5th edition

The HMA & Franchise Agreement Handbook

Hotel Management Agreements & Franchise Agreements for Owners, Developers Investors & Lenders

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&

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Owners, Developers,
Investors, Lenders & Operators

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We wrote the book™ series:

- The HMA & Franchise Agreement Handbook
- How to Buy a Hotel Handbook
- The Developers EB-5 Handbook
- The Lenders Handbook for Troubled Hotels
- The ADA Compliance and Defense Guide

Dedicated to levelling the playing field for
hotel owners, developers,
investors, lenders and operators.

Highlights in the new edition of the HMA & Franchise Agreement Handbook

The 5th edition of the HMA & Franchise Agreement Handbook has been updated and expanded to stay current with the latest important developments in the hotel industry, including the following:

- Maryland law changes historic rights and remedies in HMA and franchise litigation
- How to get a great hotel operator and a fair HMA
- The five biggest mistakes hotel owners make
- When should you choose a brand an independent operator for your hotel?
- Eight things to negotiate in your next franchise agreement
- Comfort letters in financing franchised hotels
- The two sides of dual-branded hotels
- Why most long-term hotel management agreements may now be terminable

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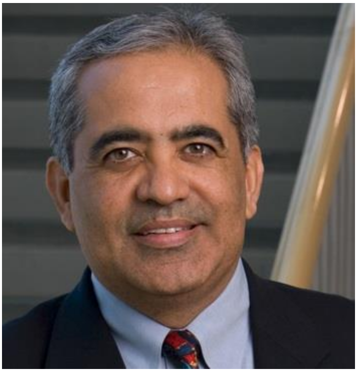

Jim Butler, Bob Braun and Mark Adams have delivered another edition of their hotel management and franchise agreement 'Bible' for owners, lenders, brands, and operators.

The new edition of their handbook totally satisfies my 3Cs: it is complete, current, and comprehensive. The book has everything you need to know about the subject, it is up to date with all the current topics relating to HMAs and franchise agreements, and it covers each topic very thoroughly.

The book is well organized, contains many insights and guidelines informed by their many years of exemplary practice, is full of tips to follow and traps to avoid, and has several thoughtful and useful checklists.

The HMA and Franchise Agreement handbook is a 'must read' for anyone interested in or involved with the creation, negotiation, administration, litigation or study of hotel management and or franchise agreements.

Dr. Chekitan S. Dev
Ithaca, New York
January 2023

Dr. Chekitan S. Dev, the Singapore Tourism Distinguished Professor at Cornell University's Nolan School of Hotel Administration, has testified as an expert witness at trials and arbitrations in numerous hospitality-related matters. An award-winning teacher and author, Dr. Dev wrote Hospitality Branding (Cornell University Press), as well as over one hundred articles in leading academic and practitioner journals, including the Cornell Hospitality Quarterly and the Harvard Business Review.

Foreword by Jan A. deRoos

Why a Practical Guide is Relevant and Needed by the Industry

Over the past 70 years, hotel owners and hotel brands (and independent operators) have developed important relationships based on the considerable value they provide to each other: one provides the real property and the other the intellectual property that together make a successful hotel.

Not surprisingly, a sophisticated and legally intricate system of management agreements (HMAs) and franchise agreements has evolved to govern how hotel owners contract with the branded or independent managers who operate, brand and have long-term control of the hotel's assets.

Fortunately, The HMA & Franchise Agreement Handbook by Jim Butler, Bob Braun and Mark Adams provides an excellent and invaluable guide to understanding the important and complex arrangements created by HMAs and franchise agreements. Now in its fifth edition, the work is revised and updated with an understanding that the great questions never change, but the answers do.

The detailed discussion of HMAs and franchise agreements by Butler, Braun and Adams is refreshingly direct and candid. It is written for businesspeople in easy-to-understand language. And it provides owners, developers, investors and lenders with pragmatic counsel that only comes from intense hands-on experience with hospitality matters that comes from representing many clients over a long period of time.

Today, the names of many hotel owners and hotel operators are recognizable throughout the real estate capital markets. But it is not necessarily the case that the party with the greatest market capitalization or success in other categories of real estate has the greatest power in negotiating an HMA or franchise agreement.

The Fifth Edition by Butler, Braun and Adams provides essential information that will help owners, developers, investors and lenders understand the far-reaching impacts of their HMAs and franchise agreements, and the important points that can and should be negotiated.

This version of The Handbook has been revised extensively to reflect a recent sea change in the hotel industry — the proliferation of franchise agreements, which have become increasingly negotiable. Hotel management agreements continue to be critical for luxury properties, resorts and larger properties. But for bread-and-butter hotels and the hot select service segment, owners and brands are placing more importance than ever on franchise agreements. This shift also raises issues of when to use independent operators and the more favorable terms that may be negotiated with them.

The authors' objective of providing the keys for "breaking the code" to HMAs and franchise agreements is fully realized in this important work. In addition, by freely distributing this work, they have committed to educating a broad audience with relevant and current practice. I commend Butler, Braun and Adams for their excellent and invaluable book.

Jan A. de Roos, PhD
Ithaca, New York
January 2023

Jan de Roos is the HVS Professor of Hotel Finance and Real Estate Emeritus at Cornell University's Nolan School of Hotel Administration. He is co-author of The Negotiation and Administration of Hotel Management Contracts, long considered to be the industry's seminal academic reference on hotel management agreements. The current fourth edition (2009), co-authored with James Eyster, is available via Amazon.

The HMA & Franchise Agreement Handbook is available electronically through hotel.law/HMA-Handbook.

Preface by Jim Butler

The HMA & Franchise Agreement Handbook traces its roots to the Hotel Law Blog

The HMA & Franchise Agreement Handbook is drawn from articles which have appeared on www.HotelLawBlog.com, with edits and revisions to bring them up to date.

Since the first edition of the handbook, hotel management agreements, or HMAs, have continued to be critical to the value of hotel assets; however, hotel franchise agreements have become more important than ever, and savvy investors are paying greater attention to getting better operators and better HMAs.

As we revised and updated our original edition, we included chapters on franchise agreements, brands and independent management agreements, and sections on how long-term, "no-cut," branded management agreements might be terminable. Brands have increased their reliance on the franchising model and limited the branded management agreement model to key strategic assets or flags. As a result, the relationships between brands, independent managers, lenders and owners have become more complicated. In this 5th edition, we have completed a comprehensive update and expansion to deal with constantly changing circumstances and strategies.

All the hotel lawyers of JMBM's Global Hospitality Group® join me in hoping that *The HMA & Franchise Agreement Handbook* will be useful to you and your colleagues. Please contact us with any experiences or thoughts you would like to share. We always love to talk with our industry friends on "what it all means" and to see if there is any way that our resources and experience might help you accomplish your goals.

Jim Butler
Author of www.HotelLawBlog.com
Founding partner of Jeffer Mangels Butler & Mitchell LLP
Chairman of JMBM's Global Hospitality Group®
Founder and Conference Chairman, Meet the Money®

Introduction

Why your hotel project needs hotel experience ... because hotels are different!

Hotels are different. And so is dealing with them — whether in negotiating, litigating, or arbitrating hotel management agreements; buying, selling, developing, financing or refinancing transactions; or in workouts, bankruptcies or receiverships. Hotels require different experience, strategies and documentation.

The lawyers of JMBM's Global Hospitality Group® are regularly surprised to see how badly world-class lenders or investors stumble with hotel assets. These players are often guided by some of the "best law firms in the country" — top Wall Street law firms with international reputations. These legal giants may be ideal for a complex real estate project or corporate finance project because they have more experience in these areas than other firms. But hotels are NOT real estate or corporate finance, and however good these firms may be in other areas of law, their lack of hotel-specific experience fails them — and their clients — when it comes to hotel transactions.

We continue to see value that is irretrievably lost, due to this lack of hotel industry experience at the outset in formulating the strategies and goals. Unfortunately, strategies and campaigns launched on the battlefield — whether in workouts, litigation, acquisitions, or financing — are too often irreversible. Once you have tripped past a decision point, you cannot go back!

The HMA & Franchise Agreement Handbook is intended to be a helpful resource for the friends and clients of JMBM's Global Hospitality Group®. But please listen carefully to this suggestion: If you don't have the hotel-specific experience you need for your hotel matters, then find a way to get it! We would be glad to discuss with you how the experience we have gained over more than 35 years and more than $123 billion of hotel transactions might provide exactly the guidance or power you need to get the result you want.

Getting started — terminology

Here is something of a glossary for deciphering the coded terms used with HMAs and franchise agreements:

Hotel managers and hotel operators. In the hotel industry, the professional companies that operate hotels are interchangeably referred to as hotel managers, hotel management companies, hotel operators, or hotel operating companies. These terms have the same meaning, and for a little variety, we may use these terms interchangeably.

A hotel brand, branded management and independent operators. A hotel brand company owns the trademark, tradename and other protected intellectual property rights associated with the brand's use in the hotel industry. This hotel brand company may or may not be associated with a hotel management company. For example, Marriott, Hilton, InterContinental, Hyatt and many other hotel companies own the intellectual property associated with one or more brand names. They can independently license the use of their brand name under a license or franchise agreement, or include the right to use the name in the HMA when they manage a hotel.

Hotel companies that own these brands are often called "the hotel brands" or just "brands." Some of these brands, such as Choice Hotels and Best Western, only license their brands and do not operate hotels. Other brands which offer hotel management services are usually called branded operators or branded hotel managers. They often manage some of their brands but not others.

In contrast with branded hotel operators, a large number of hotel operators do not own or do not license any hotel brands to identify hotels to the public. Instead, they specialize in operating hotels (either branded under some other company's franchise or unbranded). This latter group of operators without brands are often called independent operators as they are independent of the traditional hotel brands.

Hotel Management Agreements (HMAs) and their ilk. Contracts between hotel owners and hotel operators controlling the management of a hotel go by various names. They are called hotel management agreements, HMAs, hotel management contracts or hotel operating agreements. For convenient reference, in this book, we will generally use the term "Hotel Management Agreement" or "HMA." Again, each of these terms means the same thing.

HMAs allocate risk. Whatever they are called, Hotel Management Agreements allocate risk between the hotel manager and the hotel owner. Many provisions in the HMA do this, including reimbursement obligations, termination rights, performance standards, indemnification obligations, and subordination provisions. One type of "subordination" is an economic subordination, as where a manager agrees that all or a portion of its base or incentive fee will be subordinated (paid only after) to an owner's preferred return. Another type of subordination is discussed below under SNDAs.

Franchise or License Agreements. When brands grant the right to operate a property under a brand name, they do so under a franchise agreement, which is also often interchangeably referred to as a license agreement. In this book we generally use the terms "franchise" and "franchise agreement," but we might just as well have used "license" and "license agreement" as these terms mean the same thing. Whatever label is used, franchises are regulated by the Federal Trade Commission. In many cases they are also registered with state regulators and are subject to a number of disclosure requirements and substantive regulation. Franchise agreements are traditionally less negotiable than management agreements, but as we discuss in Chapter 3, a number of very important terms can be negotiated.

SNDAs. SNDAs are agreements between a hotel operator and a hotel mortgage lender governing the lender's right upon a foreclosure on the hotel, including protection of the hotel manager's right to continue to manage the hotel after foreclosure. For our purposes the following three terms are identical in meaning and fully interchangeable in the context of hotel operating agreements: SNDA, Subordination Agreement, or Subordination, Non-Disturbance and Attornment agreement (from which the SNDA acronym is derived).

Subordination Agreements are frequently used with various types of real property when someone other than the owner is occupying or using the property secured by the lender's loan. In the hotel industry, this arrangement involves the hotel owner, the hotel operator and the hotel lender. Since the lender's joint agreement is required, typically the HMA will specify that these three parties will execute an SNDA (as a free standing agreement) prior to placing any lien on the hotel. The terms of the SNDA may be specified in the HMA, set forth in an attached exhibit, or required to conform to the requirements of the hotel operator.

SNDAs are potentially so important that we have devoted an entire section to them, and several sections refer to them. (See *SNDAs or Subordination Agreements affect the value, financeability, and collateral value of a hotel*, page 58).

Comfort Letters. Brands generally do not enter into SNDAs for franchised properties; they enter into (and lenders typically require) "comfort letters," which are agreements that define the rights of lenders and the brand if the owner defaults under a loan secured by a franchised hotel. These agreements can have a meaningful impact on the terms that an owner may obtain from a lender, or on a lender's rights in the event of a default. Considerable care should be given to negotiating their terms. (See *The importance of Comfort Letters in financing franchised hotels*, page 80.)

HMAs and franchise agreements can dramatically affect the value, financing, operations, and marketability of a hotel.

This *HMA & Franchise Agreement Handbook* addresses a broad range of subjects on how to get a great operator and hotel management agreement, critical terms of a hotel management agreement, and how to terminate a bad hotel operator. It will also cover selecting the right brand, negotiating a franchise agreement, selecting an independent operator, and important comfort letter issues.

About the authors

Jim Butler is one of the top hospitality lawyers in the world (Google™ "hotel lawyer" and you will see why).

Jim is the author of the Hotel Law Blog and Chairman of the Global Hospitality Group® at Jeffer Mangels Butler & Mitchell LLP (JMBM). For more than 35 years, Jim and his team have helped hotel owners, developers, investors and their lenders find business and legal solutions with their unequaled hotel experience gained over more than $123 billion of hotel transactions, involving more than 4,600 properties all over the world.

Jim and his team are more than "just" great hotel lawyers. They are also hospitality consultants and business advisors who help clients unlock and preserve value in hospitality properties.

The hotel management agreement and franchise agreement are intertwined with virtually every legal and business aspect of your hotel. They are the keystone affecting the most crucial components of your hotel's success, including financing, owner-ship structure, value and profitability, day-to-day operations and guest perception.

JMBM's Global Hospitality Group® has negotiated, re-negotiated, litigated and advised on more than 2,700 hotel management agreements and franchise agreements. We have current, state-of-the-art experience in successfully negotiating with virtually every major hotel management company and most of the independent operators.

A structural pillar of our hospitality power is our dominant management agreement and franchise agreement expertise.

Whether it is a troubled investment or a new transaction, JMBM's Global Hospitality Group® creates legal and business solutions for hotel owners and lenders. They are deal makers. They can help find the right operator or capital provider. They know who to call and how to reach them.

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Bob Braun is a transactional lawyer who has negotiated hundreds of hotel management, franchise and license agreements for owners, developers, investors and lenders. A senior member of the Global Hospitality Group® at Jeffer Mangels Butler & Mitchell LLP, Bob represents hospitality clients in both transactional and operational issues.

On a domestic and international basis, he is experienced in negotiating hotel management and franchise agreements, the purchase and sale of hotels, resorts, restaurants and other hospitality properties, providing counsel for a wide range of strategic and operational issues, and helping clients with troubled assets.

The agreements between the owner, brand and manager affect virtually every aspect of the hotel or resort property. Bob brings to the negotiating table a wealth of experience in hotel transactions and a deep understanding of the day-to-day operating issues of hotels and resorts, and related operations such as spas, restaurants, retail, residential components, golf courses and more).

Bob's recent experience includes negotiating the management agreement for a European mixed use development, including multiple hotels and food and beverage outlets, as well as residential, retail and commercial components; dual-branded luxury, upper upscale, upscale and extended stay properties; negotiating a management agreement for a mixed-use office, retail and ultra-luxury hotel property in a major metropolitan area; and facilitating the acquisition and branding of a series of hotels acquired by a lender in foreclosure. Bob has handled a transfer of management for a portfolio of 27 hotels to six separate management companies (and negotiated the related franchise agreements); represented the acquisition and assembly of a portfolio of 10 full-service and select-service hotels by an internationally recognized private equity group; and has overseen dozens of friendly and hostile transfers of brands and management of distressed hotel properties. Bob has also worked with clients to renegotiate and, in some cases, terminate HMAs and franchise agreements. As Co-Chair of the Jeffer Mangels Butler & Mitchell Cybersecurity and Privacy Group, Bob frequently advises clients on state, federal and international privacy, cybersecurity, data breach and information technology matters, and negotiates software, internet, e-commerce, data processing and outsourcing agreements.

Bob and JMBM's Global Hospitality team have decades of experience in helping owners preserve and enhance the value of their hotel properties through hotel management and franchise agreements. They are advocates who can level the playing field between hotel owners and hotel brands.

More than just great lawyers, the members of the Global Hospitality Group® are deal makers who bring solutions to every situation.

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Mark S. Adams focuses his practice on business litigation, including, contracts, products liability, corporate and partnership disputes, and hospitality litigation. He regularly litigates high-stakes shareholder and investment disputes. He has significant litigation experience in representing real estate developers and real estate investors. Mark has successfully litigated many high profile cases on hotel management agreements and franchise agreements, fiduciary duty issues, investor-owner disputes, TOT assessments, and other hotel-specific issues.

Mark has wide-ranging trial experience in commercial disputes, including complex multi-party litigation and class actions. He has tried numerous cases in state courts, federal courts, and in domestic and international arbitrations, and is a frequent author and speaker on trial practice. Mark's trial wins have been covered by *Forbes*, *Reuters*, *Life Science Weekly* and other publications. He has obtained two of California's annual 50 largest jury verdicts in the same year. Mark has taken or defended nearly 1,000 depositions throughout North America, Europe and the Middle East.

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Chapter 1

How to get a GREAT hotel operator

Maximizing hotel value with management, branding and franchise

Imagine this: You are getting ready to start one of the most important processes in your hotel's "life cycle" — selecting the hotel brand and operator and getting them under contract. Even if you are a major hotel owner or developer, how many management or franchise agreements do you do a year? Two? Five? Ten? And with how many brands?

Or, maybe you are a very experienced real estate developer or investor, but you haven't done many hotel deals, and don't want to fall into the traps some other smart real estate investors have when they failed to realize that hotels are different. You need to know (or have a guide to) the players, the norms and customs, and the practices of the hotel industry. How can you do that?

With JMBM, no one will make a fool of you. Our experience will help you confidently establish what is "market" on management or franchise agreement terms. We will help you strike a good deal and a fair one.

What if you could make one phone call to solve your problem? One phone call to instantly tap into these resources:

> **The "little black book" of hotel industry contacts** of a hotel industry insider, complete with relationships and credibility built over more than 35 years.
>
> **A virtual data base of terms and deal points** gathered over **more than two thousand** transactions with virtually every brand and operator, so you know when you are getting "market" terms.
>
> **Top business advisory *and* legal guidance** and protection at every step.

These are precisely the resources you can access with the hospitality attorneys of JMBM's Global Hospitality Group®. We have negotiated, re-negotiated, litigated and advised on more than 2,700 hotel management agreements and franchise agreements.

Hotel management and franchise agreements are intertwined with virtually every legal and business aspect of your hotel. They are the keystone affecting the most crucial components of your hotel's success, including financing, ownership structure, value and profitability, day-to-day operations and guest perception.

In fact, a branding and management agreement can easily create more than a 50 percent swing in the value of the hotel — and often much more! And, a long-term management or franchise agreement is difficult to "fix" once it is in place.

We can help you develop your own list of deal point priorities that you "must have," "want to have" and "would like to have." These may include a host of critical items, such as: performance clauses, termination rights, ramping up management fees, owner approval rights over operating and CapEx budgets, preferred returns for owners, and subordinated incentive fees for operators.

JMBM's Global Hospitality Group® has successfully negotiated with virtually every major hotel management company and brand. Our vast experience helps create value for your project.

Three of the most important things you will ever do for your hotel

Three of the most important things you will ever do for your hotel are selecting the right hotel brand, selecting the right operator, and negotiating a fair Franchise Agreement and/or Hotel Management Agreement.

