Hotel Investment Today

Understanding key money in transactions

More and more frequently, transactions in the hotel industry include some form of key money. This article is an explanation of the origins, growth and mechanics of the use of key money.

The term “key money” is believed to be derived from the custom or practice of tenants paying an upfront amount to secure apartment leases in New York City. Key money is a synecdoche; it is a payment to receive the “keys” and, by extension, the lease for the apartment. Key money is known by several names and can be structured in several ways.

In the hotel industry, key money is a payment by which a franchise or (particularly, branded) management company, during its solicitation and negotiation of a transaction, offers to provide (and, if the transaction is successful, provides) consideration to an owner/developer for the execution of a franchise or management agreement. Typically, the key money is delivered upon (or within a short period of time following) the opening of the hotel under the key money provider's brand (the "provider"). Many of the branded hotel companies, in pursuing a management or franchise agreement (in connection with the franchise application process), use key money as an incentive in the solicitation of the owner/developer and securing the agreement sought. For an owner/developer looking to complete or "top up" its capital stack in the purchase, renovation, conversion or development of a hotel, key money can be a powerful inducement to choose a particular brand.

Key money is ordinarily structured as a self-amortizing loan from the provider to the owner that is forgiven if the pertinent agreement runs its full term. If the agreement is terminated early, however, the unamortized portion must be repaid – in addition to damages if the termination was in breach of the agreement.

Key money is readily calculable. If nothing else, it provides a disincentive for owners to terminate, especially in the earlier years of an agreement's term when the repayment obligation is largest. Regardless of the precise structure used, it is customary that, rather than requiring repayment of the amount of the key money, the provider either amortizes the amount paid on a straight-line basis over the term of the underlying agreement or reduces the outstanding amount annually over that term. If the term of the agreement ends prior to the contractual term, then the "unamortized" or unreduced amount is repayable (sometimes with interest) to the provider as a condition of termination.

Different hotel companies use different structures to implement their practices and documentation of key money. Some simply refer to it as "key money" and structure it as "consideration" in the body of the operative document; the owner/developer's repayment obligation (in the event of an early termination) is cast as a contractual obligation of repayment.

Other companies may call the key money a "developer incentive" or a "forgivable loan" and structure the transaction as an interest-free loan, requiring the execution and delivery, when appropriate, of a form of promissory note reflecting the agreed terms and, usually, guaranteed by the maker. In each instance, the treatment of amortization or reduction of the principal is virtually identical; if the franchise agreement is not terminated before its contractual term expires, the loan or other repayment obligation is forgiven. Common language in transactions term sheets might look like this:

Key Money. Franchisor (or Manager) will pay to Franchisee (or Owner), within 30 days after the opening of the Hotel, key money in an amount to be determined in consideration for Franchisee's execution of the Franchise Agreement, construction, and operation of the Hotel for the term of, and pursuant to, the Franchise Agreement. The unamortized portion of key money will be repaid (without interest) to Franchisor on a pro-rated basis if the Franchise Agreement is terminated prior to the expiration of the term.

Language in hotel agreement(s) that documents the key money contribution is ingreater detail, either in the body of the document or in a promissory note, fleshing out all the possibilities regarding payment, amortization and repayment, but the term sheet language quoted above is typical.

In my tenure as a brand development officer, an executive overseeing branddevelopment officers and an advisor to owners, I have learned that hotel developers are not reticent, particularly where their capital is concerned. If a developer believes a franchisor can or will provide key money, the developer will inquire about the substance of the key money and the possible amount thereof relatively early in the discussion.

Invariably, the specific key money conversation occurs before a developer or, for that matter, the franchisor (or manager in a branded management circumstance) is committed to a transaction and, more critically, before substantial capital has been expended by a developer in connection with a particular brand. Certainly, key money is a component of the pre-franchise application discussion, prior to commitment, between the developer and the franchisor.

There are pros and cons to a developer's receiving a commitment of key money, and management negotiations are complicated by a brand manager's agreement to contribute key money. A developer would be wise to understand those complications in a management setting before accepting the brand's commitment.

In a franchise setting, the cons are fewer, as the franchisor's concerns differ from those of a branded manager operating a hotel.