CHAPTER 16

Hotel Management Contracts and Related Documents

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16.01 INTRODUCTION

The proper execution of a management contract between the hotel owner and the management company is a vital step in the development of a successful hotel venture. The management contract spells out the basic relationship between the owner and the operator. For example, it might specify who is responsible for the provision of operating capital, the payment of property taxes, or the employment of the general

manager and other key executives. Great care should be taken in putting together the management contract, since an agreement that is overly favorable to one party can result in a contentious relationship between the owner and the operator, with potentially disastrous results for the hotel.

This chapter discusses the basic provisions that are found in management contracts, as well as some of the more common variations.[1] Included in this discussion are such topics as fee structures, contract termination, operator expenses, owner approvals, and other significant areas relating to management contracts. The chapter also includes a discussion of the annual plan and the budget approval process, two areas that are usually set forth in great detail in the management contract.

16.02 CONTRACT TERM

The term of a management contract is the length of time that the agreement is to remain in effect. Both a commencement date and a termination date are usually specified in this provision. The commencement date may be either a specific date or it may be as of a certain occurrence, such as the date the hotel officially opens for business. Whatever the certain occurrence may be, the parties to the contract must be careful to define it clearly (e.g., what does "officially open for business" really mean?).

The contract term may comprise an initial term and one or more additional renewal terms that extend the total length of the agreement.

Ideally, owners want an initial term that is as brief as possible, and the option of numerous short renewal terms. This arrangement permits the owner to tie the operator to the contract for an extended period of time, but also allows the owner to terminate the contract upon relatively short notice should the management company prove ineffective or the owner want to sell the property unencumbered by a management contract.

The contract term provision affects the hotel operator by limiting the period during which the property can be operated and a management fee collected. A hotel company generally incurs start-up costs when taking over new contracts, so the company needs a term long enough to recoup the initial one-time expenses. In addition, most management fees are structured so that they reward profitable operating results, and as a result it may take an operator several years to achieve the level of profits needed to earn a reasonable amount of compensation. For first-tier hotel management companies, the length of the contract term has additional importance because of their public name recognition. Such companies are interested in demonstrating a stable, long-term commitment to a market area in general and a property in particular, so they will usually negotiate for the longest initial term possible.

The contract term, from an owner's point of view, is directly related to two other important provisions: termination for nonperformance and contract buy-out. If the owner is able to negotiate a satisfactory provision for quickly terminating an incompetent operator along with buying out the contract for a reasonable price, then the length of the contract term becomes less important.

[1] A variety of sample management contract clauses, taken from actual agreements, can be found in Appendix 3.

First-tier hotel companies generally insist on long initial contract terms due to the high start-up costs associated with such agreements. Therefore, contracts with first-tier operators usually run for an initial term of between 20 and 30 years. On the other hand, second-tier operators are typically more willing to accept shorter agreements. Contracts with these operators commonly specify an initial term of between 10 and 20 years.

It should be noted that second-tier operators encompass a broad variety of management companies, ranging from small firms with several executive employees to large, highly structured organizations similar to many first-tier chains. The length of term that these operators agree to often varies considerably from one contract to another. When economic downturns occur and there is an increase in lender workouts handled by second-tier management companies, it is not unusual to see, on average, six-month to two-year contract terms, which enable the lender-owner to quickly sell the property, unencumbered by a management contract, in the event a buyer is found. On the other hand, some large, established second-tier operators with all the attributes and bargaining power of first-tier companies will not enter into agreements that have initial terms of less than 20 years.

Renewal terms extend the contract for a stated period beyond the initial term. The renewal term is typically structured as a contract extension option that may be exercised by either the operator or owner acting alone or in agreement. The renewal term need not contain the same provisions (e.g., the management fee) as the initial term.

Most management contracts include some form of renewal provision. In most cases, the agreement allows for a specified number of renewal terms. The permitted number of renewals is usually between one and three, while the length of the terms is commonly from five to ten years. Some agreements allow for an unlimited number of renewals on a more frequent basis, usually yearly.

The primary difference in the renewal terms for first- and second-tier hotel operators is that first-tier companies are generally less likely to offer such terms, and if they do, they run for longer periods of time—in terms of the individual renewals as well as the total of all renewals. First-tier operators are more likely to control the option to renew than are owners, but renewals generally are a matter of agreement between the two parties.