At one time, virtually all of the upscale hotel brands were only available with a hotel management agreement. In this model, the hotel company grants the hotel the right to use its brand as part of the HMA that also gives the hotel company the sole and exclusive power to manage the hotel for a period of many years. There is no franchise or license agreement. In this arrangement, when you select the brand, you have selected the operator because there is a unity of brand and brand management. Although the power of the brand and effectiveness of operations are still separate considerations, ultimately the selection of one determines the other. This model of the so-called branded management agreement continues to be important today, particularly for luxury and upper upscale hotels, as well as hotel assets that are strategically important for a brand.

But over the last 20 years, particularly with the success of select service product, the alternative of the franchise model has spread from its economy segment roots. In fact, it has become prevalent for significant segments of the hotel industry, including full-service and upscale hotels. It was once unthinkable that an owner could franchise a Hyatt, Westin, JW Marriott or the like, but such franchises are now growing more common by the day as the major hotel companies embrace the franchise model.

In this franchise model, the selection of a brand is a completely separate process from the selection of an operator. Separate agreements will be required — a franchise agreement to get legal rights to use the brand to identify the hotel and an HMA to get an operator for the hotel property.

The successful matching of the brand and operator with an asset and its owner is an important determinant to the success of a hotel project. Finding the right brand and operator for your project —

and achieving reasonable terms in your franchise agreement and HMA — can make a significant and positive impact in key areas: hotel value, financing, and operational success. If you make a mistake, it is almost impossible to correct.

The terms of a branding and hotel management agreement can add — or subtract — a huge amount of value. As noted earlier, it is widely recognized that the business and legal terms of these arrangements — wholly apart from the operator's abilities — can create a 50 percent or more change in the value of the hotel. That is huge! Take a hotel nominally worth $100 million. By this industry rule of thumb, the hotel's value could easily swing $50 million (from $75 million to $125 million) depending on the brand franchise and/or management contract terms.

We have seen many situations where the ability to terminate a long-term hotel management agreement added significant value. In one recent case we handled, it added $41 million dollars to one luxury hotel. We have also seen cases where the ability to terminate would have doubled the value of the hotel, or at the very least, added $50 to $65 million to the value of the property.

Aside from the right "marriage" partners, the terms of the franchise agreement or management contract tying brand and management together is critical, because it will likely govern the relationship for decades and is hard to change once cast.

Impact of brand and operator on financing

Many lenders will not consider lending on hotels unless they are branded, and they may even have certain preferred brands and operators.

But a hotel management agreement can also effectively prevent financing or refinancing a hotel. Sometimes the contract requires operator approval for any financing, or prohibits leverage above certain specified levels. Sometimes a lender's inability to terminate the HMA on loan default will deter financing or otherwise raise the cost and adversely affect the terms of a financing.

Owners should not assume that operator approvals will be given if they are discretionary, and should not underestimate the impact a management contract can have on a lender or investor. Sometimes, the brand itself is not financeable.

Operators' and HMAs' effect on hotel operations

Under most branded hotel management agreements, the operator will have almost exclusive control over all aspects of a hotel property and operation — hiring and firing hotel personnel, setting rates and policies, sales and marketing, renovations, capital expenditures, collecting revenues and depositing them into accounts controlled exclusively by the operator.

Brand costs. Maintenance of brand consistency and power often varies. Brands and their reservation systems ebb and flow in their quality and ability to deliver room revenues. Brands have great power unilaterally to impose changes in standards that all system hotels must meet — new computer systems and software, new signage and logos, new or revised traveler loyalty programs, design requirements, promotions, and centralized services. Hotel owners frequently come to believe that the cost of these brand-imposed standards are simply not worth the benefit. Or they think the standards benefit the brand, but not the hotel.

Owner approval rights. The owner's ability to control runaway costs and require appropriate efforts to drive the top line, when necessary, largely depend upon "approval rights" over critical matters like annual operating budgets, marketing plans, capital expenditures, entering into union or other major contracts, personnel hiring and benefit plans, and operator self-dealing.

New brands. Over the last decade or two, many brands and operators expanded so rapidly or acquired so many brands that they were unable to make meaningful brand distinctions for the consumer market. They appeared to lack the procedures, systems, personnel, and expertise necessary to properly manage all the new hotels brought under the flag. Or optimistic projections for brands reaching critical mass and economies simply failed to materialize. Sometimes regional offices were not staffed or have been closed. In some cases national sales and group marketing were either never well-developed or inadequately maintained.

Brand changes. We have seen many owners despair when the branded operators they signed up with subsequently changed their ownership, market position or strategies. Red Lion was once a very strong 4-star brand. RockResorts was founded as a chain of small luxury hotels that after initial growth, declined to only one hotel. Amfac was one of the fastest growing brands in the United States and was in the top 25 hotel management companies, until it sold and spun off most of its hotels to become a campground operator. Wyndham underwent dramatic changes when sold to Blackstone and later spun off, as did Doubletree when acquired by Hilton. Same with Le Méridien after the sale by Air France.

How would you like to be one of the hotels locked in under a long-term, no-cut branded management agreement with a "lost" or "drifting" brand in transition for several years, if not eternity?

It's almost impossible to fix a bad choice in brand, operator or contract terms

Branded hotel management contracts tend to be very long-term agreements. While it depends on the brand and your bargaining power, 30-50 years is not uncommon, and some run to 100 years!

Sometimes it is possible to negotiate amendments or changes to a long-term HMA. A few operators might agree to amendments out of a sense of fairness when they are not able to deliver on promises made, or when faced with extraordinary circumstances, such as a pandemic or economic crisis. But that is not very common. Usually, operators demand the strict enforcement of the contract terms, unless there is some mutual benefit (such as additional investment by the hotel owner) or a trade-off of value for value.

Virtually none of the branded HMAs are terminable at an owner's option — unless you negotiated for that point. So the operator will have almost exclusive control over your hotel for many decades unless you can negotiate an amicable buy out or termination of the contract. Some operators may do this, but it is unlikely to be cheap. And most operators will likely refuse to do anything to shorten their long-term contracts.

You have relatively few alternatives except to establish a material breach of contract or a breach of fiduciary duty by the operator.

Of course in some circumstances, you might be able to just breach the contract yourself and terminate the operator, but you will be liable to the operator for damages likely equal to the present value of the profit the operator would have received under the HMA for the remaining term. And, under appropriate circumstances, you might file bankruptcy and reject the HMA in the bankruptcy proceeding.

Like we said, HMAs with the branded hotel companies are very difficult or almost impossible to fix once they are in place.

So how do you get the right brand and operator for your hotel project ... and a deal you can live with?

There *is* a way to enhance greatly your prospects to get the best brand for your project and a fair deal on your HMA.

First, you need to avoid the five biggest mistakes hotel owners make in selecting operators and negotiating HMAs. (See page 9) Then, you need to understand and run a professionally guided HMA PRO™ to recruit a great operator while making the terms of the HMA one of the key ingredients in selecting the operator. The HMA PRO™ is described in the section that begins on page 18.

The five biggest mistakes hotel owners make in selecting operators and negotiating brand HMAs

We have found that hotel owners who get into bad situations with their operators usually fall into one or more of five traps for the unwary. The following are the five biggest mistakes owners make when seeking an operator or brand for their hotel, and the "famous last words" that accompany them:

Mistake #1:	Famous last words:
Focusing on just one brand and letting them know you "have" to have them.	I just have to have Brand X for my hotel. They are perfect for my project.

Even if Brand X *is* perfect for your project, the best way to get a great brand and a fair deal is to have a little competition, compare the results, and be sure each operator knows there is at least one other brand they have to "meet or beat." This process should not feel like an auction, but rather like the controlled, selective, competition that it will be. (See the sections on HMA PRO™ on pages 18 and 22.)

Mistake #2:	Famous last words:
Trying to do it yourself — the biggest false economy of all. You don't know what you don't know.	We met some operators at the recent hotel conference, and they really like our project. I think we can do a deal with them. Or ... maybe you can just give me a couple more phone numbers to call.

A casual or accidental process is not the best way to identify, recruit, and selectively draw out the best business and legal terms for your hotel management agreement. You will have already given up more than you know over cocktails or a round of golf in an undisciplined process. Hotel executives make their living by negotiating hundreds of deals with people like you. Without identifying all your project's strong points at the outset and drawing the blueprint for your HMA PRO™ (the ultimate refinement of an RFP-like process for getting a hotel operator and fair HMA terms), your deal will get shopworn and tired before it can be properly positioned. And if you let the hotel companies guide the process, you may find yourself with a Letter of Intent (LOI) or term sheet *before* you have guided and shaped the hotel company's expectations. As a result, owners can lose big, important "deal points" that could have been accomplished if they had engaged in a disciplined process.

Mistake #3:	Famous last words:
Starting to get proposals from a brand or operator thinking it expedites the process and saves money.	Let me get the LOI signed first. It's 'non-binding' anyway. Then we will bring in the management agreement experts.

It is a false economy — usually a near disaster — to negotiate the LOI terms first, and *then* bring in your hotel management agreement advisors. By the time the LOI has been discussed, much less signed, it is too late to protect your interests. Although most LOIs say they are non-binding (except on exclusive dealings with only the one operator and on confidentiality), the custom of the industry is that you are "retrading" the deal if you try to change those "non-binding" terms or address new issues when your experts try to un-ring the bells that you have set off. Yes, you could probably walk from the deal (after waiting out the exclusivity period), but you have now lost the ability to do a reasonable deal with the operator you thought would be best, and you have lost time and momentum. The operators are well aware of this, and they usually will not retrade.

Mistake #4:	Famous last words:
I will align the operator's interests with mine by getting the operator to invest in the deal. (Uh-Oh!)	We have the operator's interests aligned with ours. They are making an investment in the deal, along with us.

At first it is exciting. The operator thinks so highly of your project that this major institutional, experienced operator is actually willing to co-invest with you in your project. Be forewarned: the operator's money will be the "most expensive" capital an owner can get — not in terms of the return paid on the capital, but in the terms you will have to "give up" in the management agreement. The operator will still get its real money off the top before any return is paid to equity.

Mistake #5:	Famous last words:
Let the hotel operator take care of everything — HMA, design, budget ... They are the hotel experts and you can focus on the other important stuff.	I don't care about the hotel management agreement terms. I just need someone to take over the hotel aspects of the deal so I can do my retail ... office ... golf ... course ... condos. I'm not a hotel guy.

Our typical client is very successful in business, perhaps even in real estate or development. But many of our clients are novices when it comes to hotel development, management agreements and operational issues. For these people, it is usually better to temporarily hire the team of experts needed than to turn the hotel issues over to someone in the organization who has neither hotel experience nor the same commitment to the project.

How to avoid these mistakes

Hotel owners and operators need each other. Although some tension always exists in the push-pull of owner-operator relations, in many situations owners and operators share the same vision of what a hotel should be, how it should operate and how to make it a smashing success.

At the other end of the spectrum, there are miserable hotel owners who have great operators "locked in" on terrible 50-year, no-cut, operator-takes-all management agreements. Other unhappy owners have great management agreements with operators who cannot execute the business plan or deliver on financial or guest expectations.

How do you get the "Goldilocks" balance (not too hot, not too cold, but just right) of a great operator, a shared vision for the property, and fair management contract terms?

Over the years, we in JMBM's Global Hospitality Group® have developed our version of the hotel brand and operator RFP process. We call our optimized process the HMA PRO™ for Hotel Management Agreement Procedure to Recruit (a great) Operator. The HMA PRO™ is an organized, disciplined and highly interactive process. It's not about "putting your project out to bid." It's about strategically positioning your property to attract the right operator for you and your project. Here's how it works:

Based upon the owner's goals, the specifics of a project and its market fundamentals, we first identify an exhaustive list of possible brand and operator candidates. With the client, we review and prioritize choices, and compare alternative operator contacts and approaches, tailoring them to the individual project and operator candidates.

Unlike RFPs for many other purposes, we generally recommend that the owner plan to actively "sell" the merits of the project to the brand and operator candidates: tell them why this is a great project that they want to have in their family of hotels. Clarify your vision of what distinguishes the project, how it will be successful, and why it may be strategically or financially important to their particular hotel company.

Careful planning and execution of the HMA PRO™ is one of the most important keys to finding a good hotel operator and brand and getting a fair agreement — and one you can live with for many years!

How to get a great hotel operator and a fair hotel management agreement

Why hotel owners need HMA PRO™

Everyone agrees that the choice of the right hotel brand and operator may be one of the most significant decisions affecting the financial success and value of a hotel. The right operator will add significant value to the property, both on a current basis through better operations, and by enhancing the long-term value of the property. At the same time, the wrong brand or the wrong operator will reduce the current earnings of the property and the value of the property, making it harder to finance and resulting in a lower sales price.

Successful hotel investment also requires a fair HMA

Many owners discover too late that getting a great operator is only a part of the puzzle they need to solve. Investors also need a fair hotel management agreement or HMA. Without a fair HMA, the best operator in the world will not bring the expected benefits to the hotel investment.

The typical branded HMA is a one-sided agreement in favor of the brand and against the interests of the owner. Wholly apart from the fees and other economic terms, the operator has virtually total control of the hotel while making the owner responsible to maintain the operator's vision of its operating standards — without regard to the owner's needs.

We sometimes say that such an agreement gives the operator "all the benefits of ownership without any of the burdens."

Using HMA PRO™ to get both a great operator and a fair HMA

We are convinced that the solution to getting the best hotel brand and operator — in terms of an HMA that is fair to all, including the owner — is a process we have refined to a new level and which we call the **H**otel **M**anagement **A**greement **P**rocedure to **R**ecruit (a great) **O**perator or **HMA PRO™**.

HMA PRO™ is JMBM's refinement of the old standby Request for Proposal or RFP. We started with the typical RFP process still used by knowledgeable hotel consultants today. However, we didn't like the passive nature of the RFP process, which suggests that the owner should just wait for whatever an operator might propose. Thus, over a period starting more than 35 years ago, we made some critical changes to the typical RFP process that greatly enhance the outcome for owners and investors. We don't know anyone else who uses a unique process like ours, and we decided that our proprietary process needed a different name to distinguish it from what everyone else does. So we coined the phrase HMA PRO™.

When to bring in the hotel advisors

The best time to bring in experts is at the very beginning of your project, when you are evaluating, planning and structuring. We are like the legal and business architects helping you develop the blueprint for your hotel transaction strategies. And everyone knows that you call in the architect before starting construction. You want the architect's experience to help develop concepts, test feasibility of certain approaches, and ultimately to prepare the blueprint to guide your very first steps.

Identifying the owner's goals and priorities

Before recruiting a hotel operator, each owner must identify, evaluate and prioritize its goals and other considerations for a particular hotel. What does the owner want to accomplish with the property? How do relative advantages of alternative positioning compare? How do the ultimate ownership goals stack up against realistic alternatives? Each owner must consider its current and potential plans.

For example:

- Is this to be an iconic trophy property or a less attractive but perhaps more reliable cash generating machine?
- Must the profit and capital appreciation come from the hotel itself, or from greatly enhanced value in a

resort, integrated mixed-use components or adjoining residential, office or retail properties?

- What resources and capital is the owner prepared to dedicate to the project?

- Is the investment horizon short-term or long-term? Is it driven by any particular events or by economic return or other factors?

- How does this property fit in with other investments in the owner's portfolio? What is the cost-benefit analysis for alternative positioning?

Don't even start talking to operators until you have a grip on the 50-point comprehensive HMA PRO™ checklist!

Before your first contact with a hotel operator, you should carefully identify all of your unique ownership priorities and goals.

We help clients accomplish this by walking them through our comprehensive HMA PRO™ checklist (See page 18). In almost every case, it changes the operators you want to approach, how you approach them, and what you want to accomplish from any exchange with operators.

It usually takes several hours of focused discussion to work through the business and legal points in the comprehensive HMA PRO™ checklist, and most clients find this time to be some of the most valuable in the entire process of recruiting a great operator. The checklist is a detailed list of 50 tier-1 and tier-2 business and legal issues which an owner needs to resolve prior to or during the earliest stages of negotiating the term sheet or letter of intent (LOI) with the operator. We call these matters tier-1 for "must have" deal points, and tier-2 for "really want to have" matters that perhaps are not as crucial, but are still extremely important. The tier-3 issues are more mechanical items that can be hashed out in the actual negotiation of the hotel management agreement itself, after the term sheet or LOI is finished.

People outside the hotel industry often don't realize that the owner's ability to negotiate for these tier-1 and tier-2 checklist items will be jeopardized or lost once the back-and-forth of the LOI negotiations have begun. They find themselves drawn into a seductive process of negotiations with proposed operators, thinking no harm can come from getting a "non-binding" term sheet with an operator, and they will have the hotel experts look it over later on.

But beware! Once the first requests or comments are given by the owner to an operator proposal (even though "non-binding"), operators typically will say that the owner is "retrading" the deal if it then tries to raise these issues later on, and operators normally will not discuss these issues further even though they might have agreed to them if "properly" sequenced. What good does it do to have hotel experts look at the non-binding deal that cannot be changed on any important business or legal terms? You can basically "take it or leave it" on the non-binding deal you struck, but you may have lost an operator that would have been the best for your property.

While some operators may cut a little slack in this situation, most do not. And even with the more flexible ones, every deal point will be harder fought and more compromised. It is better to avoid being put in such a position of weakness.

How is HMA PRO™ different?

We developed HMA PRO™ because we observed that the traditional RFP did not create a competitive, owner-oriented process. The name itself, RFP or "request for proposal," puts the owner in a passive position and does not encourage the owner to shape the proposals for its maximum benefit.

HMA PRO™ is a different and unique solution. It relies on early identification of the owner's key concerns, and then approaches a small handful of pre-selected candidates who are more likely to meet the owner's needs, rather than using a shotgun approach. It does not treat operators like fungible commodities. Rather, it recognizes that each operator brings different strengths and qualities to a management opportunity. We have found that this approach makes operators more willing to participate in HMA

PRO™ than an RFP. An RFP often makes operators feel like they are wasting time and resources on an auction where they have little chance of success. HMA PRO™ lets each operator know it is special, encourages participation and focuses the parties on critical elements, mutual expectations and terms, rather than platitudes and advertisements.

It is a better and more focused process that uses everyone's precious time more efficiently.

Seven basic steps in the HMA PRO™ process

Our HMA PRO™ process has seven basic steps for identifying and contracting with the optimum operator:

1. Establish and prioritize the owner's needs and goals, and develop strategies and approaches to achieve them.

2. Identify the brand and operator candidates most likely to meet the owner's needs and goals.

3. Recruit the best brand and operator candidates by developing a package and approach to "sell" the merits of the project, generate operator interest with direct contact at the appropriate level, and gain buy-in to the HMA PRO™ process.

4. Draw candidates into a constructive, interactive process with on-site property inspections and mutual presentations by operator and owner. Elicit a proposal from each candidate that is responsive to owner's priorities.

5. Evaluate the business and legal elements of each proposal received to select the "finalists" for a "best and final" process.

6. Seek "best and final" proposals and analyze them to identify one party to negotiate with until a deal is reached (and if a deal cannot be concluded, move on to the first alternate).

7. Negotiate to conclusion and execute final agreements.

HMA PRO™ Checklist

The following is our comprehensive HMA PRO™ checklist, and most clients find time spent reviewing this checklist can be some of the most valuable in the entire process of recruiting a great operator. This list is intended to include the full range of what a hotel might consider asking for; each situation is different and some of these terms will be more than specific operators are willing to give.

