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Opinions

Contract issues between global owners, US managers

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Some undertakings are commonplace in U.S. management contracts but don't always translate effectively to hotels operated in other markets.

By William Bosch

Who should assess the value of a brand operator? Guests, shareholders, owners or some other constituency?

More commentary and analysis need to focus on the value to hotel owners, especially owners of international hotels entering into long-term management contracts with U.S.-based brand operators. Once they get past the well-crafted puffery during the romance phase, it is imperative for owners to evaluate how their contracts actually align interests during what they anticipate will be a long and happy marriage. What international owners believe they are getting from their brand operators may not actually have been translated correctly in the language of their agreements.

For example, on issues of profitability, what is the manager undertaking to do? Will the manager operate the hotel for owner's account, or will it have mixed loyalty to a broader portfolio of hotels and brands? Are corporate programs and services, including loyalty programs, being implemented for the benefit of your hotel or for the brand? And will there be adequate disclosure and accounting for the substantial costs of these programs?

Such questions may be difficult to ask during the development and contracting phase of a project, but the answers are essential. This is especially the case for international owners unfamiliar with the decades-long efforts by brand operators to craft "form" agreements that limit their duties to owners. Whether those efforts are successful depends in part on governing law, but a helpful place to start is by looking at the form agreements brand operators are asking international owners to sign. As international owners face inevitable economic cycles and market-specific challenges, they may be surprised at the most inopportune moments to find that their managers actually disclaim any financial obligations and any duties of loyalty and transparency.

1. Financial performance standards

Many hotel brands tout the "profitability" of their hotels, but that does not necessarily mean profits for owners. For international owners who rely on pro formas during the development stage or statements by brand managers touting the "strong profitability" of hotels they manage, they need to understand that many brand managers include disclaimer language, effectively running away from their forecasts as soon as the ink is dry on the management contract. When it comes time to provide annual operating budgets, owners sometimes are surprised that the numbers are wildly different from those that were used to underwrite the project, and the disclaimer language that was in fine print suddenly gets magnified.

International owners may be surprised at how little the brand managers promise in terms of financial performance. Form contracts often give the manager control over annual budgets with caveats to the effect that budgets are directional only, do not establish any guarantee and that manager is only required to act "reasonably." For those contracts that actually set a "performance test," brand operators have been careful to ensure that such tests are essentially meaningless, as the manager's superior access to performance data ensures that competitive sets and income tests establish a low bar. In other words, what managers say they will do and what they commit themselves to doing in the contracts often is very different.

2. Disclosure and transparency

Disclosure and transparency also are areas where much gets lost in translation. Owners rightfully believe that brand managers, who agree to operate for the account of the owner, will disclose how they are spending the owner's money and why, and will provide detail when reasonably requested by an owner. Under the "books and records" clauses in their contracts, however, some brand managers try to limit their disclosure obligations to "books of account," by which they mean monthly bookkeeping in accordance with the Uniform System. Ask for backup detail, however, and some managers simply refuse or rely on assertions that the information does not relate to the operation of the hotel or is "proprietary." When owners look at their contracts, they sometimes find that

the manager has undertaken very few clearly expressed disclosure obligations, and that it's hard to get a straight answer without getting lawyers involved.

3. Corporate programs and expenses

When it comes to corporate programs and expenses, the gap between owner expectations and manager performance is especially wide for international owners. Consider, for example, loyalty programs. To the extent such brand-manager programs are addressed specifically in contracts, they often focus on enrollment but say little about cost or benefit. Some brand managers rely on their discretion to implement chain services and marketing programs, relying on loose language like "fair and reasonable share" to apportion costs to owners. But charges that may be "fair and reasonable" to hotels in the U.S. may not be so for international hotels, especially when the bulk of members live and travel within the U.S. And how the brands allocate brand marketing costs to those loyalty programs—instead of covering them using brand marketing fees—is often opaque. Ask a U.S.-based brand manager to demonstrate the incremental benefits and to itemize the costs of a loyalty program to an international hotel, and an owner very well may be surprised to learn that the brand cannot do so, or simply will not. Many international owners also are surprised to learn that some brand managers use corporate charges to offload central office overhead and other expenses that are more appropriately absorbed by the managers.

4. Dispute resolution

When disputes inevitably arise, international owners frequently are surprised to learn that brand managers in their form agreements have tilted the playing field in their favor. Would an international owner going into the relationship knowingly agree to write blank checks to a U.S.-based operator by giving it control over the owner's hotel bank accounts without any right to request backup detail and any realistic prospect of gaining access to the documents in a dispute resolution forum? And yet that is precisely what some brand managers seek to impose in their form agreements. Brand managers have gone to great lengths to avoid litigation by pushing the resolution of disputes to "experts" and, in some instances, confidential arbitration. In the employment context, where arbitration is the norm, some arbitration forums have recognized the need to provide a way to evaluate the process for fairness. The American Arbitration Association, for example, now publishes the decisions of employment arbitration disputes, albeit with identifying information redacted. International commercial disputes generally, and hotel disputes specifically, largely remain cloaked behind a curtain of confidentiality that prevents any genuine assessment of whether the arbitral process yields fair outcomes.

What this means as a practical matter is owners have no readily available means of assessing whether the dispute resolution process—including the pool of available experts—is fair to owners. Brand management companies have superior access to this information and as "repeat players" in this arena have an inherent advantage. To the extent international owners rely on international arbitration forums, they need to be mindful that they may not be given access to essential information that resides uniquely within the possession, custody and control of the brand manager. That's like playing a game where the other side not only holds all the cards but also gets to decide that nothing gets dealt unless the brand manager wins.

The reality is that many international owners assume too much. They assume they have no ability to push back against form agreements that favor the brand managers, and that obscure the manager's duties. They assume that when disputes arise, the same charm from the brand manager's team that won them over during the project development stage will carry through to the the brand's operational and legal teams. And they assume that if disputes do arise, they'll have a full and fair opportunity to be heard. The safest option is to work with a brand operator that is willing to align its interests with the owner's—and to clearly spell out its duties to the owner so that nothing gets lost in translation.

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