16.03 MANAGEMENT FEE

A management fee is the compensation a hotel company receives for providing the various services called for in a management contract. For first-tier hotel companies, the management fee covers both their management services and the value of their chain identity; second-tier operators are compensated for their management services alone. The calculation of the management fee is usually tied to one or more financial indicators, such as revenue or profit.

From an owner's point of view, the management fee represents an operating expense—something that should be controlled and minimized. However, management fees can be treated as an incentive and thus become an ownership tool for fostering profitable operations. One of the primary goals of hotel owners is to receive maximum net income from the hotel operations. The ability and efforts of the management company have a direct impact on whether the hotel is able to realize this goal.

[1] Basic Fee

Under the arrangement known as the basic fee, the management fee is determined solely by a percentage of revenue, creating an incentive for the operator to increase marketing efforts and other activities that increase sales volume. The drawback to this arrangement is that the basic fee provides no incentive to minimize operating expenses. If the entire management fee is in the form of a basic fee, the operator can theoretically increase marketing and sales efforts to the point where the highest possible revenues are reached, but any margin of profit is eliminated.

[2] Incentive Fee

In another type of management fee, known as the incentive fee, the fee paid to the management company is based on a specified percentage of a defined net income, usually determined by sales volume and expense control. Therefore, incentive fee rewards the operator for efficient, profitable management.

Hotel owners generally want to have all or at least most of the management fee calculated as an incentive fee. In addition, owners want this compensation based on a defined net income that appears as low in the hotel's income statement as possible; This is why it is referred to as a low level line item.

For example, consider a 300-room hotel that is currently operating at a 73 percent stabilized occupancy with an average rate of $113.14, as shown in Table 16.1. The format shown here is standard for such income statements.

Assume the hotel will be operated by a first-tier management company and the owner believes that 5½ percent of total annual revenue, or $863,000, is fair compensation for the services and chain identity of the management company. The owner is willing to pay 3 percent of total revenue ($471,000) as a basic fee, but wants the remaining portion of the total fee ($392,000) paid on an incentive basis and calculated as a percentage of a defined profit, such as one of the standard profit line items shown in Table 16.1: Income Before Fixed Charges, Income Before Debt Service, or Income After Debt Service. (In addition to the use of these standard line item definitions, many other definitions can be developed, such as "Income Before Fixed Charges but After Reserve for Replacement" or "Income After Fixed Charges but Before Property Taxes.")

The following percentages of standard line items are needed to yield the required additional management fee of $392,000.

Line item	*Required management fee*		*Line item amount*		*Required percentage*
Income before fixed charges	$392,000	÷	$4,664,000	=	8.4%
Income before debt service	$392,000	÷	$3,732,000	=	10.5%
Income after debt service	$392,000	÷	$1,317,000	=	29.7%

In other words, if the incentive fee is calculated as a percentage of Income Before Fixed Charges, it would have to be 8.4 percent of the line item in order to yield the required $392,000. If the calculation is made using Income After Debt Service, the necessary percentage would be 29.7.

From an owner's viewpoint, the incentive fee should be calculated as far down the income statement as possible. For example, any payment from the Income After

TABLE 16.1
Hotel Income Statement

Number of rooms: 300 Stabilized occupancy: 73% Average rate: $113.14

	($000)	Percentage of Total Revenue
Revenues		
Rooms	$ 9,044	57.6
Food	4,318	27.5
Beverage	1,727	11.0
Telephone	344	2.2
Other income	260	1.7
Total	15,693	100.0
Departmental Expenses		
Rooms	1,908	21.1*
Food and beverages	4,685	77.5*
Telephone	348	101.2*
Other income	157	60.3*
Total	7,098	45.2
Departmental Income	8,595	54.8
Undistributed Operating Expenses		
Administrative and general	1,236	7.9
Management fee	471	3.0
Marketing	741	4.7
Property operations and maintenance	770	4.9
Energy	713	4.5
Total	3,931	25.0
Income Before Fixed Charges	4,664	29.8
Fixed Charges		
Property taxes	405	2.6
Insurance	135	0.9
Reserve for replacement	392	2.5
Total	932	6.0
Income Before Debt Service	3,732	23.8
Debt Service	2,415	15.4
Income After Debt Service	$ 1,317	8.4

*Percentage of departmental revenue

Debt Service line erodes only the return on equity rather than funds available for operating expenses, fixed charges, and debt service. A similar result can be achieved by calculating the incentive portion of the management fee using an item before debt service, but paying it only if there are sufficient funds to cover debt service, which is known as subordinating the incentive fee to debt service.