HMA PRO™ CHECKLIST		
Subject	**Provision**	✓
Term	Initial term	
	Renewal terms	
Fees	Base fee	
	Incentive fee	
	Fee caps	
	Subordination of fees	
Alignment of Interests, Operator Incentives	Shared investment	
	Credit enhancement	
	Key money	
	Net operating income or gross operating profit guarantees, guarantees against negative operating cash flow — guarantee, letters of credit or revolvers provided by operator	
	Joint venture structure issues	

HMA PRO™ CHECKLIST

Subject	Provision	✓
Operator Duties	Detailed listing of operator duties	
	Limits on operator authority	
	Control over reimbursements (such as markups, overhead and travel) and complimentary rooms	
Termination	Termination for cause	
	Termination on sale	
	Termination for failure to satisfy the performance standard	
	Termination for convenience	
	Termination for failure of brand to maintain: growth trend, critical mass, regional or national marketing	
	Termination for bankruptcy or insolvency of brand	
	Termination for deterioration in brand or public perception	
	Termination for brand's change-in-control or change in key personnel	
	Termination by owner for failure or inability to open, get financing, operate profitably, reopen after disaster if expenditure of more than $xx is required)	
	Transition on termination	

HMA PRO™ CHECKLIST

Subject	Provision	✓
Performance Tests	RevPAR test	
	Budget test	
	Owner's Return test	
	Two-prong or single prong test	
	Measuring period	
	Cures	
	Provision enabling owner to explore other operators at any time it is uncomfortable with operator, in its sole discretion (no interference or breach)	
Operating Standard	Fiduciary obligations, maximize net present value to owner, minimize obligation of owner to provide additional investment	
Budgets	Content	
	Timing	
	Operating budget approval	
	Capital budget approval	
	Budget compliance	
Reports and Inspection	Periodic reports, annual reports, detail and flash reports	
	Audited financial statements	
	Right of owner to inspect and audit both financials and operations	

HMA PRO™ CHECKLIST

Subject	Provision	✓
Other Matters	Who is the employer?	
	Union matters	
	Licenses and permits, including liquor license	
	Subordination, Non-Disturbance and Attornment agreements with lenders now and in the future	
	Limitation on owner contributions to working capital	
	Right of first refusal	
	Non-Compete term, area, brands	
	Indemnification — what exclusions to owner's indemnifications of operator	
	Exculpation — limit liability of owner to its interest in the hotel	
	Sale of the hotel — operator's transfer of rights under the hotel management agreement — what restrictions or approvals	
	Court system, judicial reference, arbitration and expert resolution	

How to make your HMA PRO™ successful — a practical guide

In selecting and signing up a branded operator, the first step is to recognize that this is a big event. Remind yourself of that every day.

Think about the magnitude of the opportunity ... and the hazard.

Once you are firmly focused on the importance of the task at hand, act accordingly. The next step is to round up and dedicate the necessary resources for this important job – internally and externally. You want experienced hotel experts who have been through the process hundreds of times to guide you through a process for identifying and recruiting the best operator for your hotel.

Selecting the right branded hotel operator is NOT something you do casually, quickly or without expert advice. It takes planning, strategy, analysis and game plan execution. The payoff is big. The consequences are severe.

HMA PRO™ is NOT a form — It is an interactive process

We are sometimes asked by well-meaning friends or clients if we can just give them a form for an HMA PRO™. That is the tipoff that someone needs some more background information to understand what an HMA PRO™ really is and how to make it work. Here is what we tell them:

First, the HMA PRO™ is a process and involves some important documents. Both the process and the documents should be carefully integrated to address all the relevant business, legal and hotel industry issues. We don't pull it off the shelf because it needs to be customized to your situation after the all-critical business judgments are formed. (After doing more than a thousand of these, the documents are the easiest part of the exercise!)

The process and documents can look very different from deal to deal, and combine or separate important steps. The business, legal and hotel aspects all have to be brought into focus, well before documentation. The hotel lawyers at JMBM don't just document the deal, we work to get you the best deal. The HMA PRO™ process is a great strategy for positioning your project to get the best terms possible.

What happens in the HMA PRO™ process?

How the HMA PRO™ process is shaped – i.e. how many steps are involved, how much information is provided (and when), and whether you "sell" the deal first to raise enthusiasm, and other elements – depends on the unique considerations in each deal. The process is likely to include these elements:

- Identifying appropriate candidates to brand and operate the hotel project
- Preparing a tailored presentation for owner to present to the operator candidates explaining the opportunity in general terms to gain interest and participation
- Soliciting an indication of interest in participating in the HMA PRO™ or discussions with the owner-developer
- Requesting a confidentiality agreement in order to receive further information
- Providing different levels of information to HMA PRO™ candidates in two or more stages
- Granting access to a "due diligence room" or providing a "book" of information and exhibits
- Marketing to potential HMA PRO™ participants to whet their appetites, create excitement for the project, and show them how much there is to gain if they reach to get the deal
- Collecting, reviewing and analyzing proposals
- Preparing comparative summary of key aspects of each proposal (the "matrix")

- Requesting clarifications of proposal deal points

- Running an interview process with selected finalists leading to a "best and final" proposal process

- Ultimately, negotiating and preparing final documentation with a selected candidate or two

Careful planning and execution of the HMA PRO™ process is one of the most important keys to finding a good hotel operator and brand and getting a fair agreement. Whether your project is a standalone hotel or a hotel mixed-use development — getting the right operator or brand, and a deal you can live with, is critical to the success of your project.

How to negotiate an HMA

Ten tips for a smoother process

We get a lot of calls to help owners, developers, and investors negotiate new hotel management agreements. One of the first questions they usually ask is how the negotiation process works, since there are so many different parties involved, usually in different parts of the country (or the world).

So, this section will focus on the process of negotiating the hotel management agreement. How do you effectively gather and coordinate the input from all relevant stakeholders and advisors? How do you communicate the right message to the operators and drive the process to a timely conclusion with a good result for the owner and operator.

Or, put another way, how do you expedite a hotel management agreement negotiation, while maintaining stamina to win important economic and business points? The timing, direction and focus of the process can be critical.

Ten Tips for negotiating hotel management agreements:

1 **Select your team and get access to a virtual data base of market terms.** You should identify the members of your group who will have the authority to make decisions and will be dedicated to the process. Just as importantly, you need to seek the outside advisors — lawyers and consultants — that can bring you the expertise and sense of market terms that you don't have in your organization. Our business and legal experience from more than 2,700 hotel management agreements and franchise agreements provides the largest virtual database of hotel management and franchise agreement deal terms in the world.

2 **Identify and prioritize the issues.** There are at least 50 business issues that are tier-1 or tier-2 issues that need to be raised and negotiated in a term sheet or LOI. (See The

HMA PRO™ Checklist, page 18) While term sheets and LOIs are usually nonbinding, the failure to raise these major issues at this stage will subject you to angry claims that you are retrading if you want to raise them later. It will certainly be harder to accomplish them later — if you can at all — and will delay your process.

3 **Control your own draft of the hotel management agreement.** Get the operator to provide you with a Microsoft Word copy of the form of HMA they propose to use. The operator may want to control the document revisions, but that's not realistic in an age of long distances and universal word processing. We can often conform their HMA to the agreed-upon terms faster and better than they can. In any event, we need it for the process as described below.

4 **Shaping the form HMA to meet your needs.** We don't mind starting with the operator's form HMA. That is generally the accepted custom of the industry. However, after working with you to identify the most important business and legal points, we revise the operator's form agreement to meet your needs, using redlining software to track changes in each revised version of the document. Usually, we will suggest the exact language to be used. Sometimes, we will just highlight issues or options for discussion.

5 **Making sure we are all on the same page.** Based on our earlier discussions about your priorities and goal, we then circulate a marked-up draft of the operator's form HMA showing all of our proposed changes. This draft only goes to you for your review, followed by a conference call (or, where we and the owner are local, a meeting) to discuss the agreement and any necessary revisions. We review the document with you, page by page, to get your input and approval for what we have suggested. Most of the changes will be obvious as to their purpose and effect. Some will not be, and we will discuss these so we all agree to all proposed changes.

6 **Revise and confirm.** After our joint review of the document, we make revisions to reflect your decisions. If changes are minor, it may not be necessary to recirculate to our team prior to sending to the operator. If there are major changes or there is a desire to see the revised language, we may recirculate to gain final approval before sending the document to the operator.

7 **Send the revised draft to the operator.** The next step is to send the proposed changes to the operator in the form of the marked up draft we have already cleared with our client. We jointly want to press the operator for a fast turnaround with its own indication of what changes the operator can accept or proposed changes to our changes. If at all possible, it is very much to your advantage to keep control of the drafts — our draft should be treated as the new basis for negotiations. If not, we can make it work, but the process is more laborious and time consuming.

8 **Set the all hands meeting.** The goal is to get the operator's markup or written response to our proposals, commit to agreements on as much as possible beforehand, and then to arrange a "meet until the deal is done" meeting. Virtual meetings have overwhelmingly replaced face-to-face meetings, except in unusually complicated matters. These meetings usually take several hours of focused discussion, perhaps requiring the better part of one or two working days. The biggest problem for you will be convincing the operator to make someone available for the entire time necessary. Otherwise, there can be a delay of days or weeks until the follow up meeting is scheduled and the negotiations can be completed.

9 **Location of the all hands meeting.** The availability of representatives with decision-making ability will probably drive this location, and you should be prepared to travel to meet the operator on their turf, if it means they will have the necessary people available. In some cases, the distances between the operator's and owners'

representatives may be so great that a virtual meeting may be the only way of expediting the review. Many owners and operators are more reluctant to travel as video-conferencing has become a preferred alternative; however, for intense negotiation, an in-person meeting is ideal.

10 **Exchange and finalize.** After the all hands meeting, we will circulate revised drafts of the HMA reflecting the decisions. There may be a very small handful of "final issues" to be resolved that we hold to the very end before we give them up or trade them off. But there will be an exchange of documents reflecting the final decisions that should lead to an expedited signing of the HMA. If something goes awry, we will do another meet-until-we-sign meeting.

Chapter 2

What you need in your Hotel Management Agreement

What to do *before* you start negotiating your brand HMA

Five tips for a successful relationship with your operator and a good HMA

In order to consummate any substantial business transaction, there are inevitably some challenges that must be overcome. Hotel management agreements are no exception: in part because of their complexity, and in part because hotel management agreements typically transfer effective control over valuable assets for decades, and their terms can easily enhance — or diminish — the value of hotel by a staggering amount.

We have often seen hotel values depressed by *50 percent or more* from what the hotel would have been worth without the encumbrance of an onerous, long-term management agreement. The Global Hospitality Group® at Jeffer Mangels Butler & Mitchell LLP has compiled a comprehensive list of many milestones that mark the road to successful negotiation of a hotel management agreement. As in all journeys with high stakes, advance preparation — including mapping out the most advantageous route and hiring guides that know the terrain — is critical to success. In this instance, it's needed before you ever get to the negotiating table.

This is especially true for those new to the hospitality industry. Many sophisticated developers and investors have identified the rich potential that hotels offer — particularly in hotel mixed-use projects — and they regularly bring new vitality to the marketplace. While not new to real estate development, these players are new to the norms, customs, practices and business considerations of hotels. The intertwining of single-purpose real estate with an operating hotel business presents unique issues and opportunities — opportunities that the uninitiated leave on the table, simply because they were none the wiser. Developers and owners new to the hotel arena can avoid an expensive and painful learning curve by retaining experienced advisors that know the value of each component in the management agreement from both sides.

Here are our top five pre-negotiation milestones for helping owners achieve success and strike a fair deal on a hotel management agreement:

1. Get the right brand for your project

Every project is unique, and all appropriate brands, identities and market position should be considered — along with the appropriate operators who will enhance project value. The right operator to optimize value may not be the branded management company that puts its name on your hotel. It is important to note that the continuing development of brand concepts can add great value to a project, both from "brands" that are promoted by traditional hotel companies and new players which many pundits fail to recognize for the value they can bring.

Selecting the best brand and operator requires a careful business and legal analysis of the owner's needs, goals and resources — particularly for a hotel mixed-use project where the hotel is often the spark plug for the synergies of mixing uses. That's why we like to bring our knowledge and resources to the owner's team before the brand and operator candidates are even identified. We can help identify the right players, scope out areas of strength and weakness, and help our owner or developer client articulate and prioritize goals to be accomplished in an HMA PRO™ process. This kind of preparation can enable an owner to better gauge the strengths and weaknesses of each potential brand, find the optimal terms that the brands and operators are willing to extend, and facilitate an informed decision and a smooth negotiation with reasonable expectations on all sides.

2. Look for common perspectives

Sometimes, we are brought in late on the hotel management agreement process — after the initial candidate consideration and selection and perhaps into the Letter of Intent, or LOI, stage. When this happens, we too often find that the table has not been properly set. As deal terms and drafts begin to exchange, it can appear that owners and operators are contemplating two different projects ... because they are! The owner comes to the negotiating table with one set of financial projections and program elements, while the operator has its own. Set side by side, they would seem to describe different projects — different concepts for the hotel's target market segment and customers, its sources of revenues, costs of construction and maintenance, integration of the hotel with other project elements, and even the project's financial viability.

If the owner believes the project is highly profitable and the operator does not, the natural (and reasonable) result will be for the operator to try to protect itself by demanding higher fees and incentives, which will create a chasm between the owner and the operator. If the operator believes that the project requires substantial amenities and the owner does not — or if they cannot agree on how hotel mixed-use project elements will be integrated — it is more likely that the owner and the operator will be unable to agree on key issues, such as the total cost of the project and owner's required investment. (Remember that selecting the right operator, based on objective data, makes a meeting of the minds more probable.) The operator and owner must agree as to what the project will look like and what will drive its success.

3. Address the challenges early

During negotiations, it may often make sense to defer certain tough issues for later resolution so that all the areas where agreement can be reached are understood, and the importance of the areas that require compromise are clear. However, there comes a time when the parties have to discuss the elephant in the room that they have been ignoring. Talking about the elephant sooner, and more directly, may allow both sides to create global resolutions. And of course there may be situations where owners and operators will not fully resolve certain issues, either intentionally or unintentionally. While it's true that parties cannot be expected to resolve each and every issue that might come up during the term of a management agreement — that would require the ability to predict the future — failing to address known issues can be an expensive way to reach "agreement" because it leaves potentially messy disputes for the future.

4. Know what's "market" and how it fits your goals

While both owners and operators usually seek to negotiate agreements with market terms, every hotel property is unique. And, there is really no simple metric or checklist of market terms. There are ranges of what are considered market terms for particular types of properties or projects and specific brands or operators. For example, the terms for branding or operating a 2,000-room convention hotel are quite different than a 200-room full service urban hotel or a 120-room extended stay property. And market is also defined by the competition for a particular set of brands or operators, which will vary depending on how desirable a specific hotel project is, and how important that location or property may be for the strategic and business needs of a brand or operator (e.g. to fill in a critical hole in its distribution system, maintain a presence in a key market, etc.). And, ultimately, a market deal is the deal you make.

These factors make it very valuable for an owner to have an experienced team who may know better what market is than the brand or operator — and will at least know what the operator has done in six recent deals and, just as importantly, what their three closest competitors are likely to offer on a sticky economic or business point. There are also a lot of trade-offs that make up a market package. In other words, it is a little like going to a smorgasbord buffet with $100 worth of tickets, and you have to know the price of each item if you are going to get the meal you want. If you spend all your money on the caviar and dessert, you won't have any left for the main dish or the beverage. All items on the buffet are not of equal cost or value.

So, while there are some commonly accepted ranges for business and legal parameters for hotel management agreements, an owner needs to recognize that they can be broad, and owners may need to be flexible to accomplish their goals in a particular situation.

5. Bring the right team to the table

Negotiations don't occur between companies; they transpire between the people representing those companies — and it is essential to have a team with the comprehensive set of experience and skills to negotiate and document a successful hotel management agreement. Hotel management companies usually have a strong bench of experienced lawyers, dealmakers, financial experts and others who understand fully their goals and needs, because they are actually in the business of sourcing and negotiating management contracts and franchise agreements.

Owners typically have not experienced the frequency or volume of hotel management agreement negotiations that operators have, and should retain experienced lawyers and advisors in order to level the playing field. But more than just arming oneself in negotiations, retaining experienced professionals will make the negotiations more productive for both sides.

Owners will want to draw on professionals who have had direct experience with the operator, as well as broad-based experience in the industry. A hotel lawyer and consultant who knows what a particular operator has done in other deals, as well as what that operator's competition has done (and is likely to do again) is able to bring great value to the owner's side of the discussions.

Finally, it is essential that owners understand the critical importance of their own active participation in the hotel management agreement negotiations. While it may be convenient to leave the discussions to the professionals (and certainly portions of the discussions can and should be handled by attorneys or consultants), a lot of issues will ultimately be won or lost by the passion and conviction of the owner. "I am just not going to do that," goes a long way toward convincing the operator that a specific issue is too important to be compromised.

That is one of the reasons that we spend so much time with owners — particularly first time hotel owners and developers — to help them understand the real practical significance of management agreement provisions. It isn't rocket science, but it is understanding the business implications of hotel management agreement terms on the owner's goals and plans, and seeing what should be accomplishable that makes a difference.

Preparation to successfully negotiate a hotel management agreement starts early. It starts before you ever identify potential candidates and way before you ever start talking terms. The roadmap you establish — along with the practical experience of the professional team members you line up to structure and guide the process — can make a substantial difference in the outcome and long-term success of your entire project.

Hotel management agreement performance standards and why they matter

Performance standards matter because hotel owners and hotel operators do not always share the same goals. Most hotel owners want their hotels to be profitable, or at least run with a focus on optimizing long-term value. Others may want their hotels to operate at a specified level of luxury in order to provide the right "amenity" essential to other components in a hotel mixed-use project, or adjoining property. But even where luxury is important, owners always desire to accomplish luxury in a prudent and businesslike way.

Generally, hotel operators, and brand operators in particular, want to increase the number of hotels under management or franchise (their "distribution system"), burnish or enhance the brand image and its public recognition, bring hotels to a minimum level of standardization, and increase profits by making hotel owners absorb more of the hotel operator's corporate expenses, and extending their brands to other products (like time share, or residential products).

If individual hotels are not profitable, or are not operated at the desired level of service, the operator's other goals are not necessarily impacted. In addition, hotel operators typically receive a big portion of their compensation as a percentage of gross revenues off the top before operating expenses, debt service or any return to the owner. Their reservation and marketing systems, and other centralized services are also typically supported off the top by payments from the hotel in reimbursements or as percentages of gross revenues, so these factors incentivize growth of the system (with attendant recruiting, training and staffing challenges and costs) and increasing gross revenues whether any profit is falling to the bottom line.

The difference between the owner's goals and the operator's goals doesn't reflect a "right or wrong" situation, or a value judgment; it does mean, though, that owners and operators need to work together to ensure that their needs and goals are adequately represented, and that the management agreement reflects a reasonable compromise.

One of the popular misconceptions of performance standards is that the purpose of the standard is to give an owner a "free" right to terminate an HMA without being required to pay a termination fee. That is not the purpose of a performance standard (although it can be the result, if the operator ignores its obligations). Owners only terminate management agreements as a last resort; the difficulty in finding good managers and the cost of changing managers or rebranding a property, among other things, means an owner is more likely to stay with an underperforming manager, and we regularly advise our clients to find ways to maximize the commitment and performance of their managers instead of terminating prematurely. Instead, a performance standard, if negotiated carefully, establishes a meaningful measure of the operator's performance and aligns the interests of owners and operators.

But the power to terminate a hotel management agreement does offer an owner what may prove to be a necessary tool to gain the attention of the operator and some meaningful compliance, or readjust the terms of the HMA. In this way, the performance provisions can help ensure that the HMA remains in place, because the owner and operator know what to expect from each other and will have incentives to understand their respective obligations to one another and to avoid problems in the future.

