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# ON THE ROCKS

## Observations on How the Economic Meltdown Will Affect Hotel Management Contracts

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The ordeal which the hotel industry is going through will have both short- and long-term consequences to management companies and management contracts. Here is our take on the likely new rulebook that owners and operators will work from over the next five to seven years.

### The Big Picture – A Shift in the Power Pendulum

t should come as no surprise that management contract deal terms are dramatically impacted by the balance of power between owners and operators. One need look no further than a comparison between the typical contract terms of an independent operator versus a branded operator to see how this plays out (see Figure 1).

**Figure 1**
**Comparison of Select Management Contract Terms of an Independent Operator vs. a Branded Operator**

| | Branded Operator | Independent Operator |
|---|---|---|
| Base fee-based on revenue | 2 to 5% | 1 to 3% or fixed dollars/month |
| Incentive fee-based on profit above a threshold | 10 to 25% (often stair-stepped) | Similar |
| Initial term | 10 to 25 years | 1 to 5 years |
| Options | 5 to 50 years | 1 year |
| No-fault termination | No | Yes, with minimal liquidated damages |
| Termination on sale | Sometimes but with significant liquidated damages | Yes |
| Performance termination | Yes, but difficult to fail | Yes |
| Subordination and non-disturbance agmt. | Generally, yes | No |

Note: These are generalizations – there are exceptions.

Brands need to grow – especially newer brands which need distribution to become desirable and viable. But the new supply pipeline is dry and, considering both industry performance and the unavailability of debt capital, it will be years before the industry sees any significant new hotel supply. Further, there is a high likelihood of “musical managers” as properties change hands, which is the most likely time for management to change. In addition to actual changes in management, owners will seek relief or advantage from the downturn from their existing managers. The net result will be that existing brands and managers will need to be aggressive with terms in order to secure new contracts and replace lost ones.

This supply/demand-based shift in power from operators to owners will likely remain in place for four to six years, until the cycle fully recovers, and will result in more favorable terms for owners in management contracts negotiated during that time.

### Squeezed Operator Profitability

The decline in revenue encountered in the last 18 -24 months has had a direct adverse impact on base management fees, which are almost always calculated as a percentage of gross revenue. Incentive management fees have been impacted more profoundly since it has been fairly typical over the past 15 years for these fees to be subordinate to some threshold level of GOP, Adjusted GOP, or EBITDA. Because hotels are a high operating leverage business, declines in revenue result in amplified declines in profitability. So, as a consequence of subordinated fee structures and the dramatic drop in profitability, we believe the vast majority of incentive management fees have been reduced to zero – and it will be a slow climb back. Obtaining meaningful industry-wide management fee data is difficult, but the following chart of three large publically traded companies is a pretty good indicator.

**Figure 2**
**Year-to-Date Fee Income through Third Quarter**

| | Marriott | Starwood | IHG |
|---|---|---|---|
| Number of rooms | 6.6% | 5.5% | 5.0% |
| Base management fees | -18.8% | -18.9% | See below |
| Incentive management fees | -58.5% | -37.2% | -48.1% |
| Franchise fees | -10.5% | -19.5% | -20.7% |
| Total non-reimbursed fee income | -25.3% | -23.8% | -31.0% |

Technical services fees (which are not included in the table above) provided a nominal uplift to other revenues, but these dissipate by the end of 2010, as the development pipeline dries up. Additionally, operators are under tremendous pressure from owners to reduce the centralized services that are charged back to owners.

### Relaxation of Brand Standards

As we saw throughout 2009, brands will continue to operate under a relaxed set of standards in 2010 out of economic necessity. Property improvement plans ("PIPs") have been made more lenient or postponed altogether. Additionally, conversion requirements will be far more relaxed for all but the top luxury brands. Hotels that are nearing term ends of management or franchise agreements have a two- to three-year negotiating window in which the brands will be more flexible. As the industry recovers, the physical aspect of brand standards will again tighten up. And for the most part, they should. Property condition and cleanliness cannot be compromised if a brand wants to maintain its standing in the marketplace.

What will be interesting, however, is whether brands will be able to put the operating standards genie back in the bottle. Our view is that there will be tremendous pressure from owners to keep some of the discontinued services and amenities from creeping back into operations. And rightly so. If the consumer has accepted these changes over a two- to three-year period, the justification for bringing them back will be more challenging. The brands have three arguments and none are very compelling: 1. My competitors are doing it (the same justification they used to cut rates in 2009 to disastrous results); 2. It will increase rate (prove it); and 3. It will increase occupancy (ditto).

## Foreclosures

Sometime in 2010, special servicers and frustrated lenders will accelerate foreclosure actions. For many assets, these will qualify as owner defaults and entitle the operators to terminate the management contract. We do not foresee many operators exercising that option due to the pressure to preserve fee streams.

