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Abstract
The hotel management agreement is now universally accepted as a tool to link hotel operators with investors who wish to develop and own hotels. Hotels are operated under management agreements in all parts of the world, and the same principal issues are present in any negotiation between operator and owner.[1] As I discuss in this paper, agreements in the United States differ somewhat from those used in other parts of the world. In this report, I review the origins and evolution of the international hotel management agreement, and discuss the deal points that are commonly found in such agreements today.

Keywords
management contracts, hotel operators, management agreements, service contract law, CHR, CREF

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The International Hotel Management Agreement:

Origins, Evolution, and Status

Michael Evanoff

EXECUTIVE SUMMARY

Developed over fifty years ago as a mechanism to allow hotel operators to expand globally without significant capital investment, the contemporary international management agreement has become a well accepted arrangement between a hotel owner and a hotel operating company. While the original management agreements were strongly weighted toward the operating companies' interests, current contracts have achieved a greater balance between the parties (often with a third-party lender also expressing interest in the contract provisions). Most of the risk still rests with the owner, but today the operator usually must meet performance goals to keep the contract in force. It's also possible for an owner to dismiss an operator for no reason (under principles of agency and personal service contract law), but damages may then be due to the operator. Specific contract provisions, such as base fee and incentive fee formulas and the length of the agreement, evolve and change according to market forces and the relative bargaining power of the parties.

ABOUT THE AUTHOR

Michael Evanoff worked for major law firms in New York and London before joining Hyatt International Corporation in 1984, where he served as general counsel, as vice president–development and general counsel, and as senior vice president and general counsel.

While at Hyatt International, Michael worked closely with Jay Pritzker, the legendary founder and chairman of Hyatt, and oversaw the development of approximately 70 Hyatt International hotels worldwide, as well as several casinos and multi-purpose projects. Among the investment deals for which Michael was responsible at Hyatt International were the Grand Hyatt Hong Kong, the Grand Hyatt Bali, the Park Hyatt Paris, the Park Hyatt Milan, the Grand Hyatt Mumbai, the Grand Hyatt Seoul, the Regency Hotel and Casino (Greece), and the Park Hyatt Zurich.

After serving Hyatt International for 20 years, in 2004. Michael became chairman of First Oriental Holdings Corporation (Singapore), a private equity firm that invests in and develops residential, commercial, and hotel properties in Asia. Starting from scratch in 2004, Michael led First Oriental to profits in excess of US$50,000,000 in 2007 and 2008, a return on investment of more than 200 percent.

As First Oriental grew and diversified, in 2009 Michael entered into a partnership with First Oriental's parent company, the Libra Group, and became chairman of Marlborough Hospitality Services Limited. In 2011, Michael purchased the Libra Group's interest in Marlborough, and became the sole owner. Also based in Singapore, Marlborough provides a range of legal, consultancy, and project oversight services for the hospitality and residential housing industries. He has worked on projects in Australia, Cambodia, Greece, Indonesia, Japan, the Maldives, the People's Republic of China, Russia, Singapore, Thailand, the U.S., and Vietnam. He has personally negotiated and documented over one hundred international hotel management agreements and their ancillary contracts, representing both investors and hotel management companies, and has drafted standard management agreements for several hotel chains.

Michael was educated at Michigan State University, the University of Michigan Law School, and the London School of Economics. He is a member of the New York and U.S. Federal Bars.

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The hotel management agreement is now universally accepted as a tool to link hotel operators with investors who wish to develop and own hotels. Hotels are operated under management agreements in all parts of the world, and the same principal issues are present in any negotiation between operator and owner.[1] As I discuss in this paper, agreements in the United States differ somewhat from those used in other parts of the world. In this report, I review the origins and evolution of the international hotel management agreement, and discuss the deal points that are commonly found in such agreements today.

[1] Jan A. deRoos, "Hotel Management Contracts—Past and Present," *Cornell Hospitality Quarterly*, Vol. 41, No. 1 (February 2010), pp. 68-80.

Today's management contracts reflect the basic structure of the 1963 Hong Kong Hilton contract.

My intent is to familiarize first-time hotel investors, students of hospitality management, and hotel operating personnel with the history of the international hotel management agreement and some of the underlying commercial drivers in a management agreement negotiation. Consequently, I cover topics that may be familiar to experienced hotel industry personnel, but I believe that even those working in the industry will find much of the information of value. For this discussion, I draw on my own extensive experience in representing both investors and operators over a thirty-plus-year period.

Beginnings: **Hilton International Corporation**. One of the major pioneering hotel management companies was Hilton Hotels Corporation, which was formed in 1946 by Conrad Hilton, who had been an owner-operator of hotels in the United States for some time.[2] Until approximately 1949, virtually every hotel in the world had an "owner-operator." The same entity or person both owned and operated the hotel (and, in some cases, a small chain of hotels). In other words, management was not separated from ownership.

In 1949, Hilton Hotels Corporation opened its first hotel outside the continental United States, the Caribe Hilton Hotel in San Juan, Puerto Rico, under a leasing arrangement with the owner of the asset—which was the government of Puerto Rico. Contrary to its previous practice, Hilton had no ownership interest in the hotel.[3] Furthermore, the lease payment was not a fixed amount payable regardless of performance.[4] Rather, the quantum was variable depending on financial results. About the same time, Hilton International Corporation was formed as a company separate from Hilton, to bring the Hilton brand to other non-U.S. destinations.

Although several more Hilton International hotels were opened during the 1950s, most notably, the Hilton Istanbul Bosporus, as far as I can determine those hotels were also operated under lease arrangements, with Hilton providing some financial support but not guaranteeing a fixed annual rent.