What does an operator want?

Put simply, the hotel operator does not want to be penalized for events and causes that are beyond its control. For this reason, a hotel operator will not want to be responsible for the profitability of the hotel, economic conditions that reduce the hotel's revenues or profits, labor disturbances which interfere with operations, or unanticipated events, like the cancellation of a large convention. Because of this, most operators will see the ideal performance standard as one with as few teeth in it as possible. Remember, the profitability of the operator depends on it having as many long-term HMAs in place as possible. The longer the deal, the more the operator will receive in the form of management fees, licensing fees, and the like and the higher the market will value the operator. Therefore, it is in their interest to draft performance standards in such a way that it will be very difficult to ever terminate the HMA for failure of performance.

What does the owner want?

Owners are interested in many things. It may be prestige, amenity value for other parts of a project or related properties, or an efficient and well-run place for tourists or business people to stay. These are typically all the things that brand hotel development staff (the salesmen for the brand) promise over rounds of golf and nice dinners when courting the owner for the management contract. But if these perceived promises are not engraved into the terms of the hotel management agreement — including the performance standards — they will be difficult to enforce later on. So if prudent and efficient operations, building long-term value and profitability are important to enable the owner to pay lenders, investors and itself, they'd better be properly reflected in the documentation.

These concerns lead the owner to seek performance standards which provide incentive for the operator to operate the hotel at the required level of standards, to maximize profits in accordance with the performance thresholds, and to impose those tests consistently, whether or not the operator can control the results.

Three guideposts for negotiating HMA performance standards

Here are three suggestions to follow in negotiating effective performance standards.

Know thyself. Recognize how important the HMA will be to the value of the hotel and treat it accordingly. Carefully define all of the important measures of success for your project, whether it be through profit margins, minimum revenue thresholds, or achieving specified levels of service or recognition (such as Mobil star or AAA diamond ratings). Unless you can explain your needs, you won't achieve your goals.

Be realistic. Understand your strengths and be aware of the operator's needs. Seeking unrealistic goals is likely to prevent you from gaining the agreement you want, and won't make your objectives any easier to achieve.

Get help. You need to understand the different ways you can achieve your needs. You need to know what operators have agreed to in the past and what they might agree to now. You need a legal and advisory team that negotiates management agreements every day, and has experience with all the brands and boutiques, both as to market terms at a given time, as well as alternate solutions to solve both parties' needs or find reasonable compromises.

Hotel management agreement performance standards — the operator's take

What does a typical operator performance clause look like? Operators may propose an HMA without any performance standard. That would be in their interest, because a performance standard can only be used to their disadvantage — to reduce their income, subordinate their fees, or possibly terminate the management contract. And of course, the right to terminate is the right to re-negotiate the agreement as well. So failure of a performance standard does not mean you have to terminate the operator, but it might be used as the basis to re-negotiate the allocation of financial and other risks.

The typical performance standard clause proposed by a branded hotel operator often looks something like this:

> In addition to the other rights of termination in this Agreement, the Owner shall have the right to terminate this Agreement if, for any two consecutive Fiscal Years beginning after the completion of the third (3rd) Full Fiscal Year, both (a) the Annualized RevPAR for the Hotel for such Fiscal Year is less than 80% of the average Annualized RevPAR for the Competitive Set for such Fiscal Year (the "RevPAR Test"), and (b) the Gross Operating Profit of the Hotel is less than 80% of the Gross Operating Profit of the Hotel as set forth in the Annual Budget for such Fiscal Year (the "GOP Test") (the RevPAR Test and the GOP Test are collectively referred to as the "Performance Standard").

This provision is fairly short, but it contains a number of moving parts, and we need to discuss some of the key components.

What is RevPAR?

RevPAR is the acronym for "Revenue Per Available Room." RevPAR is calculated by dividing the gross revenues for a hotel for a period of time by the total number of available room nights over the same period. The resulting number will tell you how much money you are generating from each room in your hotel for a particular period. It is a way of combining the results of two other key factors — average daily rate or ADR and Occupancy. The ADR is included in the revenue component of RevPAR, and the occupancy is encompassed in the available room night component.

What is the competitive set?

The competitive set is a group of hotels that are similar to your hotel. For example, a 100-room select-service hotel might be compared to a nearby Courtyard by Marriott, but not the Ritz-Carlton next door, which would be excluded. Picking the competitive set is a critical issue and something of an art. The data for the competitive set is provided by independent data sources, like Smith Travel Research (STR), which usually require a minimum of five different hotels and a variety of underlying brands in the set to ensure confidentiality and anonymity of hotel data participants.

What is the budget test?

The budget test requires that the Hotel achieves a minimum percentage (most often less than 100 percent) of the profit that the operator anticipated in its budget for a particular year. This standard raises a very important issue for owners, since operators prepare the budgets for the hotel and therefore have the ability to propose a budget that is easier to achieve. While owners typically have budget approval rights (or at least they should), operators are in a much better position to forecast the potential profitability of the hotel. Even more importantly, the operator, by virtue of its management of the hotel, is in a position to manipulate the operations of the hotel to achieve the necessary level of performance. For example, an operator might choose to push certain expenses into a following year to meet the operating test or accelerate certain income.

Why is it measured over two consecutive years?

Operators prefer to structure a performance test so that the operator only fails the test if it doesn't meet the minimum gross operating profit (GOP) level in two consecutive years. This helps protect operators, since the operator isn't in danger of being terminated if it suffers one bad year out of a series of good years. However, it also emphasizes one of the concerns that an owner should have about the budget test — since it takes two years of failure to trigger the owner's right to terminate, the operator can, in the second year of a down cycle, revise its projections to make it less likely that they will fail, and also make it easier to maneuver the financial performance of the property and avoid termination. It also means that a hotel could perform poorly for several years, which reduces the value of the hotel and the ability to finance it.

Is this two tests, or one?

The performance test usually proposed by an operator is designed so that the operator has to fail each of the tests in both years of the test period to be subject to termination — in other words, the operator might not achieve the budgeted profitability, but if it operates on par (or, in the example above, 80% of par) with its competitors, that year doesn't count as having failed the test. An operator wants this because it doesn't want to be penalized if the hotel doesn't make its predicted profits, but operates at least as well as its competitors; conversely, a hotel operator would not want to be subject to termination if it achieves anticipated profitability, even if other hotels in the area operate more profitably.

"Cures" and other parts of the performance test

There are often additional components or matters that relate to the operator's performance test. For example, an operator performance provision will often provide that the operator can avoid termination if it "cures" the performance failure by paying the owner the difference between the actual profits and budgeted profits for the year. Should the operator have any cures if the performance standard is to be meaningful? If so, how many? Must the cure be made for the first year of performance test failure? If not, does the two consecutive year test completely reset or just need one more failing year? What is the right measure of a "cure" payment? Does the missed profit really cover all the damage? Certainly not!

Well, the details of a "cure provision" of a performance test are complex and are not treated here except to alert you to its importance. Additionally, don't forget that the operator will typically seek to be excused from the performance tests for any period of time that involves an event that qualifies as a "force majeure." There are typically also "passes" from the test or "lockouts" from exercising any rights under it for an initial stabilization or lockout period that may run from 12 months to seven years, or longer, or during periods when the property is being upgraded.

And any breach of the HMA by owner claimed by the operator — such as failure to fund a big capital improvement program — may also excuse the operator from a performance test.

What should I consider when negotiating the performance test?

Every little thing matters. The test looks simple, but every part of it is meaningful. For example, constructing the competitive set alone raises many issues:

- Are there really five hotels in your market that compete directly with your hotel? Many times it is difficult to find those hotels, and you have to consider adding hotels that are in different classes or different locations.

- What is the right percentage for the test? If the average RevPAR for the hotels in the competitive set is lower than your hotel, a target RevPAR of 90 percent of your hotel's projected RevPAR may be too low, making the test less than meaningful. A new hotel should significantly outperform an older set of hotels. Maybe your hotel should be at 120 percent of the competitive set.

- What happens when new hotels come into the market area, or existing hotels in the competitive set close, or when hotels are rebranded? Should that change the RevPAR test?

These are only a few of the most obvious issues, and given all the other issues in a complex hotel management agreement, a hotel owner needs expert assistance to ensure not only that the performance test itself is meaningful, but also that it works seamlessly with the remainder of the agreement and all of the parties' goals.

Hotel management agreement performance standards — the Owner's Return test

In the last section, we looked at a typical hotel operator performance clause and how it protected the operator interests. For the owner to have a termination right under such a clause, the hotel operator must fail both prongs of a two-prong test: the RevPAR test, which compares the RevPAR results of the subject hotel to those of a competitive set of hotels, and the budget test, which requires the operator to achieve profitability based on the operator's projections in a budget. We also pointed out some of the challenges posed by that test.

In this section, we will look at a performance test that takes better care of the owner's concerns and which raises some issues with operators.

What is the interest that owners want to protect with a performance test?

The bottom line is that owners want to receive an adequate return on their hotel investment. Owners need the return because they are expected to pay debt service, pay property taxes and property insurance, provide working capital, fund capital expenditures and provide a return to their investors. If they don't get that return, owners should have certain rights. There are a variety of tests, but we believe the most effective, meaningful and fair test is an Owner's Return performance test.

The concept of an Owner's Return performance clause is rather simple: Unless the operator can manage the hotel to generate sufficient profit and distributable cash to provide the owner with a specified return on investment, the performance clause has not been satisfied, and certain consequences follow.

Normally, we use the Owner's Return test for two purposes:

1 **Create a viable investment.** Identifying the Owner's Return clarifies the expectations of the owner and the operator, and is an essential part of the "bargain"

between the owner and the operator. Ultimately, if the operator cannot fulfill its part of the bargain, the performance standard gives a hotel owner the option to terminate the hotel operator when the test is failed. Sometimes the ability to terminate an operator can be the only effective way to truly get the operator's attention and redirection to take care of the owner's concerns.

2 **Hurdle for incentive compensation and subordination of fees.** Independent of any termination right that may attach, no incentive fees should be payable to the operator in any year unless the performance test has been satisfied. While uncommon, in some cases, a portion of the operator's base fee — say anything over 1.5 percent of gross revenues, or perhaps anything in excess of half of the base fees — may similarly be conditioned on and subordinated to payment of the Owner's Return for the given year.

How do I measure Owner's Return?

The required Owner's Return is determined by this formula, calculated annually:

$$\text{Owner's Return} = \text{Total investment in the hotel} \times \text{Agreed upon investment return}$$

For example, if the total investment in a hotel were $25 million, and the agreed upon investment return were 12 percent, the Owner's Return would be determined as follows:

$$\text{Owner's Return} = \$25 \text{ million} \times 12\%$$

or

$$\text{Owner's Return} = \$3 \text{ million}$$

Total investment in the hotel

The first key to measuring the Owner's Return is to calculate the owner's total initial investment in the property, including all costs associated with the investment, both debt and equity, and all hard and soft costs.

That initial investment should be increased each year by all of the owner's additional investments. We typically provide for the addition of three major items to the calculation of owner's investment in the hotel:

1 **Contribution to FF&E fund, when contribution is made.** Virtually all management agreements (and franchise agreements and loan agreements) require an owner to set aside a reserve to pay for regular replacements of furniture, fixtures and equipment (FF&E). These reserves reduce the cash the owner might otherwise retain from the operation of the hotel, and represent an additional investment by the owner.

2 **Capital expenditures not paid from the FF&E fund.** As a hotel ages, the FF&E fund may not be adequate for the maintenance of the hotel. Major upgrades to its soft goods, replacements of furniture, fixtures, and equipment, or other capital projects will usually be paid out of hotel revenues (that would otherwise have gone to the owner) or from additional investment by the owner. Unless these amounts came from the FF&E fund, they also represent additional investment by the owner.

3 **Any additional working capital contributed to the hotel, not otherwise included in the preceding items.** From time to time, working capital may be required for various reasons, such as seasonal business needs or operating deficits from disasters or business cycles.

Investment return

After the owner's total investment in the property is calculated for a given year, the Owner's Return is derived by applying a percentage to that which must be paid out of profits to satisfy the test.

A common goal of owners is to achieve something on the order of a 12 percent annual return on their total investment in the hotel. Over the past 20 years we have regularly obtained a reasonable

Owner's Return provision from almost every major brand — at least when they really want to manage the particular hotel.

Their willingness to give this kind of performance test is a much truer reflection of their enthusiasm for a project and their belief in its success than all the laudatory fluff shared in the process of selling the owner on hiring the operator.

What do operators think of this test?

Operators understand the importance of a return to the owner, but often object to this test, particularly when it could allow an owner to terminate a management agreement. As we have pointed out before, hotel operators do not want to guarantee performance, and limit the tests of performance to those things that are within their control. Since operators cannot control the net income from the property, the owner's acquisition costs or continuing investments in the hotel, some operators will argue that owner termination for failure of this test is problematic.

On the other hand, if an operator can't manage a hotel to provide the owner with a reasonable rate of return, the owner should at least have the option to change things up.

Five keys for good HMA budget provisions

The budget provisions in the HMA provide the means by which the owner achieves efficiency and profitability, and the operator achieves brand integrity. While both are equally critical to the success of the hotel, operators are often able to drive the budgeting process to their advantage.

Importance of budgets

It is difficult to overstate the importance of a meaningful budgeting process for a hotel. Ultimately, the budget represents the implementation of the owner and operator's vision for the hotel. It is the means by which the owner and operator achieve the qualitative goals we associate with the brand or style of the hotel, and the quantitative goals of achieving a well-run, efficient and profitable business. Moreover, it is often the means by which we judge the performance of the operator.

The approved budget is also key to many other provisions in the HMA. Often, the inclusion of a line item expense in a budget will constitute the owner's approval of that expense without further inquiry. For this reason, owners consider the budget process seriously and recognize that it will have far-reaching impact on the success of the property. Properly drafted, the budget process created by the HMA provisions can provide the owner its most significant ability to affect the operations, profitability and success of the hotel.

Challenges

Owners face a significant challenge in the budgeting process. Simply stated, the operator has the upper hand for a variety of reasons. Unlike owners, operators create budgets all the time. Operators have entire departments of staff dedicated to budgets and have much greater experience with budgeting than owners do. This experience and capacity gap increases each year. Operators almost always dictate the form of the budget, giving them a benefit in presentation (and knowing in which three line-items an expense is buried). Moreover, operators have access to much more information than do owners, both as to the property at issue and all of the operators' other properties. For these and other reasons, operators almost always have a big "home field advantage" when it comes to creating and evaluating budgets.

Owners face another challenge in that while operators spend many months preparing a proposed budget, owners have only a short window of time at the end of the year in which to evaluate and critique budgets. Some operators have told us that budgeting is, in fact, a year-round process. Given the reality of Thanksgiving, Christmas and the New Year's holidays, owners have only four to five weeks to evaluate and respond to the budget that operators have been preparing for months.

Five key elements to a successful budget provision

Given these facts, there are five key pieces to crafting a good budget provision in an HMA that can add great value to the hotel and save a lot of grief when times get tough.

1. **Time.** The proposed budget must be delivered in time for the owner and its advisors to evaluate it carefully and thoughtfully respond — at least 60 days before the beginning of the fiscal year, typically November 1. Doing so will allow time for the necessary review, comments, redrafting and review that makes the budget process meaningful. If possible, the operator should provide preliminary budgets even earlier.

2. **Scope of review.** Some operators will attempt to limit the scope of the owner's review by stating that certain estimates, such as anticipated room rates or expenses necessary to meet brand standards, are not subject to owner's objection. This is wrong! The owner should have the ability to question everything in the budget. It doesn't mean the owner will always prevail, but the owner should have a say.

3. **Owner's approval; resolution of budget disputes.** Owner's approval rights of the budget must be similarly meaningful. It is not adequate to provide that the operator shall consider the owner's comments in good faith, and

then shall be entitled to make the final decision in its sole discretion or words to that effect.

- **Use of an independent expert.** If a dispute cannot be resolved between the parties, it should be handed to an independent expert who reviews the issues from not only the operator's side but also from the owner's side. We also like to provide a standard (other than just "brand standards") that governs how the expert will decide the dispute.

- **Baseball arbitration.** Often, it makes sense to be explicit and consider "baseball" arbitration as an alternative to "traditional" arbitration for budget disputes. In baseball arbitration, the arbitrator must adopt the position of either party, but cannot custom design his own random solution. Baseball arbitration tends to force each of the parties to be more reasonable (i.e. to narrow the gap) so that they don't lose everything they want. And it means that at least one party's vision will be implemented, instead of a cut-and-pasted collage of two different approaches, or leaving the decision in the hands of a party that has no stake in the outcome.

- **CapEx should be sole approval of the owner.** There is one exception to an arbitrated resolution of budget disputes — capital expenditures. Capital expenditures beyond the regular, agreed-upon contributions to an FF&E reserve should be within the owner's sole control.

- **What happens if there's no agreed budget?** Hand-in-hand with the approval and dispute resolution process is a means of operating the hotel pending resolution of a budget dispute. Most agreements provide that when the parties cannot agree on the budget (or any parts of it) the operator will operate in accordance with the parts of the budget that are agreed upon; for the other parts in dispute, the operator will operate under the prior year's budget with some kind of adjustments. While this is generally workable, adjustments should be considered where a prior year included one or more unusual transactions or events. Owners should also consider using the prior year's actual expenditures instead of the prior year's budget, since actual experience can be a better indication of future requirements.

4. **Budget format.** While it should go without saying, budgets must be provided in adequate format and detail to provide real information about the operator's plans. Budgets should be detailed enough to include not only the line items, but clear narrative explanations of the assumptions underlying those line items. It is also essential that the budget process be integrated, so that operating, capital and marketing expenses are presented as a unified whole.

   Budgets should also be zero-based, rather than just increased (or decreased) some increment from the prior year. The underlying assumptions and rationales of the budget need to be rethought and reanalyzed, so that owners are not presented with the repetition of prior years' mistakes and do not miss the changes in markets or technologies that move so quickly.

   Finally, an essential part of the budget should be a narrative explanation of the assumptions on which the proposed budget is based. A manager should be able to provide the rationale for its estimates, which will allow the owner to understand better whether the manager is "in sync" with the owner.

5. **Variances and amendments.** Most operators argue that budgets are a planning device but cannot be relied upon, and they should be authorized to stray from the budget. This results in a meaningless budget. We believe that the operator should be contractually required to adhere to the budget except for permitted variances which are carefully defined in the budget provision of the HMA.

Consequently, while minor variances can be tolerated, some basic guidelines should be followed such as those below.

What goes up also goes down. Operators often provide that expenses can increase when occupancy increases. That may be true, but operators should be held to the opposite as well. When occupancy drops, operators should work effectively to reduce expenses and maintain profit margins.

Budget line items are not fungible. Operators sometimes argue that savings in one part of a budget should allow for overruns in others. This merely makes the budget process ineffective. Each part of the budget should stand on its own.

Back to the future. Changes to the budget should not be imposed by the operator alone. If circumstances change, the operator should submit a new budget for review and approval on the same basis as the original budget, along with an explanation of what went awry and what is being done in response.

Don't be a stranger. The budget should be considered along with the operating results for each monthly reporting period, and the operator should be required to report regularly on its budget compliance, the causes of variations, and how they are being addressed.

Conclusion

Hotel owners who fully participate in the budgeting process can positively affect the operations and profitability of the hotel. The budgeting process can be time-consuming. But isn't it worth taking the time once a year, however inconvenient, to protect your investment? The budgeting process can also be contentious. But isn't it worth it to work through disagreements to find ways —

one line at a time — to leverage your investment into greater profitability? And wouldn't it be great if you and your operator understood and respected each other's needs and were aligned in your commitment to owning and operating a great hotel?

