely on percentage of total revenue	-3
		Response to RFP showed professional effort in:	
		Preparing operating budget	+1
		Preparing sample marketing plan	+1

Exhibit 3 (continued)

If the management company has extensive experience in one of the following specialized areas that would directly benefit the operation of the subject		Opening new hotel	+2
		Distressed property	+2
		Bankruptcy	+2
		Unions	+1
		Operating in secondary cities	+1
		Property ownership	+2
	Destination resort	+2	
	Major convention operation	+2	
	Unique market	+1	
	Major food beverage operation	+2	
Development assistance	+2		
		Your gut feel	
		Can you get along with this company	+3

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Management Agreement Provisions: Key Points Checklist

There are numerous provisions and conditions essential to a well-crafted management agreement, and the list has grown with the complexity of hotel management contracts. Presented below are only some of the key provisions that warrant consideration and inclusion in the management agreement. Although not all of these provisions will be addressed in the RFP, it is a good idea for owners to review this checklist as operator responses are evaluated. Owners can then anticipate the respondents' respective stances on key contract points and prepare their desired position on each point before entering the initial negotiation phase. This checklist can also be used at the conclusion of the negotiations to ensure that the agreement contains all of the key provisions. Of course, the provisions considered key to a given contract will vary with the owner's objectives, the requirements of the deal (e.g., operator financial participation or not), the dynamics of the negotiation, and other circumstances of the project. For a more detailed discussion of the points contained in the following list, Eyster's *The Negotiation and Administration of Hotel and Restaurant Management Contracts* is recommended.¹

Key Points Checklist

- Initial term and renewals
- Management fee structure
- Operator reimbursable expenses
- Operator loan or equity contributions (terms and conditions, priority, and payback)
- Operator performance standards
- Owner input in operational decision-making
- Operational and financial reporting
- Termination at owner's option without cause, on sale, and on foreclosure

- Non-compete covenants
- Dispute settlement mechanisms

Interview Finalists

Based on the outcome of the owner's review of the information contained in the decision matrix, two to three finalists will typically emerge as potential operators. Representatives of the finalist companies should be invited to meet with the owner's selection team so that each company's representatives are interviewed in person. The purpose of the interview is for owners and operators to ask any outstanding questions, gain further clarification of each party's intent, and ultimately to determine if a viable partnership is possible. This meeting also provides the owner with an opportunity to gain more insight into the intangible aspects of the union, such as the chemistry between the two parties—an essential component for successful negotiation and a durable relationship under the contract.

Final and Best Offers

Following the interviews, owners should take the opportunity to provide feedback and solicit final and best offers from each operator. Owners must continue to maintain the discipline of the selection process, ensuring that any information requested of one operator is requested of all operators. For instance, if an owner requests a final and best offer on the management fee from Operator A, the same opportunity must be extended to all other finalists to maintain a fair and competitive bidding process.

Selection

After all factors are weighed and interviews are concluded, the time has come to select an operator. Ideally, it would be most beneficial for an owner to enter into "hard" negotiations with more than one operator. However, due to the time and cost involved in moving to the next level of the process, it is not practical to enter into negotiations with two prospective partners—nor is it a practice generally accepted by operators, who often seek an exclusive commitment before entering into negotiations. Nonetheless, it is a good fallback plan to keep the second-choice contender interested and informed in case negotiations with the first choice falter.

Round One: Negotiating the Bill of Rights _____

At the outset of the management contract negotiation, the owner and operator are essentially on a level playing field—the owner seeks an operator to manage the asset and maximize investment returns, while the operator seeks an opportunity to manage and brand a property to enhance corporate fee revenue and increase distribution. Although this proposition is simple in theory, the process by which these two entities unite to create an equitable agreement is often arduous. To launch the painstaking process, the authors recommend introducing the owner-operator bill of rights.

The intent of the bill of rights is to recognize the core rights of both the owner and the operator. The first round of negotiations should revolve around the bill of rights, which is aimed at providing an equitable platform for negotiating the key provisions of the agreement *before* developing the legal document. The bill of rights suggests that owners and operators start negotiations not based on a legal document containing *a priori* positions, but rather parity of expectations for both sides, which becomes the premise on which the contract will eventually be drafted.

There are several benefits to conducting the negotiations in this manner. First, a discussion centered on the bill of rights allows the parties to debate and resolve key provisions before the legal document is drafted, fostering a positive relationship among the participants in the deal. It aids in creating an equitable agreement—one that provides operators with the flexibility to operate in accordance with their standards while providing owners the ability to protect long-term asset value and achieve desired returns consistent with their ownership strategy.