Hong Kong Hilton. A major landmark in the international hotel management industry came with the opening of the Hong Kong Hilton in 1963. This hotel was wholly owned by a Hong Kong company, Hutchison Whampoa, which entered into a true management agreement with Hilton International. Although this appears to be the first international management agreement as we know them today, many of its terms were based on a lease agreement, akin to the Caribe Hilton contract, since there had to be a starting point in creating the new document. Even today, many of the "standard" management agreements used by international hotel chains contain vestiges of a lease agreement—drafting that was used in the 1963 Hong Kong Hilton agreement. Ironically, the hotel was demolished to make way for an office building in 1995, despite having earned over a billion dollars during its 32 years of operation.[5]

Using the Hong Kong Hilton structure as a model, Hilton International quickly expanded to other destination cities. In 1964 Hilton International was spun off by Hilton Hotels Corporation and was subsequently sold in 1967 to Trans World Airlines, which apparently sought to emulate its prime competitor, Pan American World Airways (see below). Ultimately Hilton Hotels Corporation and Hilton International came together again, so today there is only one Hilton entity.

InterContinental Hotels Corporation.

Outside the United States, the InterContinental chain actually preceded the Hilton International chain by a few years. InterContinental was the brainchild of Juan Trippe, founder of Pan American World Airways.[6] Trippe rightly surmised that there was not much use in expanding Pan Am routes to destinations that did not have suitable accommodations for passengers and crew, and thus InterContinental Hotels Corporation was formed as a unit of Pan American. The first InterContinental hotel was opened in 1947, in Belem, Brazil. InterContinental initially tar-

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2 Since 1919, when Hilton and his partners purchased the Hotel Mobley, in Cisco, Texas. See: Daniel R. Lee, "How They Started: The Growth of Four Hotel Giants," *Cornell Hotel and Restaurant Administration Quarterly*, Vol. 26, No. 1 (May 1985), p. 22.

3 For a detailed discussion of Hilton International, see: Curt R. Strand, "Lessons of a Lifetime: The Development of Hilton International," *Cornell Hotel and Restaurant Administration Quarterly*,Vol. 37, No. 3 (June 1996), pp.83-95.

4 For example, Curt Strand recalled that Hilton put up $300,000 for "operating equipment and initial working capital" as part of the 1949 arrangement for the Caribe Hilton. See: *Ibid*., p. 84.

5 See: William Hsu and Robert O'Halloran, "The Hong Kong Hilton: The Case of the Disappearing Hotel," *Cornell Hotel and Restaurant Admininstration Quarterly*, Vol. 38, No. 4 (August 1997), pp. 46-55.

6 Stanley Turkel, *Great American Hoteliers: Pioneers of the Hotel Industry* (Bloomington, IN: Author House, 2009).

geted South America and Mexico, using United States Export-Import Bank financing to develop new properties, and gradually the chain expanded to Europe and Asia. It appears that there was a mix of InterContinental-owned properties, and management-only properties. However, whatever form of contract that InterContinental then used for management-only purposes, it did not have the same influence as Hilton International's Hong Kong agreement, which remains the progenitor of almost all the standard management agreements used by hotel management companies worldwide.[7]

Growth of the Model

In the late 1950s and continuing during the 1960s, the management agreement model—separating ownership from the operation of the asset—gained serious traction within the United States. As Hilton International and InterContinental prospered abroad, other U.S. hotel companies decided to enter the international market, using the relatively new management agreement model. Sheraton began expanding outside the United States in the 1960s, as did Western International (Westin) and Marriott. Hyatt, which commenced operations in 1957 under ownership of the Pritzker family, opened its first international hotel in Hong Kong in 1969. With some exceptions, these companies relied primarily on management agreements (and not ownership) for international expansion. Additionally, although Pan Am and Trans World faded from the scene, Hilton International and InterContinental continued to expand under a series of different owners.[8]

Today, the international hotel management agreement is vastly more complex than it was even as late as the 1990s. For tax and other reasons, the basic agreement is often split into as many as six or seven different documents.[9] New concepts have been introduced as hotel management companies and owners have grown more sophisticated, and as the landscape of the market has undergone considerable change, due to increased competition, advances in technology, new legislation, and various court decisions. However, today's international management agreements still have much in common with those that were negotiated more than forty years ago.

International hotel management agreements have become vastly more complex in recent years.

International management agreements generally are not as complex as those used in the United States. I see at least three reasons for that circumstance : **(1)** the U.S. federal government and state and local governments have intricate and stringent regulatory requirements; **(2)** owners in the United States tend to be large, sophisticated institutions that bargain intensely, plus their lenders often join the fray to protect their own interests; and **(3)** the United States is a lawyer-centric society, and the duty of a lawyer is to cross every "t" and dot every "i"—while in the international arena, owners are often wealthy individuals or families who focus mainly on purely business issues and who may even negotiate without a lawyer.[10] In fact, management agreement negotiations are so intense and complex in the United States, and so many experts and attorneys are involved, that it is difficult to speak now of an "industry standard" U.S. hotel management agreement, or even to speak of "market terms."

The Negotiation Pendulum

When management companies such as Hilton International and InterContinental first entered the international market, they had tremendous bargaining power. A developer-owner who wanted

7 David Eisen, "Management Agreements Put Under the Microscope," *Hotel Management*, August 2012 (ftp.hotelmanagement.net/operator-owner/management-contracts-put-under-the-microscope-17184).

8 Sheraton and Westin are now owned by Starwood Hotels and Resorts, which has a large number of other brands. The Marriott family of hotels has grown to include Ritz-Carlton and several other premium brands (and Marriott has agreed to acquire Starwood at this writing). Hyatt currently has four premium brands: Hyatt Regency, Grand Hyatt, Park Hyatt, and Andaz, the latest addition. Hilton has the Conrad brand. Few if any of the major chains are limited to one premium product, and all have lower-tier brands (indeed, multiple lower-tier brands).

9 One reason that the management agreement and the license agreement are separate, for instance, is that withholding taxes are usually higher for management fees than for royalties. The taxation of the operator's fees and other receipts is an extremely complex matter that is beyond this paper's scope. The other primary reason for separate agreements is to lessen the impact of the termination case law, the theory being that the management agreement may be subject to termination without cause under agency law principles, but the license agreement would survive intact. I have never seen this tested.