In the longer term, brands which provided mezzanine debt or guarantees in the bubble years have been newly reminded that values can go down, rapidly and dramatically. Much of the mezz debt is worthless and cash flow guarantees are being called. We foresee several changes occurring in this area tempered only by competitive pressure:

- Operator's will look for security for their loans (in the same fashion as third-party mezz lenders took a security interest in the equity) – not that that would have helped much in 2009 and 2010. But in a less severe economy, that would afford some protection.
- Cash flow guarantees will be tied to economic conditions. That is, operators will take operating risks, not general economic risks.
- Most operators already pro rate key money such that they get a portion back if the contract is terminated early. Given the evaporation of equity that occurred in this cycle, it would not surprise us to see key money being escrowed such that it is released to owner pro rata based on an agreed-upon schedule, as opposed to being distributed up front with a claw back.
- Operators will pay closer attention to capital stacks and leverage. They might legitimately require repayment guarantees from outside the single purpose entity that typically holds ownership in a hotel.

## The Future of Subordination, Non-Disturbance, and Attornment Agreements ("SNDAs")

Most management agreements with major brands are likely to survive foreclosure this cycle because of an SNDA that the owner/developer obtained from the lender. Although SNDAs varied from lender to lender, typical management contract language would look something like this: *"…Operator shall be able to enjoy, occupy and manage the Hotel throughout the operating term free from interference or ejection by Owner, any Mortgagee, or any other entity or individual claiming under, through or by right of Owner…and ensure that all existing and future Mortgagees provide Operator with non-disturbance agreements (or recognition agreements in the case of Mortgagees providing mezzanine financing) in a form and content reasonably acceptable to Operator..."*

Those contracts that do not include SNDAs will most likely be terminated by their lenders, since conventional wisdom holds that un-encumbering an asset enlarges the pool of potential buyers, expands the potential fixes, and therefore increases value. This view was supported

**Figure 3**
**W+C Hotel Broker Survey**
**Does a 15-plus year HMA encumbrance affect the value of a Hotel?**

| Responses | Percentage |
|---|---|
| Yes, almost always | 88% |
| No, almost never | 0% |
| Depends on the brand | 4% |
| Depends on the specific hotel/location/situation | 8% |

by a recent Warnick + Company survey of brokers (see Figures 3 and 4). Termination, when available to a lender, will likely be exercised even when the operator is willing to make significant concessions to the contract or is not at fault for a loan default.

**Figure 4**
**W+C Hotel Broker Survey**
**What is the effect on price of a 15$^{+}$-year HMA encumbrance?**

| Responses | Percentage |
|---|---|
| 5-10% increase in price | 0% |
| 11-15% increase in price | 0% |
| 16-20% increase in price | 4% |
| >20% increase in price | 0% |
| Zero or nominal effect | 4% |
| 5-10% decrease in price | 25% |
| 11-15% decrease in price | 42% |
| 16-20% decrease in price | 17% |
| >20% decrease in price | 8% |

Whatever the resolution under existing contracts, one outcome is certain: SNDAs will be among the hardest fought provisions of management contracts in the future as lenders are learning about the impact of management encumbrances the hard way. We recently asked a number of lenders about their future position regarding SNDAs and all stated with varying degrees of conviction that they will not permit them in the future. We believe them – at least until some future date when competition dictates otherwise. Lenders will win this fight due to the golden rule…he who has the gold makes the rules.

So, for the next five to seven years, management companies will be between the proverbial rock and a hard place. If they can't get SNDAs, their risk mitigation side will demand more conservative loan-to-value and debt-service-coverage ratio criteria, while their growth imperative side will demand that they allow financing terms that get deals done.

### Pre-Packaged Bankruptcies

A bankruptcy judge may do what neither the owner nor the lender may do on their own in order to best protect the interest of the creditors. Bankruptcy must be filed by the debtor (owner) who is typically a single purpose entity.

The danger for an owner is that a bankruptcy filing may trigger recourse provisions in a loan. However, that would not be the case if an owner and a lender arrange a pre-packaged bankruptcy whereby the owner files, seeks a rejection of the management contract from the court, and then hands the keys to the lender. Why would an owner be willing to do this when there is no equity left to protect. The answers vary but would include money, preservation of the lender relationship, special dispensation on other assets financed by that lender, etc. Yet to be tested in court is whether a thusly terminated operator would be able to claim that such prepackaged arrangements are an unlawful method of bypassing the protections under an SNDA.

### When Bankruptcy Doesn't Matter

The exception to a court's ability to reject a management contract in bankruptcy occurs when the operator has "an Agency, coupled with an interest" in the property. One of the more interesting developments in this area relates to the Four Seasons Aviara in northern San Diego County, California. After the owner locked out Four Seasons, Four Seasons filed for injunctive relief on the basis that they have an agency coupled with an interest for reasons other than a direct investment in the property.

They were reinstated by the court and the issue of owner's right of termination was referred to arbitration. This case has very far-reaching implications for agency in management contracts and as of this writing, is yet to be resolved.