Another benefit of starting with the bill of rights as a precursor to drafting the legal document is that “show stoppers” can be uncovered before advancing too far in the contract negotiation process. At this stage of the process, owners typically expect that there is a fundamental level of understanding between the two parties that eliminates the need to revisit the operator-selection decision; however, there are instances where unresolvable conflicts are uncovered, even at this advanced stage of the process. It is far better to identify potential show stoppers during this phase rather than later in the process, after even more time and money have been expended. Typical show stoppers are often in the areas of the performance clauses, approval rights, and cash control. In the event the two parties cannot come to an agreement on the bill of rights, ownership can revert to its back-up selection among the operators interviewed.

To expedite the process, Eyster advises that both owners and operators should enter into the negotiations with a going-in position, a fallback, and even a second fallback position.² As Eyster’s approach suggests, there will likely be a significant give and take in an effort to find the grounds for agreement on some of the key provisions. While there is a certain base level of rights that owners should expect to achieve, they should be prepared to extend parallel rights to operators to create an equitable relationship.

Owner’s Bill of Rights

A summary statement of the owner-operator bill of rights is presented in Exhibit 4. The following discussion illuminates the key reasons for inclusion of the individual owner rights and explores the ramifications of selected rights.

- *Right that operator put owner’s interests first.* Although it is seemingly logical that the operator, as the owner’s agent, should work to advance only owner’s interests, an inherent conflict exists between building brand equity and owner’s equity. Oftentimes the operator’s decisions benefit the brand but do not necessarily add asset value—and, in some instances, may detract from the value of the hotel asset. Discussion of this right reveals the owner’s

Exhibit 4 Owner-Operator Bill of Rights

Owner's Rights	Operator's Rights
<ul style="list-style-type: none"> • Right that operator put owner's interests first • Right to absentee ownership • Right to active ownership • Right to a fair and equitable management agreement (not operator biased) • Right to approve a detailed annual operating plan • Right to approve a detailed annual capital plan • Right to provide input in the selection/removal of the general manager and other key management personnel • Right to a reasonable restrictive (non-compete) covenant • Right to operator performance standards • Right for owner to terminate contract with cause or upon sale • Right to control cash in excess of operating capital requirements and in the replacement reserve account • Right to understand the costs and benefits associated with operator system reimbursable expenses • Right to meet monthly with operator to review financial performance • Right to have access to and audit the books and records of the hotel • Right for the hotel to be managed consistent with maximizing long-term asset value 	<ul style="list-style-type: none"> • Right manage the hotel without undo interference from owner (reasonable non-disturbance) • Right to manage the hotel consistent with an approved annual plan (operating and capital budgets) • Right to limited financial risk • Right to indemnification except for gross negligence or willful misconduct • Right to cash for operating capital and approved capital-expenditure requirements • Right to a stable, reasonable contract term, subject to performance standards • Right to earn a fair base management fee and an incentive fee based on performance • Right to demand that owner be well capitalized and the hotel not over leveraged • Right to operate and maintain the hotel consistent with operator's standards • Right to select, terminate, train, supervise, and assign all employees of the hotel • Right to require the owner to maintain appropriate insurance coverage and hold operator harmless for any loss sustained.

Source: Capital Hotel Management (© 2003).

expectations regarding the operator's fiduciary responsibility to place the owner's interest first and foremost, above obligations to the brand.

- *Right to absentee ownership.* Hotel owners' desired involvement in the operation of their assets varies. Some owners want to be apprised daily of

operational results and decisions at the property level, and may even engage an asset manager to assume a very proactive approach to ownership. Other owners may take a more passive stance. Regardless of the extent of involvement ownership seeks, management should respect this position.

- *Right to active ownership.* Active ownership should be defined in terms of the owner's expectations, anticipated level of involvement, reporting requirements, intent to engage an asset manager, etc., so that both parties are clear and in agreement on how the relationship will function.
- *Right to a fair and equitable management agreement (not operator biased).* This is a right of both parties to the contract, and is simply a reminder that the goal of the negotiations is to arrive at an agreement mutually beneficial to the owner and operator. The negotiation process will be extended needlessly if either party proposes prejudicial contract terms.
- *Right to approve a detailed annual operating plan.* Although the operator assumes responsibility for the financial performance of the hotel, the owner should maintain approval rights over performance goals and objectives. Therefore, this right entitles owners to review the annual operating budget and marketing plan according to a pre-defined schedule, allowing ample time for necessary changes before approval. In anticipation of those instances where the owner and the operator might fail to agree on the budget or other issues related to the annual plan, the means for dispute settlement should also be addressed in the management agreement. The procedure for resolving such conflicts at various levels of disagreement should be mutually agreed upon and clearly stated in the contract.
- *Right to approve a detailed annual capital plan.* Similarly, owners should insist on the right to review and approve the annual capital plan. It is critical that owners maintain control of how the reserve for replacement fund is spent to ensure that capital projects enhance asset value rather than satisfying brand standards without commensurate economic return for ownership.
- *Right to provide input in the selection and removal of the general manager and other key management personnel.* Owners should seek approval rights over the key executives hired to operate the hotel and should retain the right to remove any member of the executive committee should there be sufficient cause.
- *Right to a reasonable restrictive (non-compete) covenant.* Although it is increasingly difficult for owners to ensure that their hotel is the sole beneficiary of a brand's strength in a particular market, careful consideration should be given to negotiating an exclusive trade area and the term or duration of the non-compete clause. Specific attention should be given to defining similar or "sister" brands under the same corporate management (e.g., Marriott full-service hotels and Renaissance, Sheraton, and Westin), as well as to crafting carefully the legal language surrounding this provision (e.g., specifying the use of impact studies to determine infringement on a trade area). Further, as previously suggested, a means of resolving any disputes that may arise in the