10 The scene in Europe is somewhat similar to that in the United States, with a great deal of institutional ownership. Ownership in South America, the Middle East and Asia tends to be in the hands of wealthy individuals or families (sometimes through a substantial company controlled by the individual or family). Also, in many European countries a lease arrangement was the norm for many years, so the management agreement model has seen some resistance. Today, few if any management companies are willing to enter into a lease with a fixed payment to the owner that must be paid regardless of hotel performance.

The pendulum of bargaining power has swung toward owners over the years, and contract terms are more balanced.

to acquire luxury hotel expertise and the strength of a chain (and brand) for marketing muscle had few choices. Thus, the first international management agreements called for high fees and long terms (as many as sixty years), and gave the management company extraordinary control of an asset owned by another party.

Over the years, the pendulum has swung the other way. There has been a tremendous proliferation of management companies, owners have become much more sophisticated, and owners often have their own experts helping in the negotiations. For example, early on, an international management company could ask for fees equal to 5 percent of gross revenue, and 10 percent of operating profit (profit before fixed charges). Today, a more common formula would be "two and eight," and the "eight" is usually calculated using a formula that is more beneficial to the owner than in earlier years. Operating terms are shorter, performance is monitored more closely, owners have more control, and more (if not much) risk is allocated to the management company. I'll discuss these provisions below.

Pendulum swings. This is not to say that the pendulum has swung all the way over. First, although the hotel business is demonstrably cyclical, hotel development generally has continued to grow rapidly, causing in some locations a shortage of first-tier operators. In such a situation, of course—where most of the major chains are already present—an entering management company, particularly if it has a perceived premium brand, can still drive a better-than-average bargain.

Second, even with the improved terms that are available today from operators, unless the operator provides substantial financial support, the owner of a managed hotel still bears virtually all the financial risk of the enterprise. On the extreme end, the hotel could produce an operating loss, while the management company still receives its basic fee. However, even when the hotel produces an operating profit, the owner still must service debt and pay real estate taxes and other owner's costs, which could well result in a significant net loss for the owner. Thus, financial support from the operator, which is always given grudgingly, should be a first priority for the investor when management agreement negotiations begin.

Branding

While virtually every hotel management company started life with only one brand, today each major company can offer multiple brands to a prospective developer-owner. To some extent this is due to industry consolidation, but the primary reasons for having multiple brands are the same as when Quality Inns (now Choice International) introduced different franchised tiers—to enable the company to offer different products to different markets. Also, the traditional management-only companies wished to get into franchising, which now they have done in a big way. Just as important, to grow the company it is essential for the company to have appropriate brands and styles and service levels for each market situation. Deluxe, full-service hotels are simply not suitable for many destinations or locations. Not everyone wishes to stay in a large "luxury" property, nor can everyone afford to, and some travelers, particularly younger travelers, may wish to stay in a hotel with buzz and limited pretense.

In addition, the more properties that an operator has under management, no matter the brand, the greater the strength of the operator's loyalty program. A tremendous amount of room-nights come from loyalty program members (e.g., Hilton Honors, Hyatt Gold Passport, Marriott Rewards).

There is a complication when a chain has two (or more) brands in the same category, particularly if the duplication is in the luxury sphere, and in such a case an effort is made to target groups with different demographic profiles (age is viewed as a primary differentiator). One brand may be marketed to older travelers with traditional ideas as to what a hotel should offer, while another brand may supposedly cater to a more "hip" clientele. Product attributes such as location, price, room size, club and gym facilities, and wi-fi access remain strong motivators when guests choose where to stay. However, the strategy of targeting specific groups apparently is working, given the expanding number of "life style" brands.

Although life-style brands are getting considerable attention, this approach is not an entirely new concept, since the industry has been offering life-style brands for many years, including the original Holiday Inn, which popularized an entirely new lodging product, the motor inn. Since then, numerous chains and individual hotels have catered to a specific clientele, including the original Rockresorts, the Amanresorts group of hotels, the Hard Rock Hotels group, and Starwood's "W" brand. Travelers will always take location and price into account, but many travelers will be drawn to hotels and resorts that are deemed to be friendlier to their quite specific tastes, needs, and desires.

Two Clarifications

Many members of the general public hold one of two conflicting misconceptions, regarding hotel chains' franchising and hotel ownership status.

The first misconception is that all hotel chains use a franchising model, where the hotel company licenses its name and knowhow, and supplies a reservations system and worldwide marketing. In franchising, operations are conducted by the owner or a designated third-party hotel operating firm. This owner-operator franchising model is certainly present when it comes to many budget and mid-level enterprises. Franchising is common with companies offering limited services, usually only rooms, although some operators franchise their full-service, lower-tier business-level properties (including Hilton, Marriott, Sheraton, and Westin), provided a skilled third-party operator is included in the arrangement. However, among the high-end operators—companies that operate large, luxury hotels—franchising of premium brands is extremely rare. Maintaining standards is critical to these operators, and full management produces a much better fee stream. Full management of course does come with more capital investment and higher overhead, but these costs are offset by higher fees and system charges for such things as training, chain-wide marketing services, and reservations. I'll expand on system-reimbursable charges below in my discussion of contract provisions.

The second (and conflicting) misconception is that hotel management companies do in fact own all the properties they operate. As part of past development efforts a management company may well own some of its properties, and for various reasons a chain may make a small investment in a new hotel, but generally today the chains steer clear of ownership, together with the attendant risks. A few chains have created real estate investment trusts to own some of their hotels, but this is most common in the United States. Marriott was one of the first chains to do this, MGM Hotels and Resorts just announced that ten owned properties in the U.S. would be placed into an REIT, and Hilton is also preparing to spin off its owned hotels to a newly created REIT. It is true that there are a handful of chains that prefer ownership, but usually those are smaller chains owned by wealthy families that wish to have absolute control of their assets. The Peninsula group is a case in point.

Provisions of International Management Agreements

Let's turn now to the specific provisions found in international management agreements, starting with an examination of how there can be a relatively standard international management agreement when the world is so diverse, with multiple legal systems and thousands of different languages.

