HotelNewsNow.com

Tips for negotiating management contracts

10 January 2013 7:58 AM
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Story Highlights

- The performance test will not apply for the first few years of the operating term, giving the hotel time to stabilize.
- An owner will usually require approval rights over certain key positions, such as the GM, financial controller, director of sales and the HR manager of the hotel.
- One of the hardest issues for many owners to come to terms with is the fact that the owner must comply with its brand standards.

Editor's Note: This is the first in a two-part series, focusing on owners' issues with hotel management agreements.

When hotel owners look to appoint an international hotel operator to manage their hotel, they are asked to sign a hotel management agreement (which can be made up of two, three or more separate documents) that lasts for 10 years to 20 years or longer and exceeds 100 pages in length. These agreements can be overwhelming and confusing for owners that are new to the hotel industry.

Based on our experience in negotiating hotel management agreements in Asia and the Middle East, this article discusses some of the key issues to be considered by hotel owners.

In the first part, we discuss performance tests, control over the operation of the hotel, issues concerning brand standards, assignment of the hotel management agreement and termination rights.

The second part of this article, which will be featured next week, will detail additional matters for an owner's consideration, including exclusivity and financing matters.


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Performance tests
Given the long-term nature of a hotel management agreement, a hotel owner will require the agreement to contain some sort of performance test, where the owner can terminate the hotel management agreement if the operator is not performing.

Much has been written about the practical worth of these clauses to protect the hotel owner against the poor performance of the operator, and we identify some of the pitfalls below. Despite these pitfalls, the performance tests in most hotel management agreements follow a similar formula.

The performance test will not apply for the first few years of the operating term, giving the hotel time to stabilize; the operator will need to fail the test in consecutive years before the owner's right to terminate is triggered.

1. Gross-operating-profit test
Under the gross-operating profit test, the operator will fail the test, giving the owner a right to terminate the hotel management agreement, if the hotel fails to meet a minimum percentage of GOP (usually 80% to 90%) when compared to the budget of the hotel.

In situations where the owner does not have absolute approval over the budget of the hotel, the value of a GOP test, which must be failed in a number of years before termination can be exercised, might be questionable.

2. Revenue-per-available-room test
Under the revenue-per-available-room test, the operator will fail the test, giving the owner the right to terminate the hotel management agreement, if the RevPAR at the hotel is less than a certain percentage (usually 80% to 90%) of the RevPAR of the hotels in the hotel's competitive set.

Some of the challenges with the RevPAR test include the difficulty associated with identifying a true competitive set for the hotel and obtaining accurate figures regarding the RevPAR of the competitive set.

3. Cure rights
Often the performance test will include the right on the part of the operator to cure a failure of the performance test by paying the shortfall amount to the owner for one or more of the test years. An owner often limits the number of times an operator can do this during the operating term.

Control over the operation of the hotel
An unfettered right on the ability of the operator to manage the hotel needs to be balanced with the owner's ability to approve certain matters of importance to the owner. This is a delicate balancing act as the owner appoints the operator because the operator has particular expertise that the owner may not have. Conversely, the hotel is the owner's asset, and most owners will not want to give up the right to decide key matters relating to the hotel.

Key approval rights on the part of the owner usually include the right to approve the following:

- **Budget**

Provided that the owner has the right to approve the annual budget of the hotel (including operating, capital expenditure, and furniture, fixtures and equipment budgets), and provided that the operator must operate the hotel in accordance with that budget, an owner might be content to live with less approval rights in other areas.

It would follow that if the operator wishes to spend money on things not included in the budget, the owner would have approval rights over this expenditure.

Often the owner's approval would not be required if expenditure is required for fire/life/safety purposes or is required by law.

- **Key personnel**

As the operator manages the hotel on behalf of the owner, all employees at the hotel are employees of the owner. An owner will usually require approval rights over certain key positions, such as the GM, financial controller, director of sales and human-resources manager of the hotel.

The approval mechanism differs from hotel to hotel. Often, the operator will present candidates to the owner for approval. If the owner does not approve of one of the candidates, the operator will have the right to select an alternative candidate at its discretion.

- **Contracts**

Unless otherwise approved in the annual budget, a hotel management agreement will often grant the owner approval rights over certain contracts. Often, the approval threshold is linked to contracts over a certain length (for example, 12 months to 24 months) and/or over a certain contract value (for example, $50,000 per year).