application of the non-compete provision should be incorporated into the management agreement.

- *Right to operator performance standards.* Owners should pursue minimum performance guarantees based on a “flow-through” measure (e.g., house profit, net operating income) and a performance-versus-market metric (e.g., RevPAR index or penetration). Although performance guarantees will likely represent a minimum threshold calculated as a percentage of budgeted expectations, it is important that the contract be very precise in specifying the metrics to be employed, as well as the conditions triggering the imposition of each standard. Only by carefully specifying the measures and conditions of the performance clause can an operator pursue the right to terminate based on an operator’s failure to perform financially. The current standards for performance clauses seem to provide for a four- to five-year ramp-up period before owners can invoke performance clauses. Once the specified period has passed, the operator’s failure to meet performance standards for two years in succession triggers the owner’s right to terminate, although operators usually have the right to “cure” shortfalls from the budgeted performance level for at least one year, effectively buying another two-year surcease to improve the hotel’s performance.
- *Right for owner to terminate contract with cause or upon sale.* The right to terminate under all possible scenarios must be addressed in the management agreement. Owners should pursue the right to terminate in the event the operator fails to perform to an acceptable level, defaults on a substantive provision, or breaches its fiduciary duty to the owner. In addition, winning the right to terminate upon sale is an important option that can be critical to owners seeking a short-term exit strategy. When dealing with branded operators, however, owners can expect significant resistance to early termination on sale and should be prepared to pay liquidated damages to exercise this right. If the hotel is a new development, language should also be included specifying the owner’s right to terminate should the project be sold before opening or, alternatively, fail to open.
- *Right to control cash in excess of operating capital requirements and in the reserve for replacement account.* Even with the right to approve capital budgets, only owners who maintain control of the replacement reserves can ensure that funds are being spent appropriately. Most branded national chains will want to control available cash at all levels; however, having control over the cash provides owners with a system of checks and balances.
- *Right to understand the costs and benefits associated with operator system reimbursable expenses.* Putting this point on the negotiating table should lead to a discussion of the full disclosure of existing chain service fees, the methods for calculating and allocating these fees, and fee caps. A discussion of the owner’s expectations regarding the cost-benefit analyses to be presented for reimbursable fees resulting from future programs should also ensue. The owner has the right to know all related expenses and have an opportunity to verify that all future programs implemented are fair and reasonable and

allocated accordingly. The key is for owners to identify and eliminate potential expenses that serve to enhance top line revenues at the expense of net operating income.

- *Right to meet monthly with the operator to review financial performance.* Owners' reasonable expectations regarding the sharing of financial performance information should be honored. It is appropriate to discuss expectations of the level of detail to be presented, the format, and timing of delivery. Owners should seek to obtain information on a basis as close to real time as possible (e.g., receipt of financial statements within ten days of a period's close).
- *Right to have access to and audit the books and records of the hotel.* This right allows owners and their representatives full access to all records and explicit permission to conduct an audit of the hotel's financial and accounting practices at the owner's discretion.
- *Right for the hotel to be managed consistent with maximizing long-term asset value.* This right encompasses several of the items addressed above. It is similar to the owner's right to require the operator to put ownership's interests first, but reiterates the expectation that all decisions made with respect to the hotel should maximize the long-term value of the asset.

Operator's Bill of Rights

As practicing asset managers, the authors have presented the position of ownership first, but intelligent and efficient negotiations also require that both parties to the contract comprehend the rights of the operator. Accordingly, the following discussion illuminates some of the key reasons behind the individual operator rights contained in the bill of rights.