Many operators look back at the first comprehensive hotel management agreement that Hilton International constructed in connection with the Hong Kong Hilton. Hotel companies based in the United States were quick to recognize the opportunities that lay abroad, and they moved rapidly to secure management deals in foreign lands, using the Hong Kong Hilton transaction as a model. Ownership and management were separated. I know of one company that simply adopted the Hong Kong Hilton management agreement in its entirety, just changing the name of the operator. Some hotel companies, particularly in Germany, Japan, and South Korea, continued to focus on ownership, but the management-only model spread from the U.S. to Canada, Dubai, England, India, and Singapore, in addition to Hong Kong. One thing to note is that all of these countries have English as either the primary language or as a recognized second language, and most also have English common law as the basis of their legal system. Thus, it was natural for these companies to produce standard agreements in English. Also, the fact is that English is the primary language of commerce, worldwide. In most cases, no matter where the subject hotel is located, an English-language management agreement is accepted by the owner, although it may also be translated into the official national language (by law or by owner preference).

Brand standards represent a key element of management agreements.

Technical Services

All major chains insist to one degree or another that their branded properties meet the brand's standards. To ensure this, not only do management companies supply an extensive list of specifications, but they also demand that the developer engage a unit of the management company to provide technical services, which include supervision of the design, construction, and outfitting of the hotel.

Depending on the resources that a management company devotes to its technical services unit, the developer-owner can benefit substantially from having the management company involved, since the developer—and often the architect—may have little experience in the complexities of designing a hotel.

Contract duration has become noticeably shorter in recent years.

Also, the facilities offered at the hotel, the interior design, and the furnishings and equipment in the hotel must conform to the standards expected by patrons of the chain. The fees paid by the developer-owner to the management company for technical services rarely cover the actual cost to the management company of providing the services (maintaining a large staff of experienced hotel designers and outfitting experts), and developer-owners often do not realize that they are getting good value for their money. Indeed, the management firm's technical services department generally is not intended to be a profit center. A target fee for technical services may be US$2,500 per key (plus expenses), but this number is normally negotiated down by the developer.

I recommend that investors consider the strength of the operator's technical services department when selecting an operator. Not all companies devote the same amount of resources to this unit.

Ordinarily the parties execute a separate technical services agreement, although in earlier days this service component was simply addressed within the management agreement itself. Although lower-tier hotels might use a "cookie-cutter" approach (even using modular units), high end operators usually make an effort to have the property strongly reflect the local culture and ambience.

Some chains are better at doing this than others. The industry has advanced in the decades since the Berlin Wall fell and chains rushed into Eastern Europe and Russia with unremarkable exterior designs and interior designs that were purely American. In that time, a traveler sometimes could not really tell from the hotel's design whether he was in Warsaw or Chicago. However, as competition has sprung up, the formerly unimaginative operators have learned to study local culture seriously and to design accordingly.

Length of the Term

The original management agreements used by Hilton International, InterContinental, Hyatt, and others called for initial terms of twenty years, with a unilateral option for the operator to extend the term for three successive periods of ten years each—a possible total of fifty years. A thirty-year initial term with three ten-year extensions was not unheard of.

A long tenure is understandably important for a management company, in part because of the investment and effort required to open a property. Revenue streams need to be predictable, especially for publicly held companies. Success breeds success because distribution is a key component in driving occupancy rates, and it is quite damaging to a management company's public and industry image for its name to be removed from a property.

On the other hand, it is difficult to predict what the future will hold, and owners have pushed back against the original lengthy terms. In the international arena, new management agreements of twenty to twenty-five years have become the norm.[11] More to the point, it is unusual now for the operator to have a unilateral renewal right that is not subject to some type of performance test, as I discuss below. As a further note, a renewal that is subject to "mutual agreement" is not particularly valuable, since either party can decide not to agree. The "renewal by mutual agreement" language is really a means of saving face for both parties, as the provision is meaningless.

Termination Rights

It has always been the case that a management agreement could be terminated for cause—including breach of the agreement, bankruptcy, or failure to maintain or operate the hotel to an acceptable standard. More recently, it has become quite common to include a performance test for the operator. The most common form of test involves the operator's failure to meet profit targets or to perform adequately (measured by revenue per available room) when compared to an agreed-upon competitive set of nearby hotels of similar size and quality. Making the relevant calculations can be somewhat tricky, and there usually would be room for argument, so a dispute as to whether termination is justified could drag on—but having some performance measure is certainly a substantial benefit to the owner.

Understandably, operators invariably propose a low performance test hurdle. For example, an operator often proposes that it need only perform at 80 percent of the competitive set's average. However, I think most companies could accept a more stringent hurdle for four reasons: **(1)** a market downturn would affect all hotels situated in a particular location (so comparable hotels would also be suffering); **(2)** the performance test would

[11] ManavThadani and Julie S. Mobar, "HVS Management Contract Survey," August 2014 (www.hvs.com/article/7025/excerpts-hvs-hotel-management-contract-survey-%E2%80%93-usa/).

be suspended in the event of *force majeure*; **(3)** the failure to pass the performance test usually must continue for a period of at least two consecutive years; and **(4)** the operator often has the option to cure—to make the owner monetarily whole, as if the failure had not occurred. All that said, arguably, performing at only 85 percent or even 90 percent of the average performance of a truly competitive set, over a two-year period, does justify termination.

Regardless of specific contract provisions, owners may still terminate without cause in some instances, whether under common law principles or without specific legal precedent. Applying common law principles relating to agency and personal service contracts, courts in the United States have consistently held that owners have the right to terminate a hotel management agreement without cause, for example, in cases involving Fairmont and Marriott.[12]

In the Fairmont case, the court allowed contract termination using agency law principles. The court observed: "The notion of requiring a property owner to be forcibly partnered with an operator it does not want to manage its property is inherently problematic and provides support for the general rule that a principal usually has the unrestricted power to revoke an agency." This logic is hard to challenge.

