

Owners face management contract limitations

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Story Highlights

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Editor's Note: This is the final part in a two-part series, focusing on owners' issues with hotel management agreements. The first column can be read [here](#).

As discussed in part 1 of this article, the unique and long-term relationship between a hotel owner and a hotel operator, as governed by the hotel management agreement, involves a delicate balancing of rights and obligations.

In part 2, we focus on restrictions that might be placed on an owner's right to finance the hotel; areas of exclusivity; obligations that an operator will usually require to be fulfilled by the owner; and other provisions that an owner might see in a hotel management agreement.

Financing restrictions

Many global hotel operating companies are in a race to report to shareholders and stakeholders an ever-increasing pipeline of hotels and growth of the number of flags in key and emerging destinations around the world.



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Once a hotel management agreement is signed, an operator usually will want to retain its flag for as long as possible. It is for this reason an operator will often seek to secure its ability to operate the hotel in the event the owner defaults on any financing arrangements over the hotel.

The operator may do this by:

- ensuring any financing over the hotel is backed by a reputable financial institution;
- minimizing the risk of default by ensuring any financing of the hotel cannot exceed a certain loan-to-value ratio (usually around 60% to 70%); and
- requiring the owner's financier to enter into an agreement with the operator, called a non-disturbance agreement, which provides that, in the event the financier steps into the shoes of the owner for any reason, the financier will abide by the terms of the hotel management agreement as if it were the owner.

The issues relating to non-disturbance agreements could be the subject of an entire article on their own. In summary, often a financier will resist being bound in this way because:

- the financier might wish to have the option to have the hotel with vacant possession (or, in other words, with no hotel operator in place); or
- even though the financier might see the benefit of having an operator in place to keep the hotel trading in the event of any default of the owner, the financier might prefer to keep his or her options open and not tie oneself to the form of the non-disturbance agreement required by the operator. Such an action: a) can severely restrict the options open to the financier by giving the operator approval rights over any incoming purchaser of the hotel; and b) would usually require the financier to assume all the obligations of the owner under the hotel management agreement, including all obligations regarding the provision of working capital.

A hotel owner who requests the financier to enter into a non-disturbance agreement with an operator might be subject to less commercially attractive financing terms than an owner who does not place this obligation on the financier.

Whether an owner agrees to provide the operator with a non-disturbance agreement is often a point of great debate in hotel management agreement negotiations.

Exclusivity

Often, an owner will want the hotel to be the only hotel operating under the brand within a certain area.

This request on the part of the owner might not always be justified from a business perspective. Particularly with economy brand hotels, a hotel might benefit from certain synergies associated with having two or more of the same brand hotels in a relatively close area. For example, the potential for clustered operations and increased bargaining power because of economies of scale in purchasing.

Operators have been burned in the past by agreeing to large exclusivity areas, which would restrict the operator to only one hotel, regardless of the brand, in a given jurisdiction. Singapore and Dubai are great examples of this. More than 20 years ago, many operators did not foresee the growth of their brand portfolio or the fact these jurisdictions would become key cities where an operator would want to operate a number of hotels. The exclusivity agreed to by some operators in these and other jurisdictions, which has locked those operators out of growing in these markets, is a lesson for operators when agreeing to these provisions.

Accordingly, an exclusivity area agreed to by an operator:

- will usually be limited to a relatively small geographic area. For example, 2 kilometers to 5 kilometers (1 mile to 3 miles) or smaller;
- might not always be for the entire length of the hotel agreement. For example, the period might go for 10 years or relate only to the initial term and not any extended term;
- will usually commence from the signing of the hotel management agreement rather than the opening of the hotel (so, depending on how long the hotel takes to construct, much of the exclusivity period might have expired by the opening date of the hotel); and
- will usually include a number of carve outs, which, if triggered, would render the exclusivity area null and void:

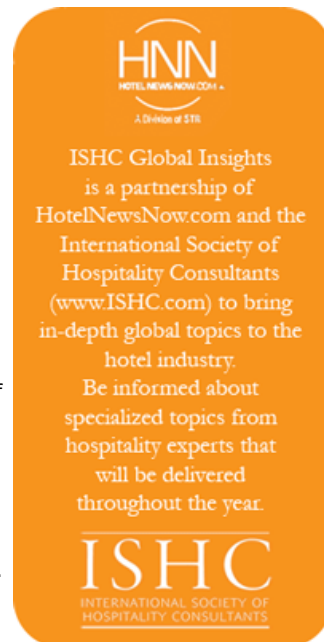
For example:

- if the operator purchases a portfolio of hotels, one or more of which is in the exclusivity area, the operator will want the right to operate and potentially rebrand those hotels; and
- if the operator wants to manage another style of property within the exclusivity area, for example, timeshare, or another business, such as a casino.

Other little "tricks" include the right of the operator to:

- operate hotels in the exclusivity area under any new brand it might develop or under brands that are derivatives of the brand over which exclusivity is given; and
- undertake pre-opening activities relating to a new hotel under the brand in the exclusivity area, but where the exclusivity restriction will expire before the full opening of the new hotel.