Indemnification provisions

Indemnification is usually a payment (or sometimes a repair or restoration) made to restore a party to its condition or situation prior to some event. In the context of HMAs, it usually means that one party, typically the owner, will protect another party, typically the manager, from a monetary claim related to the hotel or its operations.

Indemnification provisions in HMAs: What's the fuss all about?

A simplified indemnification provision in an HMA might look like this:

> Owner shall defend, indemnify and hold Operator harmless from and against any and all liabilities, fines, suits, claims, obligations, damages, penalties, demands, actions, costs and expenses of any kind (including legal fees) (collectively, "Claims") arising out of (i) any action or omission or course of action on the part of Operator in its performance under this Agreement; (ii) any obligation incurred by Operator, whether alone or together with Owner or by Owner alone, in connection with the Hotel; and (iii) Owner's breach of this Agreement; provided that this indemnity shall not apply to any Claims resulting from the willful misconduct, gross negligence or bad faith of Operator.

Why is an indemnification provision needed in an HMA?

Indemnification is usually included to deal with third party claims such as those brought by guests (for lost property or injury), governments (e.g., liquor license or fire & safety violations), or employees (sexual harassment or wrongful termination). It identifies when and how the owner will be responsible for a claim against the operator, and when the operator will be responsible for a claim against the owner.

What does it do that isn't in the rest of the hotel management agreement?

It may alter or reverse the "normal" allocation of financial responsibility for third party claims.

For example, in about 80 to 90 percent of current hotel management agreements, the operator is technically and legally the "employer" for the hotel's employees — the hotel staff and management are on the official payroll of the operator or one of its subsidiaries, and the operator recruits, hires, fires, trains and supervises the employees.

If an employee filed a claim against the operator for discrimination or sexual harassment, the employer would normally be responsible for such claims. After all, it is the employer. But a common indemnification provision might say that the owner has to indemnify the operator against any employee claims. Many owners find this extraordinary, inasmuch as any wrongful action would most likely be caused by the operator.

The theory of such a common indemnification provision by the owner or the operator is that "the operator is not paid enough to assume this kind of liability." The operator feels that it is just acting as the employer as an accommodation to the owner, and the owner should pay for all employment costs, benefits, and even such legal claims.

Under the sample indemnification provision above, the owner would probably be liable for any such employee claims against the operator.

Why should the hotel owner care?

When the owner has to pay the first $5 million judgment for employment discrimination or sexual harassment by the operator — or has it deducted from the hotel's operating accounts — the owner will care, and will appreciate the importance of the indemnification issue (although it will be too late to change the provision for the duration of the HMA).

What do hotel operators want?

Operators generally want to avoid paying any costs incurred in operating a hotel. They want to protect their base and incentive fees from any offsets or reductions, and want to be shielded from any claims incurred in the course of their operating the hotel for the owner. Operators do not want to guarantee any kind of performance or liability. They view the claims that are being indemnified as a normal and ordinary cost of doing business — claims that the owner would bear if it were operating the hotel itself.

The limited exception that operators are generally willing to make to their complete indemnification by owners, is for a claim that is caused by the operator's own gross negligence, willful misconduct or breach of the HMA. Operators are also generally unwilling to allow "attribution" — where the acts of hotel employees hired and supervised by the operator (which can include the general manager and key, high-level supervisory personnel) are "attributed" or charged against the operator.

In the operator's "perfect world," it has no liability for the negligence of its employees, including the acts of a general manager, unless the owner can show that the negligence was the result of corporate gross negligence or willful misconduct of the operator.

What do hotel owners want?

Hotel owners want operators to manage their property as professionals and experts. They generally do not expect to pay for damages or losses caused by someone else's negligence, breach of contract or violation of law — much less gross negligence or willful misconduct. In fact, hotel owners want to be indemnified by the hotel operator if the operator causes losses for any of these reasons.

What message is being given here?

The evolution of indemnification provisions mirrors the evolution of hotel management agreements in general. Originally, most hotel management agreements held operators accountable for all their negligence and misconduct. But for many decades, by industry custom and practice, most branded operators and independents today limit their responsibility to gross negligence, willful misconduct and breach of contract. Operators, (including both established brand operators and many independents) — have reduced their obligations and their liabilities, making management agreements more valuable to them.

The current state of the industry concerning indemnification provisions — like many other provisions of hotel management agreements — sends a difficult message to owners. While operators and owners should be aligned in their goals, this provision highlights the differences and the tension between the positions.

How can you resolve it?

There is no simple answer; each situation is unique. The indemnification provisions cannot be viewed in a vacuum. You need to understand how these provisions relate to the entire agreement, and address indemnification as part of the overall relationship between owner and operator in the hotel management contract.

Unless you are handling hundreds of hotel management agreements a year you will not know all the ins and outs and current market trends. Not even professional or institutional hotel investors should start the management agreement process (even in negotiating the LOI or term sheet) without veteran hotel advisory and legal counsel experienced in these agreements.

Putting it all in context...

Hotel management agreements (at least such contracts with the branded hotel companies like Marriott, Hilton, Hyatt, IHG, and the like) tend to be very long term, "no-cut" contracts. Entering one of these arrangements is a little like turning complete control of your asset over to someone on a 99-year lease, except the "rent," if any, depends on what is left over after the manager gets done operating the hotel to its standards. But in addition to that, *you* are responsible for all operating shortfalls and capital expenditures that are not covered by available cash from hotel operations. The terms of the hotel management contract are likely to govern the relationship of hotel owner and operator for many decades and are hard to change once cast.

SNDAs: Subordination agreements affect the value, financeability and collateral value of a hotel

For our purposes the following three terms are identical in meaning and fully interchangeable in the context of hotel operating agreements:

- Subordination Agreement
- Subordination, Non-Disturbance and Attornment Agreement
- SNDA

Subordination agreements are frequently used with various types of real property when someone other than the owner is occupying or using the property secured by the lender's loan. So in the hotel industry, this arrangement involves the hotel owner, the hotel operator and the hotel lender. And because the lender's joint agreement is required, typically the HMA will specify that these three parties will execute an SNDA (as a free standing agreement) prior to placing any lien on the hotel. The terms of the SNDA may be specified in the HMA, set forth in an attached exhibit, or required to conform to the requirements of the hotel operator or hotel lender.

What are the three prongs of a typical SNDA?

An SNDA typically has three prongs, as follows:

Subordination (the "S" in SNDA). The hotel manager agrees to subordinate its hotel management agreement and any other interests in certain respects to the lender's lien. Most lenders insist on having some kind of subordination from a hotel operator as a condition to making a loan, and the inability of an owner to compel the delivery of subordination in a form satisfactory to the lender may jeopardize the financing.

Non-Disturbance (the "ND" in SNDA). The lender typically agrees not to disturb the manager's enjoyment and control of the property, and not to attempt to terminate the hotel management agreement executed by the owner/borrower or to remove the manager if the lender becomes the hotel owner as a result of foreclosure. While this makes sense as long as a loan is performing, it can seriously diminish asset value and flexibility after a loan default by the owner/borrower.

Attornment (the "A" in SNDA). The manager agrees to recognize the lender, or its successor in interest, as the new owner having the right to enforce the hotel management agreement after the lender forecloses or acquires the hotel by deed in lieu of foreclosure.

What does a subordination provision look like?

While the terms of an SNDA will undoubtedly depend upon the operator's and lender's relative sophistication and bargaining strength, a typical hotel management agreement is likely to have something like the following provision:

> **Subordination.** Owner shall ensure that all existing and future Mortgagees and lessors provide Operator with non-disturbance agreements in form and content reasonably acceptable to Operator, which agreements shall preclude the termination of this Agreement absent the uncured breach of this Agreement by Operator, and shall further preclude the conveyance or leasing of the Hotel (whether on foreclosure, deed in lieu thereof or otherwise) to any Person to which Owner could not assign this Agreement without Operator's consent.

As an owner or lender, do you know why the SNDA is so important?

As one critical part of a long-term hotel management agreement that may govern the parties' rights and liabilities for decades, the SNDA controls how each party's interests will be served or thwarted. In other words, the SNDA will strongly affect the owner's ability to finance or refinance the property, and possible liability on loan default. Similarly, the SNDA will control vital aspects of the lender's flexibility on loan default and in workouts, receiverships, foreclosures, bankruptcies, or deeds in lieu. The SNDA is also likely to have a dramatic impact on the value of the hotel, and how many bidders are interested in buying the distressed property.

What does each stakeholder-party to the SNDA want?

What does the hotel operator want? The hotel operator typically wants the option to continue to manage the hotel for the full contract term (with extensions) with a solvent owner — even when the hotel fails to produce enough cash flow to service debt and the owner is faced with foreclosure.

The principal motivations of the operator are purely economic. Long-term management contracts are assets for the hotel operator. They are somewhat like bonds or annuities, creating streams of inflation-adjusted income for many years. The present value of these income streams represents a significant asset. Anything that could result in an early termination of this income stream is a problem for the operator, including the ability of a lender to terminate the operator on foreclosure (or sale by a receiver, deed in lieu or bankruptcy court).

The hotel operator also wants to control the transfer of the property, even on foreclosure, to be sure that the proposed transferee is suitable from its perspective. For example, the hotel operator wants to know that the new owner will not be a competitor, has adequate resources to meet the owner's obligations under the HMA, and get appropriate assumption agreements whereby the new owner agrees to the terms of the old HMA, or renegotiates a new one.

Operators would say that they want to protect their "distribution system." They do not want their brand going up and down on properties, confusing the public. They want the property to continue shouldering its share of system costs (reservation, centralized services, marketing, and support of national and regional offices) and they want to continue managing the property and earning their fees.

What do lenders want? Initially, most lenders really want their borrowers to perform according to the loan documents and pay off at maturity. That does not always happen.

So lenders need both certainty and flexibility. They would like certainty that a capable, professional hotel operator is running the property to maximize cash flow and preserve the value of the asset securing their loan. Operators initially gained their bargaining power from the insistence of lenders and other investors that the branded operator be "locked down" for 50 or 100 years, so the lenders and investors would not have to worry about the promoter (or managing partner) taking over the property and destroying its value. The brands were happy to accommodate being "locked down" as long as the property met their brand standards, and the owner funded all deficits in operating cash flow.

Normally, lenders would like the brand and operator to stay in place even when loans go into default or foreclosure. They do not want the asset to lose professional management, reservation systems, or to suffer the significant cost and disruption of re-branding. But to maximize the value of the hotel collateral, the lenders would like for a potential hotel buyer (or the buyer at any of the distressed sales) to have the right on closing the purchase, or thereafter, to terminate the hotel operator.

Why would the lender want the ability to terminate the hotel management agreement, or give that right to a buyer of the distressed property?

Hint: A review of all the individual hotel purchase and sale transactions of over $10 million per property throughout the last 40 years shows that in 80 percent of the transactions, the buyer was either a hotel management company or a joint venture of a capital source with a branded hotel management company. What happens if the long-term management agreement cannot be terminated on foreclosure or bankruptcy sale or on a deed in lieu sale, and 80 percent of the typical buyers for the hotel don't bid because they cannot substitute their management? What is the impact on value?

In fact, when our hotel workouts team worked with major lenders in the late 1980s and early 1990s, including acting as counsel for the Resolution Trust Corporation (established out of the Savings and Loan meltdown) in the resolution of many hotel bankruptcies, the typical lender swore that it would "never again" agree to an SNDA without the option to terminate the operator on loan default or distressed sale. And that determination was strong ... at least for a few years until people forgot about what happens in the bad times. In every economic downturn since the S&L Crisis, lenders start to remember why their predecessors said never again.

What do owners want? Hotel owners usually have the simplest goal. They want reasonable freedom to get attractive financing for the purchase, construction, improvement or equity take-out of the hotel. They don't want to find that lenders are spooked by their hotel management agreement, or that the terms of financing are adversely affected. They want the hotel operator to give the lender whatever is necessary to facilitate the financing and don't want to be "held up" by the hotel operator when the lender needs some accommodation.

And lending standards can change dramatically over relatively short periods of time, at least when compared to long-term management agreements.

What are the challenges?

Negotiating the subordination provision in a hotel management agreement is challenging.

In a new development deal, the hotel owner frequently has to get the operator before meaningful negotiations with the lender take place, and therefore the HMA with the subordination provision is usually in place long before talking to a lender. Also, many owners and their advisors do not understand the importance of this issue or ignore it until it is too late. Many owners are lulled by the manager's assurances that the manager has great influence with lenders, that lenders will be attracted to the project because of the manager, and that a deal has never been held up because of this provision. The last might be true, but that's only because the borrower bears the cost!

Lenders' standards are constantly changing. As lenders underwrite loans during times of easy credit, they are more likely to accept some terms from managers that they will not during challenging economic conditions. But since management agreements can have terms of 20, 30, 40, even 50 years or more, owners have to anticipate that they (or their buyers) will need to approach lenders many times over the course of the agreement, not just when the agreement is executed. The burden a subordination provisions places on financing will undoubtedly affect the value of the hotel through many transactions over the life of the property.

What is the answer? How can you resolve the conflicting interests?

There is no simple answer. Each situation is unique. You need to understand how subordination provisions relate to your interests, the entire agreement, the lending environment, and address it as part of the overall relationship between owner and operator in the hotel management contract.

Exculpation clauses — protecting the owner's assets

This section briefly reviews the benefits to hotel owners in including a provision in hotel management agreements limiting the liability of the owner to its interest in the hotel property. This kind of provision is commonly referred to as an "exculpation clause," because it exonerates someone from blame or liability. While this clause is in many ways basic blocking and tackling, it is important to remember as acquisitions in the hotel sector increase, and as owners renegotiate agreements with brands and independent managers.

If you like the idea of both a belt and suspenders in any part of your financial dealings or business life, please note that you will rarely see an exculpation clause in a draft HMA from a hotel management company. In fact we have not seen them in very many HMAs drafted by others.

Why take a chance?

Limiting the hotel owner's liabilities under the HMA

Most hotels are owned in a special purpose limited liability company or other entity designed to facilitate financing, and to also limit liability to the assets of the hotel and its related business. Sometimes operators will seek the personal guarantee of individual owners or investors so that they will stand behind the ownership entity's promises in the HMA, but most owners won't consider that. And if there is any kind of reasonable equity investment in the project, and appropriate insurance, personal guarantees should be out of the question.

Limitations on liability in management agreements

Over the development of HMAs, hotel managers have become more aggressive in limiting their liability for operating hotels. These limitations include the indemnification provisions that typically require the owner to indemnify the operator for all losses or damages arising out of the hotel, unless it was caused by the operator's gross negligence, willful misconduct, or breach of the HMA. In other words, they are indemnified for their negligence.

Some brands have also added limitations on claims to a fixed amount (such as half the basic management fee), or "actual damages," preventing the owner from making any claim for consequential damages, punitive damages or other "extraordinary" remedies.

These clauses are designed to protect operators, but rarely does the operator's draft of the HMA contain any protections for the owner. We have almost always been successful in making the limitations mutual, and, in addition, we have successfully demanded protection for our owner clients from unwarranted liabilities through an exculpation clause.

What does the owner's exculpation clause look like?

While each situation is different, a typical exculpation clause looks like this:

> "Notwithstanding any other provision of this Agreement to the contrary, the liability of Owner arising out of or in connection with this Agreement and the transactions and obligations contemplated hereby shall at all times be limited to the interest of Owner in the Hotel, and in any litigation or any other dispute, neither Manager nor any other party shall seek or have recourse to any other asset of Owner or to Owner's partners, members, associates, agents, executives or Affiliates. Without limiting the foregoing, neither Owner nor any party associated with Owner shall have any liability in excess of Owner's interest in the Hotel for any act by Owner, including liability for the gross negligence, willful misconduct (either prior to or during term of or after the expiration or earlier termination of this Agreement) or breach of this Agreement by Owner."

What does the exculpation clause do?

The purpose of the exculpation clause is to ensure that the liability of the owner and its principals to the manager, and any other entity making a claim under the management agreement, is limited to the owner's interest in the hotel property itself. The clause extends the protection to the principals and affiliates of the ownership entity, not just the owner. This clause covers not just direct claims under the management agreement, but also any claim arising out of the management of the hotel. The limitation is important and meaningful — owners build or buy an expensive asset and invest significant sums in its equity. A manager should be satisfied that the substantial equity investment is adequate to secure performance by the owner.

Why an exculpation clause?

It is generally possible to negotiate with a manager so that the limitations on damages are mutual — that is, both the owner and the Manager are limited in their claims. Moreover, hotels are typically held in single purpose entities, which limits their liability. Why is it preferable to include an exculpation clause?

While there are several answers, the key issue is that holding an asset in a single-purpose entity, and limiting damages and causes of action, does not prevent a manager or another party from "piercing the corporate veil" and pursuing claims against the principals of the owner. This is particularly the case because the clause should include not just contract actions, but also other claims which are more easily brought against the principals of the owner.

Owners should also be aware that the asymmetry of the owner-manager relationship militates toward ensuring, through all possible means, that the owner is protected. The owner should not lose sight of the fact that claims by an owner against a manager may be difficult to prove. They often depend on subjective measurements of quality, and often relate to matters where the manager has more leverage. The manager, on the other hand, typically seeks monetary damages based on fee calculations, which are transparent (particularly where the manager has been keeping the books)! Strictly defining the owner's potential liability is, therefore, key to balancing the relationship.

Chapter 3

About Franchise Agreements, Brands & Independent Operators

Decisions about brands and management

Branded vs. unbranded hotels, and branded vs. independent operators

When should you brand your hotel and when should you leave it unbranded? How do you know when the benefits justify the costs? And if you decide to brand, should you go with brand management or an independent operator? What are the considerations?

Few decisions are more important. Here are some insights garnered by our Global Hospitality Group®'s experience in helping clients with more than 2,700 hotel management agreements and franchise agreements.

Why hotel branding and management decisions are so important

One of the first decisions in the hotel development or acquisition process can have a lasting impact on the success of the project: whether the property should be branded, and whether that brand should manage the property. The hotel's brand will be a defining part of the profitability, image and value of the hotel, and there may be no other decision which has a greater effect on the future of the property. Similarly, the management of a hotel can enhance the value of the brand, protect the owner, or detract from the value of the hotel — by as much as a 50 percent swing.

The three fundamental questions

While a hotel owner will live with these choices for years — if not decades — owners and developers often fail to ask three key, threshold questions:

1. Should the hotel be branded?
2. If it is branded, which brand?
3. And if it will be branded, should the brand manage the property?

We recognize that there are many voices in the decision. Lenders or other investors may be more comfortable when a hotel is branded, and may feel that a brand manager will better operate the hotel. Some investors may be predisposed to one brand or another (often based on personal experiences as a guest, rather than an owner), and may have preconceptions of the ability of hotel ownership to operate the property. However, even where these strong voices have input, the owner or developer should consider the pros and cons of brands and brand management.

Four options available to hotel owners for branding and management

At the outset, there are four basic choices available to an owner:

- Management by the brand, where a single firm will agree to operate the hotel under a specific brand, and the owner essentially hands the property over to the manager with oversight rights and obligations defined in a management agreement.

- A franchise with a third party manager. Here, the owner enters into two agreements, one of which is a license agreement with the brand, giving the owner the right to operate a hotel under a specific brand, and a second with a third party manager who will actually operate the property.

- A self-managed franchise. In this case, the owner obtains a license or franchise to operate under the brand, but manages the property itself.

- Finally, an unbranded hotel, operated either by a third party manager or by the owner.

Why a brand?