The Marriott decision drew from personal services law, rather than agency law.[13] While the court ruled that the parties' management agreement was not an agency agreement, the court held that it was a personal services contract that was not enforceable by injunction. That is, the owner could lawfully terminate, leaving the management company to sue for damages. This is U.S. law, but presumably courts in other common law jurisdictions would give the U.S. precedents a fair amount of weight. English law appears to support the U.S. line of cases.[14] On the other hand, the relevant principles sometimes are modified by local legislation.[15]

The fact that the owner can terminate a management agreement without cause does not exempt that owner from damages payable to the management company. These could be significant, depending upon the contractual termination date of the agreement. Also, changing management companies is an expensive exercise, due to rebranding costs (which are extensive). However, an owner may deem the amounts payable to be a worthwhile expenditure to be rid of an unwanted operator.[16]

Courts have held that owners can terminate contracts, regardless of contract language, but may have to pay damages.

Finally, the rule of law is not present in every jurisdiction around the world. Even though the management agreement provides that, for example, New York or English law applies, and that any dispute should be arbitrated under international rules in a neutral forum, local authorities and courts may ignore these contractual provisions and allow the owner effectively to throw out the operator—on occasion by force. This certainly is not common, but it also is not unprecedented—in the fairly recent past, operators have been summarily removed in Caracas, Venezuela, and Curaçao.

The Caracas case concerned a Four Seasons hotel, and the Curaçao case concerned a Hyatt. In both cases the ousted operators sought legal redress. Four Seasons won an arbitration award for damages, but research has failed to reveal the outcome of the Curaçao litigation, except that Hyatt failed in a bid to be reinstated as the operator.

The Non-Disturbance and Attornment Agreement

Both in the United States and in the international arena, management companies place enormous weight on having the owner obtain a Non-Disturbance and Attornment Agreement (NDA) from the party providing debt financing for the deal. Under an NDA, the lender is required to keep the management company in place in the event that the lender forecloses and takes control of the hotel. Such an arrangement of course is designed to protect the operator if the lender does in fact seize the hotel due to a payment default by the owner.

12 *Woolley v. Embassy Suites Inc.*, 227 Cal. App.3rd, 278 Cal. Rptr. 2nd 719 (Cal. Ct. App. 1991); *Pacific Landmark Hotel, Ltd. v. Marriott Hotels*, Inc., 19 Cal. App.4th 615, 23 Cal. Rptr.2nd 555 (Cal. Ct. App. 1993); *Government Guarantee Fund of the Republic of Finland v. Hyatt Corporation*, 95 F.3rd 291 (3rd Circuit 1996); FHR TB LLC et al. v. TB Isle Resort LP, 865 F. Supp.2nd 1172 (S.D. Florida 2011); and *Marriott International, Inc. v. Eden Roc LLP*, 104 A.D.3rd 583 (2011).

13 *Marriott International, Inc. v. Eden Roc LLP, supra.*

14 For example, see: *Frith v. Frith*, House of Lords [Privy Council] (1906) (The Law Reports, Appeal Cases, page 254); and G.H.L. Fridman, *The Law of Agency*, 7th Edition (London: Butterworth, 1996).

15 For eample, see: Maryland Code, Commercial Law Sections 23-102 and 23-104.

16 For example, in 1994 the owner of the Hong Kong Hilton, Hutchison Whampoa, wished to demolish the hotel and build an office tower. The management agreement, signed in 1963, was a fifty-year agreement and had about twenty years to run. To terminate the management agreement, Hutchison Whampoa paid Hilton the sum of US$125 million, but apparently Hutchison Whampoa thought this amount was justifiable under the circumstances, with the expectation that the office building would be of far greater value. See: Hsu and Halloran, p. 48.

Most contracts provide for ramping up fees early on.

I do not see this protection for the operator as being absolute, and depending on the country where the hotel is located, and on the governing law, it can easily be set aside. Thus, I argue that management companies should not obsess in every case over whether an NDA can be obtained, even though I see this occurring frequently.

Slim protection. Here's why an NDA does not always provide the expected protection for management firms. First, lenders to international hotel projects are often local banking institutions who simply will not sign an NDA, as the concept is essentially an American one and may not be recognized in the subject jurisdiction. Second, under some bankruptcy regimes, a court can set aside a burdensome or onerous contract, no matter what that contract may say about termination. If the court deems the management agreement to be detrimental to a bankruptcy workout, the court may order it terminated. Third, as a lender essentially steps into the shoes of the defaulting owner, if some form of common law governs the owner-operator relationship, the lender may terminate the management agreement under legal principles relating to agency and personal service contracts (although damages could be payable).[17]

In a situation where it is uncertain whether the lending institution will sign an NDA, I believe it is preferable for the operator to impose an obligation on the owner to use its "best efforts" to obtain the NDA, rather than for the operator to walk away from the deal because the owner cannot make an absolute commitment that an NDA will be obtained.

[17] See: *Government Guarantee Fund of the Republic of Finland v. Hyatt Corporation, supra;* and Mondrian Soho-Morgans Hotel Group case in the New York Supreme Court (Morgans Hotel Group v. German American Capital, case number 653255/2014).

Fees

The traditional, and still normal, management-only fee structure calls for a basic management fee that is a percentage of gross revenue, plus an incentive management fee that is a percentage of gross operating profit (GOP) or adjusted gross operating profit. The adjustments, or the expenses to be deducted in calculating operating profit, are a matter of serious negotiation. Although I've seen wide variations, relatively common percentages are 2 percent of gross revenue and 8 percent of gross or adjusted gross operating profit. Again, I hesitate to generalize. It is not unusual, for example, for different percentages to apply depending on the ratio of operating profit (gross or adjusted) to gross revenue.[18]

The economic concept for the dual fee structure is that the basic fee, which is not strictly performance related, will help to cover the management company's reasonable overhead, while the incentive fee will reward good performance, thus aligning (in theory) the interests of the operator and the owner. In some cases, however, the entire fee is based upon operating profit, resulting of course in a higher percentage of operating profit being due to the operator.[19]

Aside from the actual percentages to be used, the basic areas of fee negotiation relate to **(1)** stepping up the fees over time, **(2)** fee deferrals, and **(3)** what is taken into account when "operating profit" is computed. Hotel accounting worldwide is generally done in accordance with the *Uniform System of Accounts for the Lodging Industry (USALI)*.[20] However, the practices set out in the *USALI* are not carved in stone and may be altered by agreement between the owner and the operator.