- *Right to manage the hotel without undue interference from the owner (reasonable non-disturbance).* This assures the management company that it will not be encumbered or prevented by ownership from doing the job for which the operator was engaged.
- *Right to manage the hotel consistent with an approved annual plan (operating and capital budgets).* Operators are entitled to the reassurance that owner-approved annual operating plans and capital budgets are working documents that will serve as a valid road map to achievement of the owner's objectives, and that the owners will not materially alter them after approval. The approved budget also serves to align the operating philosophy and the financial objectives of the owner and operator.
- *Right to limited financial risk.* This is the operator's expectation that the owner bears the risk of owning real estate and accepts the business risk of operations. Owners should not expect or require that operators respond to cash calls from ownership.
- *Right to indemnification except for gross negligence or willful misconduct.* Like the preceding right, acceptance of this provision protects the operator from

liabilities associated with the asset, with the exception of liabilities arising out of gross negligence or the intentional misconduct of employees.

- *Right to cash for operating capital and approved capital-expenditure requirements.* Operators have the right to expect that owners will fund operating-capital requirements and capital projects on a timely basis, in accordance with the provisions of the management agreement and approved annual budgets.
- *Right to a stable, reasonable contract term subject to performance standards.* Discussion of this operator's right should result in an agreed upon duration of the contract. Performance standards should be equitable and should consider the impact of economic cycles beyond the control of the operator. Although owners typically attempt to limit the term of the contract, operators need long-term agreements. Branded managers will require ten- or twenty-year terms, with publicly traded companies especially reluctant to manage for fewer than twenty years. Unbranded independent management companies may accept terms ranging from three to ten years.
- *Right to earn a fair base management fee and an incentive fee based on performance.* Management agreements have evolved significantly from the operator-biased contracts of the early 1970s that were based solely on top-line results, yielding substantial fees to management companies regardless of whether owners were realizing bottom-line profits. Management fees are structured much more equitably today, typically including a base fee (ranging between two and four percent of gross revenues) and an incentive fee component (typically 10 to 12 percent of net operating profits after debt service). In some instances, the incentive fee is structured so that an owner receives a minimum return on equity before the distribution of the incentive fee. However structured, an incentive fee must be earned and should not be paid unless ownership has met its minimum return requirements.
- *Right to demand that owner be well capitalized and the hotel not over-leverage.* The operator has the right to require that the owner be able to perform reasonably, supporting the provisions and intent of the management agreement by maintaining a minimum net worth. In addition, the owner should be required to maintain a prudent loan-to-value ratio when debt is used to finance the asset.
- *Right to operate and maintain the hotel consistent with operator's standards.* Operators should be able to operate the asset in accordance with their brand standards; however, an operator needs to provide clear and uniform standards across its brand. Further, brand standards need to be consistent with the owner's objective of maximizing long-term value.
- *Right to select, terminate, train, supervise, and assign all employees of the hotel.* By and large, under today's management contracts employees work for the operator, not the owner. The only limitation on the operator's right to manage its employees according to its standards and practices is the owner's right to selection and removal of executive committee members.

- *Right to require the owner to maintain appropriate insurance coverage and hold the operator harmless for any loss sustained.* Similar to the operator's right to limited financial risk, the owner must assume responsibility for all risk associated with the real estate, including the risk of business interruption.

Round Two: Negotiating the Legal Document

At this final stage of the negotiation process, the assumption is that the owner and operator have reached a consensus on the key provisions of the owner-operator bill of rights. Legal counsel should now become more active in the process, integrating the key provisions agreed upon and couching them in the legal language that constitutes the management agreement. The authors recommend that owners insist on drafting the management agreement because experience has demonstrated that the party that controls the development of the contract document controls the process.

With the legal document—preferably drafted by the owner's counsel—in hand, negotiation of the definitive contract can commence. Since numerous of the key provisions have been addressed in the first round of negotiations, this final phase requires only the fleshing out of the management contract's clauses according to terms already agreed to by the owner and operator.

Conclusion

The industry as a whole has made great strides in leveling the playing field in the negotiation of hotel management agreements, which for many years were drafted by—and in favor of—the operator. Owners who clearly define their investment strategy, create a competitive bidding environment, and assemble a team of qualified, experienced consultants and legal counsel will enhance their leverage going into the negotiation process. Owners and operators who use the bill of rights presented in this chapter as the basis for their initial negotiations will have the opportunity to create an equitable platform at the start the negotiation, thereby closing the gap between the parties' expectations, reducing the time and money invested in the process, and ultimately yielding a more equitable agreement for both parties.

Endnotes

1. James J. Eyster, *The Negotiation and Administration of Hotel and Restaurant Management Contracts*, 3rd ed. (Ithaca, N.Y.: Cornell University School of Hotel Administration, 1988). See especially pages 35–87.
2. Eyster, pp. 139–142.

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