[3] Owner and Operator Requirements

From the operator's point of view, the management fee represents compensation for services rendered. The fee must be enough to both cover the management company's operating expenses and provide an adequate profit.

Operators understand the need of owners to receive the maximum net income possible from hotel operations, but they also realize that in some instances they have little control over operating results. In over-built markets or depressed economies, even the best management companies find it difficult to generate suitable profits. In such situations a management company might be unfairly penalized if its entire fee is calculated as a percentage of a defined profit. The same is true for new hotels, where a period of occupancy build-up and initial operating losses are expected.

To protect themselves from these uncontrollable external factors, management companies seek to have the bulk of their fees calculated as a percentage of revenue (usually total revenue), which may decline somewhat when adverse conditions affect the property, but is never totally eliminated.

Most management companies are able to cover their actual operating (i.e., home office and supervision) expenses with the basic portion of the fee. Expressed as a percentage of total hotel revenue, the operating expenses to the management company generally range from 1½ to 2½ percent. A basic fee of 3 percent of total revenue will cover all of the operator's costs and leave a small profit. The incentive portion is therefore largely profit for a second-tier operator and profit and identity compensation (e.g., for trademarks and public image) for a first-tier operator.

It must be recognized that a sizable portion of the total operating costs for a managment company are incurred during the initial part of the contract term. During the start-up phase for a newly opened hotel or the takeover phase for an existing property, the operator must devote a significant amount of supervisory time to institute new systems, procedures and controls. This phase also entails greater efforts in recruiting, training, marketing, purchasing, and accounting. Some management companies will even temporarily relocate skilled personnel from other properties to insure a smooth opening or takeover. In order for a contract to be attractive to an operator, there should be some reasonable expectation that these initial costs can be recovered over the contractual term.

[4] Risk Compensation

Operator's naturally view the incentive portion of a management fee with much greater uncertainty than the basic portion. While the owner would like the incentive fee calculated using a line item near the bottom of the income statement (e.g., Income After Debt Service), the operator's risk of not receiving adequate incentive fee compensation increases significantly as the line item used for the calculation descends on the property's income and expense statement. Essentially, if the incentive fee calculation is based on Income Before Debt Service, the risk is similar to that of a mortgagee. Moving the calculation down to Income After Debt Service alters the risk so that it resembles what is experienced by an equity investor (that is, the incentive fee is based only on money remaining after debt service). To compensate the management company for assuming this greater risk, either a greater percentage of the line item specified or some form of incentive fee accrual would reasonably be expected by the operator in order to be sure of an adequate compensation over the term of the agreement.

As shown in the previous section, different percentages are required of each line item to produce the desired incentive fee. This percentage can be adjusted for risk (i.e., the likelihood that the line item will not generate a sufficient incentive fee) through a probability and income sensitivity analysis. The first step in such an analysis is to determine the probability of the subject hotel achieving a certain operating level (occupancy) at any given point in time. A review of the local market shows that

over a 20-year period the area-wide occupancy varied from 53 percent to 83 percent. A factor representing the probability that a specific level of occupancy will be achieved in any given year is assigned to each occupancy level over this range so the total of all probabilities equate to 100 percent. A projection of income and expense is then made for each level of occupancy and the net incomes in question (i.e., Total Revenue, Income Before Fixed Charges, Income Before Debt Service, and Income After Debt Service). Using the 300-room hotel from Table 17.1 as a basis, the following table shows the assigned occupancy probabilities along with the various line item incomes can be calculated at each occupancy level.