Stepped up fees. After a hotel opens, usually three or even four years go by before operations stabilize and average occupancy and room rates reach the anticipated levels. To allow some breathing room for the owner, who must service debt from day one, the fees may be increased gradually in the first three or four years, before the final numbers kick in. Outright fee deferrals may also be included as part of an operator's financial support, as I discuss below.

Concerning the calculation of operating profit, historically the incentive fee was based on GOP, a somewhat artificial calculation where costs deemed to be operating expenses were deducted from gross revenue. So-called owner's costs, such as building and contents insurance, real estate taxes, and the reserve for replacement of and additions to furnishings and equipment, were not deductions. The theory was that the incentive fee should be measured by reference to those costs that the operator could control, and not those for which the operator was not responsible (considered to be fixed charges). Of course,

[18] Thadani and Mobar, *op.cit.*

[19] *Ibid.*

[20] American Hotel and Lodging Association, *Uniform System of Accounts for the Lodging Industry*, Eleventh Edition (Lansing, MI: AHLEI, 2014).

many expenses supposedly under the control of the operator are actually not variable, which is why the gross operating profit calculation is to a degree artificial.

Over time, owners have increased pressure to include additional costs in the incentive fee calculation, thereby lowering the adjusted gross operating profit. Simple GOP is now found less commonly. Of course, this remains an area for hard negotiation, and again sweeping generalizations are not appropriate. Certainly, the owner's head office overhead, debt service payments, and income taxes are not taken into account when the incentive fee is calculated.

Fees are often characterized as being partly for management services and partly as a royalty for the license of the brand, trademarks and trade names, knowhow, and proprietary technology. Interestingly, market forces generally dictate that even though each deal is subject to negotiation, the quantum paid by the owner and received by the management company does not differ greatly from one deal to another, at least within the same geographic area for management agreements negotiated in the same general time frame.

Control, Employees, and Budgets

The management company's control over the property has been an area of considerable evolution. At one time management companies had so much control over the operation of the hotel that their executives joked that if the owner wanted to have a coffee in the café, he had to pay for it. Now, the degree of control to be exercised by the management company is heavily negotiated. As a result, owners generally are entitled to receive and comment on detailed monthly reports, to approve portions of the annual plan (which contains the budget for the ensuing year), to approve the hiring and request the dismissal of senior hotel employees, to approve capital expenditures, to hold monthly meetings with the hotel's general manager, to approve material contracts, to approve any contracts that the operator may wish to enter into with an affiliate, to approve the engagement of lawyers and auditors, and to approve the institution of litigation. By no means is this list exhaustive.

Almost invariably all hotel employees are employees of the owning company, although senior managers are supplied from the pool of managers originally recruited by the hotel management company and then rotated periodically through the management company's hotels. Though these managers may owe their primary loyalties to the management company, their remuneration is tied to hotel performance, and these managers have a strict fiduciary duty to the owner, as does the management company.

Generally, much time is spent during negotiations debating approval rights relating to the annual budget for the ensuing year. This budget is prepared by the hotel's management team, sent to the management company's regional or head office for approval, and then sent to the owner for the owner's "comments and suggestions." Management companies are loath to give full approval of the annual budget to the owner, but during negotiations the owner normally gains a fair amount of influence and, in practice, the management company and the owner are usually able to agree on the budget. Finally, as a practical matter, the owner is given a great deal of respect and authority by the management company, as owner–operator wars are extremely unhealthy, and a happy owner may well become the developer or owner of more hotels to be operated by the management company.

This issue is normally not as critical in the international arena as in the U.S. The international owner knows or suspects that his or its opinion will ultimately enjoy the respect of the management company, since having a good relationship between operator and owner is critical. In the U.S., on the other hand, the relationship between the operator and the owner is often more generally fractious (big management company vs. big financial institution), and thus the issue of approval rights generally occupies a great deal of negotiation time.[21]

> Financial support from operator to owner has taken many forms, including an outright "gift."

Operator Financial Support

Operators signing management agreements have often provided some form of financial support from the beginning. Although the standard hotel management agreements offered by hotel management companies call for a simple operator–owner relationship, with fees payable to the operator, owners often negotiate successfully for some level of financial support from the management company, if only to provide cash flow during the pre-stabilization period.

For a time, this financial assistance sometimes took the form of an equity contribution to the entity that would develop and own the hotel. In most cases, this contribution represented a small percentage of equity, as the primary intent was for the

[21] See: deRoos, *op. cit.*

Owners cannot negotiate away system charges, but the amount of those charges usually reflects the market.

operator to have "skin in the game." However, this practice is rarely seen today, because **(1)** a "sliver" shareholder can be a nuisance to the other, major shareholders, **(2)** a shareholding gives the operator additional control over the asset, and **(3)** with the operator having a financial interest in the owning entity, terminating the operator without cause becomes much more difficult.

Operators sometimes offer simply to provide "key money" to secure a management agreement. This is a straightforward payment to the developer-owner (often called in the industry the "Goldman Gift," after its principal proponent). Whether this "gift" can be recovered if for some reason the management agreement is prematurely terminated depends on the specific contract arrangement. Some management company development officers view key money as a simple way to expand the chain without prolonged and complicated negotiations. To me this sounds like such officers certainly are more focused on earning bonuses for adding properties than on choosing deals that will have the best benefit to their management company. Frankly, it is not difficult to negotiate an alternative to the Goldman Gift or at least to negotiate a claw-back of the key money payment. Drafting claw-back contractual provisions is not complex.

Another method is for the operator to provide a mezzanine loan that would be subordinated to the senior loan from the owner's primary lender. Again, this increases the difficulty of terminating the operator, and also places on the operator an unwanted risk from nonperforming loans.

Capped operator guarantees are not unheard of, but are not popular with operators due again to the unwanted assumption of risk, even with claw-back mechanisms.