Obligations of the owner



The hotel management agreement is drafted around the premise that the operator manages the hotel for and on behalf of the owner, in return for a fee, and the risk of the operation of the business remains with the owner. In this regard, it is often stated the operator has "all care but no responsibility."

Accordingly, it is the obligation of the owner to:

- construct and fit the hotel in accordance with plans approved by the operator, to the operator's standards and by contractors approved by the operator;
- purchase the initial operating supplies for the hotel;
- fund all working capital at the hotel over the term of the hotel management agreement (regardless of whether the hotel is cash flow positive);
- replace furniture, fixtures and equipment at the hotel over the term of the hotel management agreement (even if the hotel's FF&E fund does not contain sufficient funds to undertake the necessary refurbishment). The funds required to replace FF&E would be the owner's funds and would not generally be operating expenses of the hotel;
- fund all capital improvements, repairs and replacements not being ordinary repairs and maintenance at the hotel over the term of the hotel management agreement (and the hotel management agreement will often require the owner to undertake any capital improvements required to maintain the hotel in accordance with the operator's brand standards). The funds required to make capital improvements would be the owner's funds and would not be operating expenses of the hotel;
- ensure the hotel is in accordance with brand standards. The funds required to insure the hotel may or may not be operating expenses of the hotel; and
- de-identify the hotel, at the cost of the owner, upon the termination or expiry of the hotel management agreement. Such de-identification acts will include removing all exterior and interior signage from the hotel that refers to the brand and removing from the hotel all other items that refer to the brand. This could include branded operating supplies and operating equipment.

When the funds required to undertake these obligations are not operating expenses, those expenses would not be deducted from revenue for the purposes of calculating the operator's incentive fee.

It is because of these financial obligations that, as mentioned in part 1, it is important that the owner have real approval rights over the budget of the hotel and the operator be required to operate the hotel in accordance with the budget.

One of the biggest issues for owners to come to terms with is that, if the hotel is not doing well for any reason, the operator might not be obliged to listen to the owner's ideas, and the owner must continue to fund working capital for the hotel and pay the operator's fees notwithstanding that the hotel is not making any profit.

Other terms in a hotel management agreement

While we have endeavoured to highlight the key terms in a hotel management agreement, they also usually deal with the following issues:

- the appointment of key staff at the hotel such as the GM and the director of finance and whether the owner has approval rights over the appointment of such employees. Often, the owner will have the right to reject a specified number of candidates put forward by the operator for each key position. If the owner does not accept any of the candidates, the operator can appoint a candidate to the role at its discretion;
- whether the owner gives any indemnity to the operator for losses suffered when acting on behalf of the owner and, if so, whether the operator indemnifies the owner for losses suffered in acting on the owner's behalf;
- what reports relating to the operation of the hotel are provided to the owner;
- who owns certain information at the hotel, for example, information relating to guests;
- whether the operator has the right (with or without the owner's approval) to cluster operations at the hotel with other hotels they operate in the same region;
- whether the hotel is to be repaired or rebuild (and whether any compensation is paid to or insurance proceeds are shared with the operator) in the event the hotel is damaged or destroyed;
- what rights, if any, the owner has to use certain intellectual property of the operator; and
- how disputes at the hotel are to be resolved. For example, what disputes are appropriate to be determined by an industry expert and what disputes are appropriate to be resolved by arbitration or litigation. If the parties are to resort to arbitration or litigation, what is the governing law of the hotel management agreement, where should any proceedings take place and what will be the applicable arbitration rules?

Conclusion

In considering the rights and obligations of a hotel operator and owner it might be easy to presume the journey throughout the term of a hotel management agreement is a rocky one. While this can sometimes be the case, in most situations the parties find a balance that allows for the smooth operation of the hotel, operators who have discretion to do what they do best—manage the hotel—and owners who are proud of their asset and enjoy

a healthy return.

The best hotel management agreements are those that clearly reflect the rights and obligations of each of the parties, but that, following signing, sit in a drawer and are rarely referred to as the parties work together to resolve any issues regarding the operation of the hotel that might arise.

About Ashurst

We have 24 offices in 14 countries as well as an associated office in Jakarta, and a best-friend referral relationship with an Indian law firm. With over 400 partners and 1,700 lawyers in total, we offer the international insight of a global network combined with local market knowledge.

We provide consistently high quality, commercially relevant legal advice worldwide, and build teams that are specific to our clients' needs, combining specialist legal skills, industry experience and regional know-how. We have a track record of successfully managing large and complex multi-jurisdictional transactions and projects. Our focus is on getting to the heart of your legal needs and delivering practical, commercial solutions.

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In the course of working in Ashurst's Hospitality & Tourism Group, Rhiannon Barnard has been involved in a number of recent significant hotel and tourism related transactions spanning the Asia Pacific region and the Middle East. Rhiannon also has experience advising hotel clients on a wide range of operational issues.

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