Brand standards and support. Brands provide many benefits. The major brands establish standards, which are intended to be consistent across all operations so that guests are better assured that they will receive the level of service and amenities they desire and expect, wherever the property is located. Along with standards, brands provide operating manuals, which are intended to provide a "turnkey" approach to the operation of the property. This is intended to reduce the number of mistakes and help ensure that the property is, in fact, operated pursuant to the brand standard.

Importantly, brands provide services that drive occupancy, such as reservations systems, websites, brand marketing, loyalty programs, and quality control. While they are often cited as important reasons to affiliate with a brand, they can be costly to establish and maintain, and the direct benefit to the property is not always apparent.

But are the benefits worth the cost? There are, however, a number of reasons not to use a brand. The most obvious reason is cost. Brands charge a variety of fees — management, royalty or license fees, loyalty program fees, marketing fees, reservations fees, training fees — the list can seem endless. Moreover, many of the fees are unrelated to the brand's actual performance. Base management or license fees and marketing fees are paid on gross revenues, regardless of the source of the revenues. Thus, the brand is compensated for occupancy even if the brand was not responsible for it.

Similarly, brand standards, while benefiting the property in some ways, come at a cost. These standards are designed to benefit the brand, not a specific property. Even if a standard does not add value to a property, the owner is obligated to adopt it because it is a brand standard. Brand standards are generally inflexible, and impose added costs on owners. Owners should also be aware that, over the term of the management or license agreement, brand standards change, and the driving force for the change is usually to enhance the benefits to the brand as distinct from the interests of owners.

Ill-conceived programs? More than that, some hotel programs are ill-conceived or have wildly disproportionate costs to some affected hotels and benefits to other. Over the past 35 years, we have seen brands adopt programs to centralize sales, accounting, quality control and other functions only to revert back to the prior regime of decentralized services when they do not provide the benefit promised. The cost of these programs are borne by hotel owners, and the cost is multiplied over the development of the plan, its implementation, the struggles to overcome flaws, and finally dismantling the plan. Brands have the luxury of experimenting because they do not have to foot the bill.

Are expensive loyalty programs worth the cost? There is also a big controversy as to whether loyalty programs actually benefit hotels. Many analysts have called their effectiveness into question. Again, the owner must consider whether their benefit is worth the extra cost, both in terms of contributions to the loyalty program and redemptions by guests. These programs are not optional.

Issues with long-term commitments. Owners need to recognize that both brand management agreements and brand license agreements require a long-term commitment, measured in decades. Brand affiliation agreements make it difficult, if not impossible, for an owner to terminate for bad performance of the operator. This lack of control can seriously depress the value of the hotel at sale, or even lead to financial failure and foreclosure.

In addition, owners must take into account that the terms of these long-term agreements do not protect owners from the possibility of brand dilution or decline. There are a number of brands that, over the years, rode a roller coaster of changing target markets and ability to deliver on owner expectations. Many left owners without expected support for years or declined in value. Nonetheless, the owners were obligated to support expensive brand standards and programs that did not deliver expected benefits. (Radisson, Red Lion, Wyndham Resorts, Doubletree, Westin, Sheraton, Amfac, and RockResorts to name a few). Some brands recovered to varying degrees over years. Others did not.

Why not be independent?

Given that branding a hotel carries with it costs and burdens, some owners consider whether it would be advantageous to go it alone. Those who do cite a number of advantages:

- No license or system fees — at the outset, the owner will save in the neighborhood of 10-15 percent of gross revenues that it would otherwise pay to the brand for the right to operate under the brand name and mandatory services.

- Greater flexibility to meet the market. While unbranded properties don't have the support of system standards, they also do not have to take the good with the bad, and can structure a hotel standard that perfectly meets their market. Moreover, they can experiment and change, which can be difficult, if not impossible, in a brand's regime.

- Don't pay for what you don't need. There are some instances in which a brand simply isn't needed. For example, a hotel adjacent to a university hospital might not need a brand affiliation. The location of the property itself will put heads in beds and drive a high occupancy.

Owners need to be aware, however, that taking the independent route has its drawbacks as well.

- Unbranded hotels lose the benefit of a brand's support system, including detailed operating manuals and procedures, training, access to best practices, and perhaps most importantly, the bench strength and human capital that can make the difference between a successful and unsuccessful hotel. Many independent operators do, however, have excellent support systems.

- Not having a brand also makes the owner rely on its own resources and that of its on-site manager. Placing the success of the hotel in the hands of the wrong third party manager can be a risky venture. Nonetheless, the right independent operator can often bring better and more focused resources.

- An unbranded hotel will not have a dedicated reservation or marketing system. While there are a number of generic options available, they are not necessarily designed to the specific needs of the hotel or, conversely, require increased investment by the owner to create an effective reservation and marketing program. However, the online travel agencies (OTAs) and other viable alternatives are now available to independent operators.

- An unbranded property is vulnerable to marketing programs by larger, branded operators. With larger marketing budgets, a branded property may be able to compete more effectively with an unbranded hotel. However, the saving in brand costs may be more than adequate to provide more marketing in the hotel's relevant markets.

Who should manage the property?

Once the decision is made about whether the hotel should be branded or unbranded, the owner must address whether to have the brand itself manage the property, or whether to seek a third party manager (or self-manage).

Brand managers provide a number of benefits. They are closest to the standard and how it is implemented; the brand cannot argue that its own manager is failing to meet the operating standard (unless the owner interferes with the process or fails to provide capital). Some owners also see brand managers as being the most efficient alternative, since typically only a single management fee is paid, instead of a franchise or license fee and a separate management fee. And in many cases, the brand manager will have the deepest bench — the brand is likely to have more experienced personnel who can parachute in to the property to fill a vacancy temporarily, or to provide specific expertise on a problem.

Brand management also comes at a cost. While the nominal fees might seem to be less, brand operators are more likely to emphasize the highest interpretation of brand standards and be less concerned with achieving economies in operation or even maximizing revenues. The primary concern of a brand operator is the presentation of the brand, regardless of its economic impact on the owner. To put it directly, the loyalty of the brand manager is to the brand, not to the property. And to exacerbate the issue, brand managers are difficult and expensive to oversee. Since they have full access to and control of the hotel, even understanding where their operations might be improved can be difficult.

When is it appropriate to engage the brand to manage the property? First, brands reserve the exclusive right to operate certain of their flags. For example, Ritz-Carlton, Four Seasons, St. Regis and other flags are exclusively operated by their corresponding brands, since they are flagship properties and the brands protect those standards jealously. It is the right choice because there is no other choice.

In addition, certain types of properties, such as large, convention hotels, require skills and expertise — and national group sales offices — that have been developed by only a small circle of operators. While there are a number of independent operators that can operate larger hotels, the staffing, systems, and resources of a branded operator will normally benefit hotels with more than 600 rooms, significant meeting space, and multiple food and beverage outlets.

Conclusion

The decision to brand a hotel, the selection of the brand (if any), and the selection of the manager are all interrelated and essential decisions for the hotel owner. The outcome of the decision will have a lasting impact not only on the current income and success of the hotel, but also on the ultimate value of the property.

The myth that franchise agreements cannot be negotiated

Eight things to negotiate in your next franchise agreement

The main purpose of this section is to debunk the myth that franchise agreements are not negotiable. Franchisors, given the proper motivation, will negotiate certain franchise agreement terms, particularly business issues that can have a real dollars and cents impact; the key is to understand what is negotiable, what will make the most impact, and how to get there. In these cases, understanding what a brand has done and is willing to do will create value. So, throw away your old conceptions!

As a "starter kit," we have listed eight areas that are frequently the subject of negotiation in franchise agreements today. But there are many more. And, you are missing out if you don't get advice on what and how to handle your next franchise negotiation.

The ascendancy of hotel franchise agreements

Branded hotel franchise agreements continue their rise to dominance in the hotel landscape. Branded hotel management agreements are not dead, but the advantages of having a hotel operator independent of the brand have been widely recognized and continue to propel the franchise model. (The considerations of branding and using branded — versus independent — management are discussed at length in the previous section.)

Franchisees are told by the brand that the franchise agreements are not negotiable, but then they hear that someone else has been able to negotiate at least one or two contract terms. Potential franchisees don't want to waste time chasing something they cannot get, but the contracts seem so one-sided, and they want to get as much substantive relief as they can.

The most common question we hear from clients is, "What's really negotiable in a franchise agreement?"

Based on our experience with more than 1,600 hotel franchise agreements, JMBM's Global Hospitality Group® knows that there is wiggle room to get some important concessions if you know what to go for and don't waste your effort where it won't do any good.

We have listed a few areas where we have been able to help owners improve their contract terms. Depending upon your circumstances, there may be other significant opportunities. It's important to recognize that there is more room to negotiate business terms than legal terms, and that spending time negotiating some provisions can be counterproductive.

But, a word of caution! One of the biggest mistakes we see is owners trying to negotiate the franchise terms themselves. Their lack of experience shows that they are amateurs, and the brands quickly realize that they don't have to give much by way of concessions.

Setting the context: Understanding the competing interests

Most branded hotel properties are operated under franchise agreements which are long documents with lots of fine print. They are usually presented to owners as "non-negotiable." This brand position is justified on the basis of need for uniformity in agreements and insuring that hotel guests will have a consistency of amenities, operations and experience in all hotels bearing the same flag.

However, hotel owners seeking a franchise also have legitimate interests, and there needs to be some recognition of these needs and the unique circumstances of every situation. In fact, our experience shows that, within certain limits, some provisions of these franchise agreements can be negotiated to address franchisee concerns. Franchise agreements are not nearly as negotiable as hotel management agreements, so owners are well advised to understand what can and cannot be negotiated in order to realize the greatest value from their relationship with the brand.

We have negotiated more than a thousand franchise agreements with every major traditional brand (and most of the others), and based on our experience, we believe there are key franchise agreement terms that hotel owners should normally be able to accomplish.

Eight things to negotiate in your next franchise agreement

Here are eight of the most common franchise terms we are seeing negotiated today:

1 **Franchise and royalty fees.** While it's unlikely that franchise fees will be reduced for the entire term of the agreement, a "ramp up" in fees over the initial years of the agreement, particularly for a newly built hotel, can often be achieved. While other chain fees are more difficult to negotiate, it can be possible to get some temporary relief there as well.

2 **Area of protection or non-competition.** Hotel owners are properly concerned about the brand opening a competing hotel within their property's market area. If it's not offered, a franchisee should ask during the negotiations for a geographic area of protection or non-competition. The duration and area of protection of the restriction varies, but some protection is usually granted.

3 **Ownership transfer.** Most franchise agreements are still based on a simple ownership model, contemplating a single owner (or investment group) of a single hotel. Our experience is that more complicated owners (including REITs, private equity groups, real estate funds and other institutional investors) are increasingly focused on hotel investments. As a result, the transfer provisions should consider the structure of the owner and flexibility for transfers to certain related parties. In that regard, while a sale of a hotel often precipitates a property improvement plan (PIP), the owners should not trigger

a new franchise agreement negotiation, set of franchise application fees and PIP when the transfer is to a related corporate entity or to another family member or trust set up for estate planning purposes.

4 **Independent management and changes in management.** The essence of a franchise structure is providing the power of a brand with the greater flexibility and responsiveness of an independent operator (i.e. an operator unrelated to the brand). A good independent operator can provide an owner with a valuable buffer to the brand's demands for operating and capital expenditures, implementation of new and expensive brand standards, property improvement plans, and certain brand programs that may not make sense for a given property. While brands are, understandably, concerned that an operator must have the experience to run the property, the management company should be the owner's choice, and should have primary loyalty to the owner, not to the brand. Thus, it's important to prevent a franchisor from having veto power over change in management of the hotel.

5 **Liquidated damages.** Liquidated damage provisions in the franchise agreement give the franchisor the ability to collect damages on the early termination of the franchise agreement. They can be a key inhibitor to the owner's ability to maximize the value of the property on sale, because liquidated damages have ballooned in recent years to large multiples of the average annual combined franchise fees and reimbursements paid to the franchisor (and in some cases, even more). While brands are generally unwilling to negotiate liquidated damages directly, understanding the impact and the conditions in which they can come into play will allow for better planning and execution.

6 **Capital investments.** Franchise agreements usually give the brands the ability to require substantial additional capital investments by owners to meet new physical brand requirements. There are a number of ways to

reduce an owner's exposure, including restricting time periods and clarifying the types of capital improvements that can be required. This is particularly the case for a newly built property or an acquired property that may have recently undergone renovation.

7 **Personal guarantees.** Most franchisors require guarantees. Owners should seek to eliminate or restrict the scope or amount of guarantees. As more and more owners are institutional, this requirement is less and less necessary to protect the brand's interests.

8 **Key money.** Many brands are willing to provide key money as a means of securing franchise agreements. While owners are typically excited about the prospect of getting additional funds, they should remember two things: First, key money is typically only paid after the hotel opens; it doesn't provide funds for construction. Second, and more importantly, key money is probably the most expensive money an owner will get; in return for key money, brands typically will be even less willing to negotiate important franchise agreement provisions. A nominal amount of key money is unlikely to benefit the owner as much as it gives leverage to the brand.

While there are limited areas that an owner can expect to successfully negotiate with a brand in a franchise agreement, changes in these limited areas can make a big difference in the value of the brand to the owner. Our expertise in understanding how to implement these changes, and what other changes might be appropriate in particular circumstances, has achieved significant value for our clients.

The importance of comfort letters in financing franchised hotels

If you are buying, building or refinancing a hotel, you'll almost certainly be looking to a bank or other lender to finance it. When you do, you'll need to negotiate dozens of documents, some long, some short, but all of them necessary to get your loan. In other sections, we have talked about the importance of subordination, non-disturbance and attornment agreements (SNDAs). SNDAs are used in the context of a hotel management agreement — usually only long-term branded HMAs — to define the rights of lenders vis-à-vis the hotel operator in the event of the owner's/borrower's loan default, breach of the HMA, foreclosure by the lender or a deed-in-lieu of foreclosure.

But what about franchised hotels? Lenders who take security in a franchised property will want a "comfort letter," an agreement between the lender and the franchisor defining the rights of the lender with respect to the franchisor if the hotel owner defaults on its loan obligations, the franchise agreement or other related arrangements. In other words, lenders seek SNDAs to deal with their rights and obligations with respect to HMAs. They use comfort letters to deal with their rights with respect to franchise agreements.

What is a comfort letter?

A comfort letter is, essentially, a form of assignment of the franchise agreement for the hotel brand. It governs the ability of a lender to operate a hotel property under a brand name after a foreclosure, receivership or other loan default.

Why do lenders want a comfort letter?

Lenders make loans on branded hotels because they believe that a hotel is more valuable if it can be operated (and sold) as a branded property. If the hotel franchise agreement is terminated, the value of the property could drop significantly. Even where there is no foreclosure, the lender may want the ability to be able to "step into the shoes" of the borrower and continue to operate the property under the existing hotel franchise agreement. More than that, a lender will want to be able to sell the hotel after foreclosure (or in connection with a receivership or similar action), and may believe that transferring the franchise to a buyer will increase its recovery. This, of course, requires the consent of the franchisor/hotel chain.

Who writes the comfort letter?

Most hotel brands have a standard form for a hotel comfort letter and, as a practical matter, brands will insist on negotiating from this form. When parties ask a hotel brand to use a new or different form of comfort letter, the brand may refuse or, at best, it will delay loan closing until the negotiation over the form of comfort letter is concluded. While the lender's rights under the comfort letter are limited, most institutional lenders have been willing to accept the comfort letter as providing the lender with sufficient "comfort" that it will have the ability to maintain the franchise relationship and the value of its collateral in the specified events of the owner/borrower default.

What's in the comfort letter?

While each hotel chain's form of comfort letter differs to some extent, most comfort letters have the following provisions:

- The lender wants the brand to give the lender notice and right (but not obligation) to cure any default by the borrower under the franchise agreement prior to a termination of the franchise agreement.

- The lender wants the ability to assume the franchise agreement and avoid the payment of the application and other initial fees charged to franchisees. Hotel chains will often charge a lender a "processing" or administrative fee, which is less than the initial fee usually charged to a new franchisee.

- The lender wants the ability to have a receiver operate the property under the terms of the existing franchise agreement, at least for a short period of time during the foreclosure phase. Most hotel brands are generally willing to allow the receiver to operate the hotel under the "franchise flag" for a relatively short period, provided: (a) any monetary and nonmonetary defaults are cured promptly; (b) the hotel continues to maintain the insurance coverage required by the franchise agreement; and (c) the lender guarantees the obligations of the receiver under any short term license issued.

- If the lender acquires the hotel property as a result of foreclosure, it will typically want to sell the property quickly. As a result, the lender wants to obtain some assurances that the purchaser can also obtain a franchise agreement with the hotel chain.

- In addition, most lenders would like to be released from liability under the franchise agreement once it sells the hotel to a third party purchaser. Most hotel chains are willing to agree that, in the event of a sale of the hotel to a third party that party can apply for a franchise agreement and that such application will be processed in accordance with the franchisor's then existing requirements and procedures.

What's the challenge?

Comfort letters, while a key requirement for most lenders, are challenging to borrowers because they require the lender and franchisor to come to agree on matters that have no immediate effect on them (or on the borrower!), but can prevent the closing of critical financing. Moreover, the lender and franchisor may have a different agenda than merely facilitating the closing of the owner's/borrower's financing transaction. For example, the lender may have other issues with the borrower, and the borrower may still be in the throes of finalizing the franchise agreement. Even in the best of situations, the borrower's counsel is often saddled with the task of negotiating a comfort letter that his or her client has little interest in, and trying to mesh the sometimes incongruent interests of the lender and the franchisor. The ultimate payoff to the borrower, of course, is the making of the loan by the lender.

Brand franchise issues in hotel purchase and sale transactions

Key issues in hotel purchase agreements for buyers and sellers of branded hotels operating under franchise agreements

Buying or selling a hotel operating under a brand name requires special attention. Typically, the existing franchise agreement will be assumed, terminated or modified in some way, and the new branding arrangements will usually have a significant impact on the value and profitability of the hotel. The JMBM Global Hospitality Group® has represented buyers and sellers of hotels with all the major hotel brands, and has developed practical solutions to achieve a smooth transition of the franchise from the seller to the buyer, or to change the franchise if that suits the buyer's goals. Knowing when and how to work with the franchisor as part of the transaction can save both parties a lot of money, avoid major disruptions of hotel operations upon the sale and increase the value of the property itself.

In this section, we discuss some of our experience dealing with a few key hotel franchise issues that need to be addressed during the hotel purchase and sale agreement negotiation and during the transition process.

The first thing you need to know: The franchise does not follow the property. It terminates on sale.

Some hotel buyers and sellers believe that the hotel brand can be sold along with the hotel. That is not true. Virtually all franchise agreements currently used by the major brands provide that the seller's existing franchise agreement terminates when the hotel is sold. The buyer will need to apply for, gain approvals and then enter into a new franchise agreement if the buyer wants to retain the brand. This leads to two key concerns.

First, unless a franchisee (the seller) has negotiated otherwise with the franchisor, the sale of the hotel will cause the termination of the franchise agreement, obligating the seller to pay a significant termination fee. While most franchisors will waive the termination fee when an approved buyer enters into a new franchise agreement, the transaction documents, conditions and timeline must deal with this reality.

Second, the new franchisee (the buyer) must make independent arrangements with the franchisor to continue to operate the hotel under the same brand (if it chooses to do so), starting on the day the transfer takes place.