Owner's priority. Perhaps the most popular, easily workable, and fair concept today is the stand aside, or owner's priority arrangement. Under this provision, before the operator can take its annual incentive fee, the owner must receive a certain minimum amount of adjusted profit, or even cash flow. This gives the owner some comfort that its debt service obligations will be satisfied, but at the same time the operator has no obligation to provide funds from its own pocket. Also, this method does not give the operator a financial interest in the hotel, which makes termination of the operator less problematic. In any event, usually the incentive fee is described as being deferred, and is payable later (with or without interest) when and if the annual adjusted profit or cash flow exceeds an agreed-upon sum.

System Charges

In addition to receiving the basic and incentive management fees, hotel management companies impose system-reimbursable charges. Hotel operations are charged for such services as worldwide marketing, reservations, training programs for hotel personnel, visits by management company specialists, regional and worldwide meetings, and proprietary software.

In imposing system charges, identical charging formulas must be used for every hotel in the chain, no profit element should be present in the charges, and the management company should provide evidence, usually in the form of an audited statement, that the charges are being imposed as agreed. The operator may alter the charging formulas unilaterally, so long as every hotel in the chain receives the same treatment. Perhaps the only available explanation for why such fees are not included in the basic management fee is that this is a long standing practice that owners cannot negotiate away.

Although all major chains have comprehensive system charges, market forces generally serve to keep system charges in check. A chain cannot charge significantly more than its competitors. Chains also must keep charges in line because many services are now available more cheaply from third-party providers (for example, training and reservations). Additionally, new entrants to the management company scene can and do gain a competitive advantage by keeping their system charges lower than the charges imposed by the majors, thus causing the established operators to re-assess their charging formulas. Having said the foregoing, I must acknowledge that system charges are almost always a bone of contention between the owner and the operator, and management companies must be careful not to overreach.

Fiduciary Duty

The management agreement should make it plain that the operator owes a strong fiduciary duty to the owner, even though this is implied in agency law. I know of no jurisdiction where the service provider does not owe a fiduciary duty to the client.

Unfortunately, the presence of system charges creates the potential for the operator to breach its fiduciary duty to the owner. Because some operators offer third-party services and goods to their managed hotels, on top of system charges, and because senior hotel executives who are appointed by the operator control the bank accounts, there is ample room for operator abuse. There has been considerable litigation concerning operator abuse in the United States, with several notable cases having been settled on confidential terms.[22] Certainly, in the international arena owners should watch the operators carefully, and operators should be diligent in observing their duties to the owner.

Replacement Reserve

No hotel can go too long without being refreshed. Therefore, management agreements call for a certain percentage of gross revenue to be set aside and placed in a dedicated replacement fund to purchase replacements of and additions to furnishings and equipment. This reserve is also a topic of bargaining, since owners may see it as siphoning off cash flow (even though the reserve is essential). Historically the common percentage for the replacement fund has been 3 percent, but 4 percent has always been more realistic, and operators typically bargain for that level. Since renovations can wait for some time after opening, usually there is a step-up in the percentage of gross revenue that goes into the replacement fund (say, 2 percent in the first year, 3 percent in the second year, and 4 percent thereafter).

The replacement fund is absolutely the property of the owner, but normally the fund is under the control of the operator, who will deploy the funds as required by the hotel's annual budget. On rare occasions, when the owner of the hotel is known to the operator and is demonstrably solvent, the fund may be placed under the owner's control, with the operator having the right to call for funding as contemplated by the budget.

Reserves for replacement are rarely sufficient to cover a major refurbishment, which typically will be needed after seven or eight years, depending upon the volume of hotel use and the agreed-upon quality standards. Hopefully by the time an owner needs to provide additional funds for a major refurbishment, the hotel will be producing a healthy net profit, so as not to inconvenience the owner unreasonably. If all goes well, the funds spent on the refurbishment should be recoverable by virtue of higher occupancy and room rates after the hotel has been revitalized.

Sale of the Hotel

Even the prospective sale of the property is a topic of negotiation between owner and operator (and the party providing financing also has an interest in this discussion). For its part, the management company would want the right to veto any sale of the hotel, on the grounds that the management company is entitled to protect itself against having an unfamiliar, difficult, unsavory, or undercapitalized new owner. By the same token, the owner would like to have the right to sell the hotel without the burden of the management agreement, as this would increase the universe of buyers. Some potential buyers could be linked to other management companies, and most would wish to renegotiate the existing management agreement, to make it conform to prevailing market terms or to satisfy a particular concern that the buyer may have. The normal compromise is to allow the owner to sell the hotel to any well capitalized, reputable party willing to accept the management agreement with no material changes.

[22] For example, see: *2660 Woodley Road Joint Venture v. ITT Sheraton Corp.*, 369 F.2nd 732 (3rd Circuit, 2004); and *In Town Hotels Limited Partnership v. Marriott International Inc.*, 264 F. Supp. 469 (S.D.W.Va. 2003).

Geographic protection is often a point of contention between operator and owner.

Area Protection

Most hotel operators will agree to an owner's demand for a limited area of protection for the identical brand, but the challenge comes when the management company wants to locate one of its other flags near the hotel in question.

From the owner's perspective, a well-crafted area of protection clause would prevent the management company from operating another hotel in the protected area using any of its brands, since the two would at a minimum have reservation systems and loyalty programs in common, and could compete for the same accounts. Moreover, owners generally do not buy the management companies' argument that if there is to be a second hotel nearby in any event, the competing property might as well be a different brand from the same management company, since there's at least the prospect of controlling the competition. Owners would correctly see this as merely an effort by the management company to freeze out competitors' brands.

Again, a well crafted protection clause would prevent a management firm from locating one of its other brands nearby, but even if there are loopholes in the area of protection clause, it is not certain that a management company can do an end run around the clause by using a different brand.[23] In the KMS case,

[23] *P.T. Karang Mas Sejahtera v. Marriott International Inc., et al.*, Civil Action No.: 8:05-cv-00787-PJM (U.S. District Court for the District of Maryland, 2008). An excellent discussion of the KMS case and its import can be found in: Chekitan S. Dev, John H. Thomas, John D. Buschman, and Eric Anderson "Brand Rights and Hotel Management Agreements: Lessons from Ritz-Carlton Bali's Lawsuit against the Ritz-Carlton Hotel Company," *Cornell Hospitality Quarterly*, Vol. 51, No. 2 (May 2010), pp. 215-230.