### Failed Performance Tests

In the past decade and a half, most performance tests in contracts with premium brands have been two-pronged. They are commonly called "and" tests because they require simultaneous failure of two separate tests. One prong is based on RevPAR penetration rates relative to a defined competitive set--usually 10 to 15 percentage points below what a given hotel should yield (in essence, a C-grade) and almost never over 100%, even if that is justified based on a given hotel's quality and location relative to its competitive set. The second prong is based on some financial test typically calibrated off of a percentage of budgeted GOP or some other negotiated financial hurdle. The tests also require failure in two-of-two or two-of-three consecutive years. Such two-pronged tests are exceptionally hard to fail because: (a) the required threshold for RevPAR yield is so low, compared to what it should be (there is a reason operators refer to this prong of the test as a "RevPAR save"); and (b) they are often calibrated off budgets which, of course, are generated by the operator. An owner's right to approve the budget provides cold comfort since key elements are often excluded from approval (e.g., ADR and occupancy projections). In any event, disputes are subject to resolution by an arbitrator/expert and, absent "baseball arbitration" methodology, will likely result in a compromise rather than a decision favoring one side.

Given the length and breadth of this downturn, it is a virtual certainty that any performance test that does not include a "RevPAR save" will be failed by the end of 2010 – if not already. Depending on how the contracts were written, it is possible the termination attempts may be thwarted by operators claiming Force Majeure.

So, what happens next? In the case of existing contracts, there are a number of possible results.

1. The performance failure can be forgiven by the owner.
2. If no cure provisions are available to the operator, the owner can:
    - Terminate the contract;
    - Attempt to renegotiate for more favorable terms; and/or
    - Seek a payment from the operator to retain the contract.
3. If the operator has a remaining cure right, and the owner issues a termination notice, the operator can cure the failure per the contract terms. Curing the failure may result in a renegotiation of contract terms initiated by either owner or operator depending on the specific circumstances. For instance, Warnick + Company recently provided counsel involving a situation where an operator agreed to cure – but only if the performance standards going forward were relaxed.

The outcomes will be heavily influenced by factors such as:

- Whether the relationship between owner and operator is favorable or unfavorable;
- Whether there is fault beyond market conditions;

- Underlying motivations of the parties that may have nothing directly to do with the failure itself.

The longer term implications are actually more interesting because of the likely impacts on future contract terms and negotiations.

We expect operators to:

- Attempt to build general economic meltdowns into Force Majeure clauses.
- Be even more insistent on a two-pronged test (with a RevPAR save).

We expect owners to:

- Try to raise the bar on the RevPAR portion of the test.
- Resist the Force Majeure change on the basis that such protection is baked into the RevPAR test.

**Payroll Liability – Another Game-Changing Impact on Operators**

In the past 10 to 15 years, most operators have shifted from wanting all hotel employees to be employed by the owner to wanting the employees to be employed by the operator. The previous stance was predicated on aversion to liability. However, over the years, operators came to the conclusion that if they were responsible for hiring, training, managing, and firing employees, it didn't matter whether employees were "called" employees of the owner, they were de facto employees of the operator and they could not hide behind language to the contrary in a contract. Rather, operators came to rely on contract indemnity provisions for protection. Moreover, there were psychic benefits to the employees being part of a company like Marriott, Hilton, etc., versus being employees of The Blankety Blank Hotel, LLC. So, most operators took on the employer liability and set up reimbursement mechanisms (e.g., payroll accounts) to offset the cost.

Fast forward to an industry-wide meltdown with hundreds of hotels on the brink of failure. What happens to the operator when the hotel runs out of money and the operator is on the hook for salaries and wages? This liability, which could be amplified by such factors as the W.A.R.N. Act and union contracts, could be very substantial. The operator will have fronted large sums and be an unsecured creditor in a single purpose entity with no assets.

We expect future contracts to incorporate significant changes to address this issue. Possibilities include:

- A return to the old paradigm – employees are the employees of the owner
- Personal guarantees from a creditworthy owner entity
- A reserve account with sufficient funds to offset any potential operator employee liability (assuming such an account can survive bankruptcy or foreclosure)

### Territorial Restrictions

The issue of whether a branded operator can put the same brand or one of its related brands in a market where they already operate a hotel has typically come out in favor of the operator. The impact on an existing hotel of an operator branding another property in the competitive market can be painful in normal operating environments. Under current market conditions, a two to five percent drop in rooms revenue can be the difference between survival and foreclosure. We expect owners to take a much harder stance in the future and, in instances where reasonable territorial protection will not be granted, we expect lawsuits against the operator for a breach of their fiduciary duty to the owner.

### Summary

The current industry upheaval is unprecedented. As is always the case, contracts, including loan documents, are a reflection of experience – especially recent experience. No one contemplated the degree of pain being felt in the lodging sector today, and, accordingly, documents were not written to accommodate current circumstances. Add to that new financing vehicles introduced in the last cycle and the movie rapidly changes from *Gone with the Wind* to *The Rocky Horror Picture Show*. All constituents of the hotel business will learn from the experiences of this cycle, and we can expect the terms of management contracts and related documents to reflect these events long into the future

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