The owner might wish to approve all contracts of a certain nature, such as those relating to the lease of any commercial space at the hotel.

Brand standards
One of the hardest issues for many owners to come to terms with is the fact that the owner must comply with brand standards. These are standards which apply to all hotels operated under an applicable brand by the operator. Often the owner's usual approval rights (for example, in relation to expenditure) will not apply if a requirement at the hotel falls within the ambit of brand standards. In addition, the brand standards are usually subject to change at the operator's discretion.

Certain provisions can be included in the hotel management agreement to give the owner some certainty around expenditure required on account of brand standards. For example, if such expenditure is not included in the hotel's annual budget, the owner is not required to approve the expenditure. In this case, the operator would usually have a right to include such expenditure in the budget for the following year.

Also, the brand standards should be consistently applied to most of the hotels under the brand in a certain areas.

Assignment of the hotel management agreement
Usually the hotel management agreement will include a right on the part of the operator to assign the hotel management agreement to any third party without the approval of the

owner. While any assignee of the operator would usually (but not always) be the assignee of the relevant intellectual property so the hotel can continue to be operated under the given brand, in most cases there is no requirement for the assignee to have any particular experience in the operation of hotels. In this situation, the owner could be locked into a long-term hotel management agreement with an operator who might not have the necessary skills or experience (or at least the same skills and experience as the existing operator group) to operate the hotel.

Conversely, the operator will often require approval rights over any assignment of the owner's rights under the hotel management agreement, including in the event of any change of control of the owner. The operator's justification in this regard is they need to be satisfied that any assignee has the resources to operate the hotel.

The hotel management agreement will often include restrictions on the type of people the owner can assign the hotel management agreement to or to whom the owner sells the hotel.

These restrictions include an assignment or sale to:

- a competitor of the operator;
- a person with whom the operator is prevented from contracting (for example, if the operator is a U.S. company, it will be prohibited from contracting with a person listed as a "specially designated national or blocked person" by the United States Department of Treasury's Office of Foreign Assets Control); or
- a person who does not have the necessary financial resources to operate the hotel.

Rather than allow the operator the right to prevent any sale of the hotel, an owner might wish to include a termination on sale clause in the hotel management agreement. However, these clauses are not always agreed upon by the operator, and can come at a cost, as identified below.

Termination rights
Given the long-term nature of a hotel management agreement, the situations under which an owner may terminate the hotel management agreement are of great importance. Common termination rights include the following:

- **Termination for breach**

The owner would be permitted to terminate the hotel management agreement if the operator were to fail to perform any material obligation under the agreement. Usually the hotel management agreement would require the owner to give the operator notice of the default and allow the operator time to cure the default.

The operator would also have a corresponding right in the event of any breach of the hotel management agreement by the owner.

Other events of default would include a party becoming insolvent or the owner becoming a competitor of the operator, or a person with whom the operator is prevented by law from contracting with.

- **Termination without cause**

A right on the part of the owner to terminate the hotel management agreement without cause (or without any breach of the hotel management agreement on the part of the operator) is not common.

Where a right to terminate the hotel management agreement without cause is insisted upon by an owner and agreed by the operator, the right usually contains some provisos such as: The right cannot be exercised until the hotel management agreements has run for a certain minimum period (for example seven years to 10 years); and upon exercise of the right, a fee is paid to the operator.

The fee would usually correspond to a number of years fees payable to the operator (calculated based on the average of the fees paid in recent years). The number of years may relate to the number of years left to run on the hotel management agreement, or it could be a pre-agreed number, for example, three to five years of fees.

- **Termination on sale**

As mentioned above, because of the operator's restrictions on the owner's assignment of the hotel management agreement or sale of the hotel, an owner might insist the agreement include a right on the part of the owner to terminate the hotel management agreement in the event of any sale.

Often the right will be subject to the same provisos identified above in relation to termination on cause. In addition, the owner may only be permitted to exercise the right if the operator refuses to approve any sale or assignment to the incoming purchaser.

Conclusion
The relationship between a hotel owner and a hotel operator is a complex one that needs to stand the test of time to provide the best platform for the long-term success of the hotel. Accordingly, the negotiation of the hotel management agreement should be approached with a view to balancing the rights of the parties to ensure the operator can manage the hotel without any

undue interruption while satisfying the owner that they have real approval rights in relation to the decisions that matter most to them.

We touched on some of the issues we see as being of key importance to a hotel owner. The issues that we have discussed are by no means exhaustive.

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