Owners generally must indemnify the operator, except in cases of gross negligence or misconduct.

for example, a jury in the United States found, *inter alia*, that the defendant management company violated an area-of-protection clause, allowing termination of the management agreement, even though the second hotel carried a brand name and style that was quite distinctive from the first hotel.

One approach that might be acceptable to an owner is for the management company to put a low- or mid-tier property near a hotel with a top-tier brand, since those would not compete directly. So, some latitude should be given to a management company wishing to put two different brands in the same geographical area if the company can demonstrate that those brands have entirely different target markets.

Indemnification

Standard management agreements call for the owner to indemnify fully the management company from almost any liability imaginable, while the management company wishes to give back only limited protection to the owner.

Typically, the owner must indemnify the management company against loss unless the management company has been guilty of gross negligence or willful misconduct. In all other situations where the operator suffers a loss, regardless of the culpability of the operator, the owner must hold the operator harmless. Conversely, the management company need only indemnify the owner when the management company is guilty of gross negligence or willful misconduct.

This seems unfair, but it must be understood that large management chains operating throughout the world, often with headquarters in the United States, are much better targets for legal action than special purpose entities established solely to own a hotel. Also, management companies insist that their managed hotels carry comprehensive insurance policies, and in addition, the management companies have worldwide umbrella policies in case a local policy issued to a hotel is insufficient. In other words, regardless of fault, losses due to negligence would almost always be covered by insurance.

Governing Law and Dispute Resolution

There seems to be no hard and fast rule when it comes to designating the governing law should disputes arise. From a lawyer's perspective, there is a good argument to specify a sophisticated legal system with well established principles of law. On the other hand, there is a good argument that the hotel's local law should apply. Each side to the negotiation should conduct some legal research on matters such as the right to terminate and fiduciary duties, before agreeing to the governing law. A good deal of operator–owner litigation relates to the early termination of a management agreement, where the termination was not made pursuant to a contractual performance test or pursuant to some other contractual right of the owner. Thus, the parties must resolve whether they are governed by the laws of a common law jurisdiction, due to the agency and personal services contract principles previously discussed.

Many contracts provide for arbitration in a neutral country, although international arbitrations are becoming increasingly costly and time consuming. Even though efficiency and finality are no longer guaranteed, arbitration is still favored by most management companies, and I don't see many international owners being overly concerned about where the arbitration might take place, or under what rules. Of course, neither party wants the arbitration to take place in the other party's backyard, and the arbitration needs to be in a jurisdiction that has the appropriate arbitration machinery.

Restricted Persons and Anti-Corruption Provisions

Over the years, an elaborate set of laws, rules, and regulations have evolved to battle illegal activities, including corruption, and to enforce sanctions and other penalties imposed for various reasons on nations, companies, and persons. The United States, the United Kingdom, and the OECD all have their own complex regimes. The U.S. Office of Foreign Assets Control (OFAC) regulations, and the U.S. Foreign Corrupt Practices Act, are particularly far-reaching (some would say onerous, as I discuss in a moment).

Long lists have been compiled of nations, companies, and persons that are considered, for one reason or another, to be taboo—unworthy of doing business with, for legal, ethical, or policy reasons. Thus, companies based in the U.S., U.K., and other Western nations are required to vet thoroughly their prospective owners and any prospective buyer (as well as any other prospective business associates). Those prospective owners, buyers, or other business associates must not be on a restricted list, or controlled by a person or entity on a restricted list. If a management company does end up doing business in a restricted country or with a restricted person or entity, severe penalties can ensue. This has become such a matter of concern that complex software now exists to determine whether a particular country, person, or entity is restricted or somehow connected or associated in any way (however remotely) with a restricted country, person, or entity. The OFAC rules are extremely comprehensive and can have a chilling effect. Some completely honest and reputable owners simply do not want to allow the U.S. government to examine their investment strategies or, with respect to individual owners, their estate planning.

An equally problematic area concerns anti-corruption laws, such as the U.S. Foreign Corrupt Practices Act. Clearly, fighting corruption is laudable, and no management company can justify paying bribes under any circumstance. It must be recognized, however, that in many countries around the world the wheels of commerce do not turn without ample grease. I believe that a management company can easily avoid a direct violation of anti-corruption laws, but it is extremely difficult to police a developer-owner in a country where corruption is endemic. I cannot provide an answer to this dilemma, except to say that the Western anti-corruption authorities are aware of the problem and in all likelihood have a modicum of sympathy for companies that do business in countries where corruption is tacitly accepted as being a part of everyday life.

In fact, in November 2012 the U.S. Justice Department and the Securities and Exchange Commission published a 130-page document in an effort to respond to complaints from businesses that ambiguity in the Foreign Corrupt Practices Act was forcing companies to abandon business in high-risk countries and to spend millions of dollars investigating themselves.[24]

24 U.S. Department of Justice, "A Resource Guide to the U.S. Foreign Corrupt Practices Act," November 2012 (www.justice.gov/criminal-fraud/fcpa-guidance).

A Two-way Street

While today's international hotel management agreements still bear a strong resemblance to those used as early as the 1960s and as late as the 1990s, they have evolved extensively in the last twenty years and now involve many more areas of negotiation than were contemplated by Hilton International when the deal for the Hong Kong Hilton was made, let alone when the Caribe Hilton opened. In that deal, Hilton rented the property from the government of Puerto Rico at a cost of two-thirds of GOP, meaning that the remaining portion of the profits was retained by Hilton.[25]

As a basic matter, I see a reasonable balance today between the owner and the operator in the international arena, except perhaps in the area of risk allocation. Greater sophistication on the part of owners, general market pressures, and the presence of alternative sources for many services previously offered only by chain management companies, plus a handful of court decisions, have eroded the heavy advantage that the management companies once enjoyed. It is still true however that owners bear almost all the financial risk in a hotel enterprise, and it is unlikely that there will be any dramatic change in the near future. ■

25 Strand, p. 84.

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