The hotel purchase and sale agreement should address these concerns. For example, the seller might include provisions in the hotel purchase and sale agreement to require that the buyer receive approval from the franchisor, and a new franchise agreement from the franchisor, before the closing of the transfer. If the buyer intends to change the franchise, then the seller needs to take into account the termination fees that the franchisor will charge for termination of the franchise. The seller may also want to increase the purchase price or negotiate terms with the buyer that reflect the seller's payment of any franchise termination fees. The parties' respective obligations to effectuate the transition should also be spelled out.

The hotel purchase agreement must allow enough time to complete the new franchise approval

Hotel franchisors have an application process, which requires detailed background and financial information from the prospective hotel buyer before they will accept the buyer as a new franchisee. The seller will want to find out how long the franchisor will take to review the buyer's franchise application. The buyer needs to be prepared to file a franchise application and to submit the necessary background and financial information to the franchisor as early as possible. A franchisor can take several weeks to review a franchise application from a new franchisor. Less time may be required for a buyer who already operates other hotels under the same franchise, but the buyer will generally still need to submit a new application and obtain franchisor approval.

The franchisor may also require the buyer to commit to upgrades of the hotel as a condition of approval (more about that next). The buyer will want to review the franchise agreement presented by the franchisor, and perhaps negotiate a few modifications. The seller and buyer need to provide time in the transaction process for the buyer to go through the approval and negotiation process with the franchisor before the closing. Once the buyer and the franchisor have agreed to the terms of the new franchise agreement, it may take additional time for the buyer to receive the signed franchise agreement from the franchisor. It is prudent for both the seller and buyer to wait until after the buyer has a signed (new) franchise agreement before closing the sale of the hotel.

For the buyer: How to deal with PIP requirements

Almost every hotel franchisor will require a new franchisee to undertake a property improvement program or "PIP" as a condition of receiving a new franchise agreement. If the hotel has not been upgraded for several years, the franchisor may require the buyer to make a substantial investment in property upgrades. If, on the other hand, the seller has recently made upgrades, the buyer may be able to reduce the required improvements, and/or to negotiate a longer time period after closing for the buyer to complete property improvements.

The buyer will want to start the discussion process with the franchisor early in the purchase transaction, so that the buyer can determine the costs of the improvements being requested by the franchisor, and be prepared to discuss a timeline with the franchisor to manage the costs and operating disruptions that will be required for the upgrade. Inexperienced buyers will want to engage knowledgeable consultants to help review and evaluate the franchisor's requested improvements, and suggest "value engineering" modifications to the franchisor's property improvement plan to reduce the buyer's cost.

For the buyer: How to negotiate with the franchisor for better terms in the franchise agreement

Although many of the terms of a franchise agreement will not be negotiated by a franchisor, there are some provisions that are negotiable. Some of the most frequently negotiated provisions include:

- Lower initial franchise fee rate, with a ramp-up in franchise fees over time

- Include or expand an area of protection or restricted area within which the franchisor will not issue new franchises for the hotel brand

- Permit transfers to certain of the buyer's internal affiliated persons or entities and to accommodate certain financial arrangements

- Eliminate any of franchisor's right of first refusal, right of first offer, or right of first negotiation

- Eliminate or reduce termination fees for the future sale of the hotel by the buyer

- Establish some protection or standard before the franchisor can require the buyer to make future renovations

Another major issue for negotiation will be the guarantees that the franchisor requires from the buyer and its affiliates. Buyers should be aware that there are different forms of guaranty, and it is possible to negotiate a guaranty that will reduce the potential liability of the guarantor. For additional recommendations on Hotel Franchise Agreements, see *The five biggest mistakes hotel owners make in selecting operators and negotiating brand HMAs* at page 9.

For the seller: How to deal with liquidated damages

Most hotel franchise agreements require an owner/seller to pay a termination fee or liquidated damages on termination of a franchise. Often this amount will be a multiple of the average annual franchise fee earned by the franchisor over the prior years. The franchisor may also charge the seller other fees, such as charges for the hotel signs that the franchisor leases to the seller for a fixed term. The seller will want to ask for a waiver of all liquidated damages, which the franchisor will often grant, as long as the buyer enters into a satisfactory new franchise agreement with the franchisor. The seller should not allow a buyer to close on the hotel purchase before the seller has obtained a waiver from the franchisor and the buyer has obtained a new franchise agreement from the franchisor.

Unless there is a specific condition in the contract, even if the buyer is obligated by the purchase agreement to execute a franchise agreement after the closing (and does so), the franchisor has no obligation to waive termination fees. And of course, if the buyer does not enter into a franchise agreement after the closing, the franchisor can demand that the seller pay all of the termination fees and charges.

Often times, such termination fees and related charges are secured by the personal guaranty of the owner/seller, which means that the franchisor can sue the owners directly for these amounts. Therefore, it is critical to the seller to obtain the waiver of termination charges by the franchisor before the closing.

For the buyer: How to coordinate a de-branding if the hotel is changing flags

If the buyer intends to change the hotel flag, the process of removing the old name and replacing it with the new name will require coordination and timing. This is typically done by the buyer immediately following the closing, in accordance with a pre-arranged schedule. The buyer will want to coordinate with the franchisor, because hotel brand signs are often leased, rather than owned, by the seller. In addition, all items with the old hotel brand name and logo will need to be removed from the hotel and replaced.

In addition, a change of hotel brand will likely also mean a change of reservation systems. This may necessitate replacement of existing technology at the hotel to accommodate the new reservation system and training of personnel who are not familiar with the new system. The buyer will want to be in a position to immediately turn on the new reservation system when the old one is turned off, to avoid a disruption in bookings. If the hotel does a significant amount of group business, the buyer will want to discuss existing group bookings with the franchisor, and if possible obtain a commitment from the franchisor to leave the existing group bookings in place without soliciting the groups to move to another hotel within the franchisor's system.

At the same time, buyers should be aware that franchisors often steer bookings away from properties when those properties change brands. Thus, the buyer needs to start marketing the property as soon as possible to avoid unreasonably low occupancy when the hotel opens under new ownership and brand.

For the buyer: Obtaining approval of the hotel manager and the right to change managers

The hotel buyer will often bring in an independent hotel management company to manage the hotel under a hotel brand franchise agreement. Since the hotel franchise agreement will include a provision that requires the franchisor's approval of any third party manager of the hotel, the hotel buyer will need to confirm early in the transaction that the franchisor will approve the buyer's choice of hotel manager. For future flexibility, it is also wise to negotiate for the ability to change hotel managers without the franchisor unreasonably withholding its consent.

Dual-branded hotels — what every owner or developer should know

The growing trend of dual-branded hotels

Dual-branding of hotels in a single structure or complex is quite a trend in the hotel industry and has been picked up by the popular press.

The hotel lawyers in JMBM's Global Hospitality Group® have worked on dual-branded hotels since the early inception of the concept, so we thought we would share some our observations on the pros and cons of this approach.

One building — two brands: Two sides to the dual-branding coin

USA Today has reported that hotel chains are increasingly offering owners and developers a "two-for-one" deal – a single building housing two separate hotels. While this is not entirely new (hotel companies have been placing multiple brands adjacent to each other or sharing facilities for many years), the trend of "dual-branding" is accelerating. JMBM's Global Hospitality Group® has worked on a number of these projects, and sees both benefits and challenges in this trend.

Here are a few of the considerations that we have noticed.

Benefits of dual-branding hotels

Probably one of the most appealing parts of a two-brand, one-building approach is the ability to maximize the value of land, which is one of the biggest costs of developing a new hotel property. Hotel brands typically provide for a range of room sizes and configurations in any single hotel. By effectively putting two hotels on a single parcel, a developer can increase the number of guest rooms and provide a greater variety of guest room types to maximize the revenue from that property.

Different brands from the same brand family can also appeal to broader range of guests. For example, Hyatt Place and Hyatt

House properties are often co-located, making it possible to offer both a select service hotel and an extended stay property. And at LA Live in Los Angeles, Marriott International has combined a Ritz-Carlton and a JW Marriott Hotel on the same property. In a separate building across the street, Marriott co-located a Courtyard by Marriott and a Residence Inn. That gives Marriott four Marriott-family brands to offer guests in two buildings!

Locating two hotels in a single property may also permit more efficient use of space. The two hotels sharing a building may be able to share costly parking, pool, fitness center facilities, meeting space, restaurants, retail areas and engineering facilities, which would otherwise have to be duplicated.

Just as important as maximizing the efficiency of physical space is the cost savings that may be achieved in operational efficiency. It may not be effective to have a full time chief engineer or accounting staff for a single, 100-room hotel, but it may work if they service two co-located hotels with a total of 250 rooms. Similarly, having more hotel rooms operated in the same building, by the same brand, has some potential for greater flexibility and scalability with other personnel (housekeeping, maintenance, front desk and so on), and thus can reduce employment costs and increase efficiency.

Challenges of dual-branding hotels

While there are clear advantages to putting more than one hotel in a single property, there are a number of challenges as well. One of the key challenges an owner will face in a dual-branded property is that different brand families generally refuse to cooperate on a dual branded property. It is virtually impossible to imagine two different brands would agree to operate hotels in the same building. So even if the owner felt that a Hilton hotel and a W hotel would be the perfect mix, if they ever did both occupy the same building, they would never share operating space, facilities or personnel.

Even mixing two brands from the same brand family can be tricky when the two brands are far apart in typical guest profile — the amenities of a luxury hotel would be compromised by sharing space and personnel with a limited service hotel. For that reason, most of the dual-branding efforts have been with brands that are fairly close on the brand family chain scale. At the same time, putting two very different brands together can muddy the differences between different offerings.

Owners should also consider financing issues. Financing lenders may want to aggregate cash flows from the two hotel operations for debt service coverage ratios and other benchmarks for internal credit purposes. At the same time, they would normally also want separate legal parcels for each hotel for remedy purposes. This adds a few complications (generally not insurmountable) to negotiations and transaction costs, that should be more than set off by cost savings and efficiencies of dual-branding.

In the typical dual-branding situation today, the properties would normally both be managed under a single management agreement, or at least by a single manager, so as to achieve the greatest operating efficiencies. Under a single agreement, the manager would combine the financial results of the properties together, and would apply a joint performance test. While that would avoid some of the problems of running two separate hotels in one building, it would also tend to hide the actual performance of the individual hotels. It would also mean that if the owner wanted to terminate the manager of the non-performing hotel, it would also have to terminate the performing hotel. These issues can all be dealt with in management agreement negotiations if an owner or developer is well-advised.

At the same time, if the dual-branded hotels operated under franchise agreements, they would require two different franchise agreements. Franchise agreements for dual-branded properties need to have customized approaches, contact provisions and operating procedures to optimize the benefits of dual-branding.

Five things to keep in mind when you look for a hotel operator

Setting the record straight on HMAs

Over the past several months, a lot has been written about what hotel management agreements should or should not say. The Global Hospitality Group® at Jeffer Mangels Butler & Mitchell has been negotiating, re-negotiating, litigating, arbitrating and advising clients for more than 35 years on more than 2,700 hotel management agreements and franchise agreements. Our experience extends to virtually every brand and every significant independent manager, as well as many less well-known players.

Based on that experience, we thought it would be helpful to set the record straight on some key issues that owners need to consider.

1. **Owners and managers are not partners.** One of the common statements we hear from owners and managers is that the management agreement "aligns the interests" of the owner and the manager, and that the manager is "just like a partner" in the hotel. While the interests of the owner and manager can be reconciled, they are not aligned – even when the operator makes an equity investment in the hotel. Managers are focused on maximizing their portfolio and overall revenue, while hotel owners are concerned about the value and income of a single property. Managers can "sacrifice" the profitability of a single property so long as the value of their portfolio is enhanced and they get their money off the top from gross revenues, whether or not the hotel is profitable. Owners expect to profit from each property.

2. **Managers are NOT taking ownership risk.** While it's true that hotel managers take on some costs and risk in managing a property, the fact is that in almost all cases, their risk is dwarfed by the owner's risk. Owners are responsible for funding all of the costs of the hotel, regardless of its profitability; managers are not. Those who

raise funds for charities often refer to the difference between "involvement" and "commitment." And they like to make an analogy to a ham and egg breakfast, where they say the chicken was involved, but the pig was committed. In the world of hotels, managers are "involved," but owners are "committed."

3. **The hotel management agreement is important.** Many commentators, including those with experience in the industry, argue that the manager's track record is more important than the management agreement. We agree that an owner should verify the manager's track record before making a commitment. However, the track record alone is not enough. First, while every management company has a list of highly touted successes, every management company also has a less-publicized list of disappointments — the track record goes both ways. Beyond that, a hotel management agreement is a complex document that identifies the expectations of parties for a period of five, ten, twenty, fifty years or more. Over that period of time, a good track record can turn into a disappointment, and relying on decades-old assumptions may be disastrous.

4. **Owners need meaningful approval rights.** All of these factors lead to a key conclusion — owners need to have a meaningful say in hotel operations. While owners hire managers to operate properties because of their expertise, resources, personnel and reputation, the relationship between owners and operators is "asymmetrical," and the goals of the two differ. While managers like the idea of a 70s-style management agreement, where the owner simply hands the keys to the manager and hopes for the best, today's owners are vitally interested in operations. This means that owners should have clear oversight and approval rights over budgeting, expenditures and key operating decisions. They should not be dissuaded from exercising those rights because of an operator's track record.

5. **The gap can be bridged.** Despite the differences between owners and managers, the gap can be bridged, but to do so

requires expertise and experience in the options and alternatives available to the parties. From the owner's point of view, an attorney that understands what managers need and how their requirements can be met, is essential. Just as important is bringing to the table advisors that can recommend meaningful and practical compromises, and who are known to be credible players in the industry.

Chapter 4

How to Terminate a Hotel Management Agreement

What can you do when an HMA isn't working?

There are always disputes between hotel owners and operators, and most of them are resolved without any legal action. But some disputes advance into litigation with the filing of a complaint, and others go to arbitration. The choice between litigation and arbitration is normally controlled by the terms of the management agreement.

The number of owner-operator battles ebbs and flows with economic cycles, escalating substantially in difficult times as the survival of many hotels teeter on the brink. What the public sees is just the tip of the iceberg.

Setting the stage: the owner-operator relationship

The relationship between a hotel owner and hotel operator is complex. While the owner bears the financial risk of the hotel's success or failure and its gain or loss in value, the operator has the exclusive right to manage the owner's business and is paid "off the top", whether or not the hotel is profitable. The hotel management agreement typically transfers and entrusts control of the hotel's assets to the operator, while the owner assumes the costs and risks of operation.

Hotel owners nationwide are increasingly aware of both the benefits and impediments of long-term hotel management agreements with branded operators (and nearly all such contracts are long term, often running 40 or 50 years). On the upside, the brand can provide stability, consistent standards, a reservation system, marketing expertise and professional staffing.

The downside can be hard for owners to live with — brands can incur needless expenses, be unresponsive to market conditions, or even indifferent to the owner's need to run a profitable business and protect an asset.

While the majority of hotel owners and operators work hard to achieve a balance that is a win-win for both parties, it is easy to understand how things can go badly, quickly.

The root cause of owner-operator disputes

When problems boil over, at the heart of the matter, usually you will find the owner believes that the operator is not running the hotel in a satisfactory manner, and is treating the owner unfairly. Often, the operator is the only one in the relationship to make any money.

Operators don't want to give up their lucrative management agreements, and many of them can't, or won't, change their actions to satisfy owners who bear all the financial risk of the hotel investment. Owners may find themselves dipping heavily into other funds to meet negative operating cash flows or mortgage payments. Many face foreclosure — and loss of their entire investment — with the operator's sub-par performance. Owners feel cheated when operators continue to take their money off the top (from gross revenues) and won't cooperate to improve the owner's unprofitable situation.

When hotels operate at a loss for a sustained time, tensions increase sharply. Operators are in virtually complete control of the hotel. All the activities that might generate income, from the talents and skill sets of the people they hire at the property and corporate level, to what marketing programs they develop and deploy, and how they tap into corporate or other resources to develop business at the hotel. They also control (or fail to control) hotel expenses. For example, the operator determines which restaurants to keep open, what hours concierge service will be available, and what amenities are offered to guests. The operator sets the prices for everything at the hotel, and determines staffing levels.

Under these circumstances, owners feel helpless and often seek cooperation from operators to reduce losses and create a profit or break even. When the operator controls all aspects of hotel operations, who is to blame for sustained bad results? Often owners do not feel that operators are doing enough, and may want to force some kind of change in operations or even a termination of the relationship, feeling that almost anything has to be better than what they are stuck with.

At the same time, operators tend to feel that they are doing the best they can under difficult circumstances. They have their own profit situation to monitor and their own shareholders to satisfy. They may also feel they must maintain the integrity of their brand, and that compromises for a short-term benefit to an owner may cause long-term damage to the operator's reputation. Operators often say that they made a deal with owners, and the owners should live up to their agreement and provide whatever resources it takes to ride out the downturn or other difficulty.

When the economy adds financial stress

The tension between owner and operator is ever-present, but exacerbated in difficult financial situations. Clearly, bad economic times create more friction between hotel owners and operators. When all stakeholders in the hotel are making lots of money, owners and operators aren't motivated to correct every wrong. When hotel operations hit the skids, and owners have to write checks to keep the doors open, they want fast and responsive cooperation on critical issues.

Wrestling over approving budgets and forcing compliance often depends upon the terms of the HMA. Some HMAs give owners no right to approve any budgets, while others give limited rights, leaving the operator in control while disputed line items are arbitrated. Too often there is no standard for how the arbitrator is to decide whether to allow the disputed budget item, except for the operator's "brand standards." And how can an owner prevail when the branded operator insists the budget item is necessary to maintain the standards it establishes?

Most owners become incensed when they feel that their operator is not responding to a critical situation. The aggravation level escalates when the operator isn't proactive in driving business, cutting costs and better managing capital expenditure issues. Whatever the reasons, bad financial results can severely wound owners and lenders who feel they are entitled to expect results from operators who proclaim their expertise and take their money off the top — as a percentage of gross revenues, or through markups, purchasing fees, reservation fees, frequent traveler charges, and the like. They are dismayed when the operator is unable or ineffectual at getting results.

What happens in hotel management agreement lawsuits?

Most branded hotel management agreements run for decades. They are not terminable just because the hotel is underperforming. They usually have very tricky procedures requiring notice of perceived breach, with one or more opportunities for the operator to "cure" the default. Operators design their management agreements to make them difficult to terminate. If an owner terminates the management agreement and does not have proper justification, the owner will be responsible for damages for breach of contract, which could amount to the net present value of the income stream the operator would have received for the remainder of the contract term. This could be very expensive. Nonetheless, some owners are willing to pay the price to unencumber the hotel and remove an ineffective operator. There are times when the cost of terminating an agreement, however high, is less than the cost of a weak operator.

When disputes between owners and operators escalate to litigation, decisions of the trial court may be brief and difficult to find. The decisions are less likely to be published, and often are not accompanied with rationale underlying the court's decision. Only cases that have been appealed and decided by appellate courts result in reported decisions, which become part of our case law and precedent for other cases.

That said, the reported case decisions on owner terminations of operator management agreements are typically favorable to owners in that the HMA generally creates an "agency relationship." This means that there is an absolute right of the owner to terminate such contracts (though the owner may be subject to damages), and that this agency creates fiduciary duties imposed on the operator.

There is no way to know how many unreported lawsuits or arbitrations may exist on this matter. From our own experience, we would say that disputes are not uncommon, though most are resolved or settled prior to decision.

Important cases impacting today's HMA litigation

There is a long history of brands resisting owner terminations, and court battles emanating from the 1991 *Wooley vs Embassy Suites* through 2012's *Marriot vs. Eden Roc*, both of which have defined how hotels and operators interact with each over the last 30 years.

A brief summary of important cases follows.

Woolley vs. Embassy Suites

Woolley vs. Embassy Suites in 1991 was the first case to establish the precedent that the owner/operator relationship is one of "agency" — one company providing services to another for a fee. Agency, as defined by English common law for hundreds of years, includes obligations to act in the principal's (in an HMA, that would be the hotel owner) best interest, and also stipulates that the principal can terminate the relationship at any time.

In *Wolley*, Robert Woolley and Charles Sweeney owned 22 hotels throughout the country, all of which were managed by Embassy Suites. Woolley/Sweeney sued Embassy for termination in January 1990. The eventual outcome of the suit was a decision affirming the agency relationship between the parties and determining that an owner could terminate an HMA at any time, although it may face damages or other consequences.

Turnberry Isle vs Fairmont

Turnberry Isle vs. Fairmont further cemented the ability of owners to terminate HMAs, even if the contracts said otherwise. The Turnberry Isle Resort & Spa, in Aventura, Florida (near Miami) was owned by Turnberry Associates, and was operated by the Fairmont chain under a 50-year management contract. Dissatisfied with the operator's performance, Turnberry undertook terminating the relationship.

Turnberry's strategy included a surprise takeover of the resort, ousting Fairmont and terminating the management agreement without any advance notice. On the morning of August 28, 2011, Turnberry informed Fairmont that they were de-branding the resort, and directed Fairmont to immediately leave the property escorted by an outside security team. Turnberry then changed the branding of the hotel, from napkins to marquees, retained employees loyal to Turnberry, switched to a different room reservation system and website, and removed all references to the Fairmont name.

Two days after the takeover, Fairmont sought emergency relief in federal court to get back into the hotel. After a hearing on the matter, complete with testimony from top executives of Fairmont and the hotel owner, as well as industry experts, the court ruled against Fairmont. Turnberry maintained control of the operations of the hotel and Fairmont was not reinstated.

The *Fairmont* court had a clear grasp on extremely complex and difficult legal issues. Both federal judges in the case independently came to the same conclusion: Turnberry had the power to terminate the 50-some-year agreement, despite the agreement's express provisions to the contrary. A year later, the court dismissed Fairmont's lawsuit for damages because the parties had reached a settlement.

Marriott International vs. Eden Roc

Marriott International vs. Eden Roc defined the relationship between owners and operators outside of the "agency" principle. In March 2012, Key International, the owner of the Eden Roc hotel in Miami Beach, terminated Marriott as the hotel's operator "following years of mismanagement of the property and a failure to maximize the Eden Roc brand," according to its news release. Marriott refused to acknowledge the termination or vacate the hotel. In October 2012, Eden Roc attempted to remove Marriott from the hotel's premises, but Marriott refused and obtained a temporary restraining order barring the hotel's owner from trying to oust it as Eden Roc's operator.

Key International appealed the decision and in March 2013, a New York appeals court issued an order vacating the lower court's injunction. Key International was free to terminate Marriott as Eden Roc's operator. Under this decision, virtually all existing hotel management agreements became terminable at will by owners.

Marriott International v. Eden Roc reaffirmed the "power" of an owner to terminate a hotel management agreement and to regain control of its property for any reason. However, if the owner does not have the "right" to terminate the agreement — adequate legal justification such as a material breach by the operator — then the owner will be liable to the operator for damages resulting from terminating the contract. Those damages may be very substantial, and no owner should undertake a termination of a hotel management agreement without legal advice on alternative approaches, as well as the potential consequences of the action.

In the *Eden Roc* decision, the appeals court agreed that the hotel management contract "is a classic example of a personal services contract that may not be enforced by injunction." At first blush to someone outside the hotel industry, this case might have seemed unremarkable. It restated and affirmed legal principles that have been used throughout the United States for more than a century regarding personal services contracts.

The fact that the *Eden Roc* decision was based solely on the use of an injunction to enforce a personal services contract, however, was novel in the hotel industry. Up to that time, all other hotel terminations were based on agency principles. Notably, in *Eden Roc*, the court did not rely on agency principles at all. In fact, the court stated that it found no agency relationship under those facts.

After a few high profile lawsuits over the termination of hotel management contracts, many operators had accepted that under the typical hotel management agreement the operator would be the "agent" of the owner, with all the attendant implications of fiduciary duty. These operators did not fight the basic concept they were subject to the "cardinal rule of agency" that a principal (the owner) always has the power to terminate his agent (the operator).

Marriott and a few other operators, however, took a different tack. They sought to strip their management contracts of any "agency" overtones or language, while retaining complete control over hotel operations. These contracts apparently confused some of the lower courts into thinking that because they purported to be nonagency contracts, they must be so, and therefore could not be terminated under traditional agency principles.

The *Eden Roc* court noted in a one-sentence conclusion that the hotel management agreement did not create an agency relationship. In denying the agency relationship, the *Eden Roc* court gave owners a tool potentially even more powerful than the agency relationship when it comes to getting control of a hotel back from an operator.

Although these three cases have had a significant impact on how owners and operators manage their relationship and proceed with terminations, they are now 10 or even 30 years in the past. New laws and new, potentially precedent-setting cases are changing the landscape. Virtually every hotel manager now takes the position, and includes in its standard agreements, provisions disclaiming fiduciary obligations. In 2004, Maryland adopted a statute governing hotel management agreements and it is worth an in-depth examination, as it has significant consequences for owners and operators throughout the country.

Maryland law changes historic prevailing rights and remedies in HMA and franchise litigation

The choice of governing law provision of your HMA or franchise agreement can have a significant impact on the rights and remedies of the parties under the agreement. This is the provision that is usually found near the end of the agreement. It may have a caption like "Governing Law" or "Applicable Law," or it may be one of many subsections of the "Miscellaneous" provisions. It may be combined with other provisions or set out in a separate provision. Wherever located, the essence of the choice of governing law provision will contain something like the following:

> This Agreement shall be construed in accordance with and be governed by the laws of the State of Maryland without recourse to its choice of law or conflict of law principles.

In most contract negotiations, the choice of governing law is not a very controversial issue. In the context of HMAs and hotel franchise agreements, however, insertion of this choice of law provision (or acceptance of it) deserves careful consideration. This choice of Maryland law changes certain important rights and duties of the parties from historic prevailing common law and statutory provisions to the contrary in every other jurisdiction of the United States. These Maryland statues were adopted by the Maryland legislature in 2004 in response to the hotel brands' political influence as one of the largest employers in that state.

The state of Maryland has a unique statutory scheme designed to prevent an owner's termination of a franchise agreement or hotel management agreement, absent some uncured breach of the agreement by the operator that would entitle the owner to the express contractual right to terminate.

The Maryland law eliminates the application of any implied or common law principles that are favorable to owners and would control agreements governed by the laws in other states.

Specifically, the Maryland statute changes the law of agency and personal services contract for contracts governed by Maryland law. The result is a dramatically different outcome: it enables operators or brands to force owners to stay in an unhappy relationship and to specifically perform their agreements.

This situation now means that when owners select their operator or franchisor, one important selection criteria should be the state law that the parties chose to govern their relationship.

The History Leading to Maryland's Law

The Maryland law was enacted in 2004 (Md. Code Ann., Com. Law § 23-101 to 23-106 (West)) in response to a series of court rulings favorable to owners, and unfavorable to hotel operators or brands. The law was enacted to override the precedent of these other owner-favorable cases.

The Maryland law was enacted,

> [f]or the purpose of providing that if a conflict exists between the express terms and conditions of an operating agreement and the terms and conditions implied by the law governing the relationship between a principal and agent, the express terms and conditions of the operating agreement shall govern; authorizing a court to order a certain remedy notwithstanding the existence of an agency relationship between the parties to an operating agreement; providing that express covenants or other provisions of an operating agreement that establish a party's duties and obligations under the operating agreement create the only duties and obligations enforceable against the party under the operating agreement; providing that an operating agreement that states that it shall continue for a period of time or until the happening of an event shall be enforceable between the parties until the expiration of the period of time or the happening of the event unless the operating agreement contains a right of early termination; requiring that the covenant of good faith and fair dealing be implied in an operating agreement except under certain circumstances; prohibiting duties

> from being implied into an operating agreement unless the operating agreement contains a covenant or other provision that specifically incorporates the duty into the operating agreement; prohibiting this Act from being construed to limit the defenses of fraud, duress, or illegality or affect any claim between a third party and a party to an operating agreement; defining certain terms; requiring that this Act be construed to apply to all operating agreements that are executory agreements as of a certain date or are executed and delivered after a certain date; and generally relating to operating agreements that relate to hotels and retirement communities.

(2004, Maryland Laws Ch. 292 (S.B. 603).)

While not directly identified in the 2004 legislative history, the unfavorable "out-of-state court rulings" were likely references to *Woolley v. Embassy Suites, Inc.* (1991) 227 Cal.App.3d 1520; *Pacific Landmark Hotel, Ltd. v. Marriott Hotels, Inc.* (1993) 19 Cal.App.4th 615, and *Government Guarantee Fund of Republic of Finland v. Hyatt Corp.* (3d Cir. 1996) 35 V.I. 483 —generally holding that based on implied or common law principles, and despite provisions in the hotel management agreement to the contrary, hotel operators are agents of the owners and so the owners have the power to terminate the operators at will, subject to having to pay damages in the event that the owner lacked the contractual right to terminate. The upshot of these cases had the effect of removing the so-called operator's "death grip" on the hotel owner.

The Maryland Law Statutory Scheme

And so, in 2004, no doubt in reaction to strong pressure from hotel brands with headquarters domiciled in Maryland[1], the Maryland

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[1] Among other hotels operators headquartered in Maryland, are Choice Hotels; Host Hotels & Resorts; Marriott International, and the Ritz-Carlton Hotel Company. As of 2004, 11.1% of Maryland's private sector was employed in the leisure and hospitality sector. That grew to 13.05% as of 2019. hotel.law/Maryland

legislature passed a number of statues aimed at avoiding the application of implied or common laws, to wit:

Md. Code Ann., Com. Law § 23-102 (West) provides, as follows:[2]

(a) If a conflict exists between the express terms and conditions of an operating agreement and the terms and conditions implied by the law governing the relationship between a principal and agent, the express terms and conditions of the operating agreement shall govern.

(b) A court may order the remedy of specific performance for anticipatory or actual breach or attempted or actual termination of an operating agreement notwithstanding the existence of an agency relationship between the parties to the operating agreement.

Md. Code Ann., Com. Law § 23-103 (West) provides, as follows:

Express covenants or other provisions of an operating agreement that establish a party's duties and obligations under the operating agreement create the only duties and obligations enforceable against the party under the operating agreement.

Md. Code Ann., Com. Law § 23-104 (West) provides, as follows:

If an operating agreement states that it shall continue for a period of time or until the happening of an event, the

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[2] Included in the key words defined in the statute, Md. Code Ann., Com. Law § 23-101, are the following:

(b) "Hotel" means a hotel or motel with more than 30 rooms for rent that is primarily used by transients who are lodged with or without meals.

(c) "Operating agreement" means a written contract, agreement, instrument, or other document between at least two persons that relates to the management, operation, or franchise of a hotel or a retirement community.

operating agreement shall be enforceable between the parties until the expiration of the period of time or the happening of the event unless the operating agreement contains a right of early termination.

Md. Code Ann., Com. Law § 23-105 (West) provides, as follows:

(a) The covenant of good faith and fair dealing shall be implied in an operating agreement unless the operating agreement states that a party may perform a duty or obligation in the party's sole discretion.

(b) Unless an operating agreement contains a covenant or other provision that specifically incorporates a duty into the operating agreement, no duties shall be implied under the operating agreement.

Case Comparisons Between the Maryland Law and Other State Laws

To date, only one published case applying and analyzing the Maryland Law has reached a court of appeal conclusion: *IHG Management (Maryland) LLC v. West 44th Street Hotel LLC* (N.Y. App. Div. 2018) 163 A.D.3d 413 ("*44th Street*"). In 2018, in a series of three rulings, a trial court in New York applying the Maryland Law found that it provided protection for hotel operators or brands facing termination. The *West 44th Street* appeal court reviewed and affirmed each of the three trial court rulings.

In the *West 44th Street* case, the owner of the InterContinental New York Times Square Hotel, a $500 million property, hired IHG pursuant to a 40-year term hotel management agreement that still had another 30 years left on the term. The owner attempted to terminate the agreement early based on its power and right to do so grounded on the common law and alleged breaches by IHG. IHG contended that the owner neither had the power nor the right under Maryland law to terminate.

IHG sought a preliminary and permanent injunction to prevent the owner from terminating the hotel management agreement and specific performance of the HMA to allow IHG to continue operating the hotel.

Applying the Maryland law, the court issued a preliminary injunction to prevent the owner's termination of the HMA until it could be determined whether an event of default had occurred (*i.e.*, whether the owner had the contractual right to terminate the HMA based on some uncured event of default). In granting IHG's preliminary injunction preventing the owner's early ouster of IHG, the court stated:

> Most compelling to this Court is, however, if a Preliminary Injunction is denied Plaintiff [IHG] will be deprived of its contractual right (under Maryland Law) to seek specific performance of the HMA. It is not disputed if the Preliminary Injunction is not issued, Defendants [owner] will follow through on their attempt to terminate the HMA. Therefore, if Plaintiff [IHG] can demonstrate it did not default, it will be unable to retroactively return as manager to the property. The necessary forfeiture of a contractual right outweighs Defendants [owner] alleged harm in having to work with Plaintiff for a few more months.
>
> ***
>
> Plaintiff [IHG] argues if the injunction is not granted, Plaintiff [IHG] will be deprived of its day in court. In addition, Plaintiff [IHG] contends such a decision would cause significant uncertainty with respect to hotel management agreements that are governed by Maryland law. Defendants [owner] argue they are being prohibited from managing their own Hotel, and, if forced to continue to employ Plaintiff [IHG] as manager, Owner might default on its loan obligations. Defendants [owner] claim their Owner's debt financing recently matured and all refinancing options are at significantly less favorable terms that may require debt payments in excess of the Hotel's available cash flow.
>
> While Defendants' [owner] complaints may have credence, the Court is also cognizant that the Defendants

> [owner] voluntarily entered into a long-term management agreement with Plaintiff [IHG]. To permit Defendants [owner] to unilaterally terminate the contract, in violation of Maryland law and without establishing whether the grounds on which the termination is based are valid, would unduly prejudice Plaintiff [IHG].
>
> (*IHG Management (Maryland) LLC v. West 44th Street Hotel LLC*, 2018 WL 1730843, at *2 (N.Y.Sup.).)

As to IHG's claim for specific performance (i.e., that IHG could force the owner to perform its obligations under the HMA and keep IHG), the owner claimed based on common law principles that the HMA was a personal services contract for which specific performance was not an available remedy to IHG. Therefore, the owner contended, it had the power to terminate the HMA. The owner relied on *Marriott Intern., Inc. v. Eden Roc, LLLP* (N.Y. App. Div. 2013) 104 A.D.3d 583, a seminal case finding that an HMA was a personal services contract under New York law.

IHG contended that the parties agreed that the HMA was to be governed by the Maryland law and that the Maryland law specifically provided IHG performance as a remedy for an anticipatory or actual breach or attempted or actual termination of a HMA. As such, IHG argued that the holding of *Eden Roc*, a New York case, was inapplicable to the subject case. Drawing on the definition of "operating agreement" under Section § 23-101(c) of the Maryland law, IHG argued that HMAs were specifically contemplated by the Maryland legislature when enacting the Maryland Law and, as such, HMAs are afforded its protection. IHG argued that it is axiomatic that the Maryland legislature, fully aware of other jurisdictions position on HMAs and the potential for them to be found exempt from specific performance under the common law, such as *Eden Roc*, took care to create a law that prohibits that unilateral termination ability from hotel owners, and that is likely why the term "operating agreement" was so defined in § 23-101(c) of the Maryland law to remove any question as to whether an HMA falls under the definition of "operating agreement." (*IHG Management (Maryland) LLC v. West 44th Street*

Hotel LLC, 2018 WL 1730840, at *2 (N.Y.Sup.).) The trial court, in agreeing, with IHG stated;

> Indeed, § 23-101(c) [of the Maryland Law] removes all ambiguity from interpretation as to whether a hotel management agreement may be specifically performed. Maryland legislature has said yes. Section § 23-101(c) defines operating agreement as a "written contract, agreement, instrument, or other document between at least two persons that relates to the management, operation, or franchise of a hotel . . . ." Still, however, to ensure Defendants personal service argument is aptly dealt with, the Court will nevertheless address whether this HMA is exempt from injunctive relief under *Eden Roc* and similar cases.
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> (*IHG Management (Maryland) LLC v. West 44th Street Hotel LLC*, 2018 WL 1730840 (N.Y.Sup.))

The trial court went on to additionally conclude that the language in that HMA did not give rise to become a personal services contract and therefore IHG could require that the owner specifically perform the HMA. *(IHG Management (Maryland) LLC v. West 44th Street Hotel LLC*, 2018 WL 1730840, at *1–2 (N.Y.Sup.).)

> The *West 44th Street* appellate court affirmed all three of the trial court's rulings and stated:
>
> The court properly denied defendant owner's motion to dismiss the cause of action for specific performance. It is undisputed that the hotel management agreement (HMA) at issue provides for the application of Maryland law, which specifically provides that a court may order specific performance for anticipatory or actual breach or attempted or actual termination of a hotel management agreement (Md. Code Ann., Com. Law § 23-102[b]; 23–101[c]). Sections 14.02(d) and (e) of the HMA provide that either party could seek specific performance, where applicable. Defendant owner's argument that personal service contracts such as the HMA cannot be specifically enforced as a matter of constitutional and Maryland law because such enforcement violates the Thirteenth

> Amendment's prohibition against involuntary servitude is inapposite since, among other things, the owner voluntarily negotiated for and signed the contract. Moreover, the Maryland statute is presumed constitutional and the presumption may be upset only by proof persuasive beyond a reasonable doubt, which is absent here [citation omitted].
>
> (*IHG Management (Maryland) LLC v. West 44th Street Hotel LLC* (N.Y. App. Div. 2018) 163 A.D.3d 413, 413–14.)

Contractual Choice of Law Provisions

Below are typical provisions in HMAs and franchise agreements that would mandate the application of Maryland law, in lieu of the implied or common law of other states, in an attempt to stop an early termination of the agreement and an ouster of the operator or brand:

> *Applicable Law.* This Agreement is to be construed under and governed by the laws of the State of Maryland without regard to Maryland's conflict of laws provisions. The terms of this survive the termination of this Agreement.
>
> *Injunctive Relief.* In all cases, either party may seek injunctive or equitable relief, including restraining orders and preliminary injunctions, in any court of competent jurisdiction.

Because of the dramatic difference in results in the potential outcome of an early termination or ouster based on implied or common law, as opposed to the application of Maryland Law, an owner should carefully consider the consequences of the law it selects to govern the relationship with the potential operator or brand. And, in the event of an impasse during negotiations as to which law will govern, the owner might consider selecting a different operator or brand that does not require Maryland law. But, if there is no choice and owners is stuck with Maryland law, then particular attention should be given to other provisions in the agreement by sophisticated legal counsel who specialize in such matters. As the power to terminate becomes less of an option, the right to terminate becomes more important, along with creating agreements that demand accountability and responsibility from operators.

Epilogue

Hotel management and franchise agreements, and the relationships between owners, managers and brands, is an evolving world — the final chapters of this book remain to be written.

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But most of all, we want to hear from you. We are an enthusiastic part of the fabric of the hotel industry and enjoy discussing what matters to others in our world or about to join it.

So please contact us to discuss any of the issues raised in the HMA & Franchise Agreement Handbook, or other topics that concern you.

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