Assumed occupancy levels	*Probability factors*	*Total revenue ($000)*	*Income before fixed charges ($000)*	*Income before debt service ($000)*	*Income after debt service ($000)*
53%	1.00	$12,119	$2,139	$1,296	($1,119)
55	2.00	12,477	2,394	1,542	(873)
57	4.00	12,835	2,644	1,783	(632)
59	5.00	13,191	2,897	2,027	(388)
61	6.00	13,549	3,149	2,270	(145)
63	9.00	13,906	3,401	2,513	98
65	11.00	14,624	3,654	2,757	342
67	12.00	14,621	3,907	3,001	586
69	12.00	14,978	4,159	3,245	830
71	11.00	15,335	4,412	3,489	1,074
73	8.00	15,693	4,664	3,732	1,317
75	7.00	16,051	4,916	3,975	1,560
77	6.00	16,407	5,169	4,219	1,804
79	3.00	16,765	5,421	4,462	2,047
81	2.00	17,122	5,674	4,706	2,291
83	1.00	17,480	5,928	4,951	2,536
	100.00				

Assuming that both the owner and operator agreed that a fair total fee expressed as a percentage of total revenue would be 5½ percent, the calculation of the most probable total fee would be as follows:

Assumed occupancy levels	*Probability factors*	*Total revenue ($000)*	*Total management fee (total rev. × 5.5%) ($000)*	*Weighted average (probability × fee) ($000)*
53%	1.00	$12,119	$667	$ 7
55	2.00	12,477	686	14
57	4.00	12,835	706	28
59	5.00	13,191	726	36
61	6.00	13,549	745	45
63	9.00	13,906	765	86
65	11.00	14,624	785	69
67	12.00	14,621	804	96
69	12.00	14,978	824	99
71	11.00	15,335	843	93
73	8.00	15,693	863	69
75	7.00	16,051	883	62
77	6.00	16,407	902	54
79	3.00	16,765	922	28
81	2.00	17,122	942	19
83	1.00	17,480	961	10
	100.00			$814

The first three columns in this table are taken from the previous table. The management fee is calculated by multiplying the Total Revenue at each occupancy level by the assumed total fee percentage of 5½ percent. The most probable total fee is determined by first mulitplying the total fee at each occupancy level by the assigned probability factor and then adding the results together. In this example the most probable total management fee is $814,000.

Assuming that the total fee is to be calculated by using a basic fee of 3 percent of total revenue and an incentive calculation representing the remainder, the split between the basic and incentive components is calculated as follows:

$$\frac{\text{Basic fee percentage}}{\text{Total mgmt. fee \%}} = \frac{3.0\%}{5.5\%} = 54.55\% \text{ (basic component)}$$

$$\frac{\text{Incentive fee percentage}}{\text{Total mgmt. fee \%}} = \frac{2.5\%}{5.5\%} = 45.45\% \text{ (incentive component)}$$

Most probable total management fee	$814,000
Basic component percentage	.5455
Basic component	$444,000
Most probable total management fee	$814,000
Incentive component percentage	.4545
Incentive component	$370,000

This calculation shows that the operator would expect to receive on an average a total annual management fee of $814,000 that would be divided between a basic component of $444,000 and an incentive component of $370,000.

Using the same probability factors, a similar calculation can be made to determine the incentive fee percentage required to yield the $370,000 incentive management fee component. The incentive fee percentage is determined through an iterative process, which takes the line item net income at each occupancy level and multiplies this amount by the probability factor and an assumed incentive fee percentage. The grand total of each of these calculations is compared to the required incentive component of $370,000, and if it differs, the incentive fee percentage is adjusted until equality is obtained. The result is an incentive fee percentage that takes into account the dollar amount of the incentive fee component along with the various probabilities that over a period of time different occupancy operating levels with be achieved. The following tables show the end results of the iterative process for each line item net income.

Income Before Fixed Charges

Assumed occupancy levels	*Probability factors*	*Income ($000)*	*Incentive fee percentage*	*Probability × net income × incentive fee percentage ($000)*
53%	1.00	$2,139	9.18%	$ 2
55	2.00	2,394	9.18	4
57	4.00	2,644	9.18	10
59	5.00	2,897	9.18	13
61	6.00	3,149	9.18	17
63	9.00	3,401	9.18	28
65	11.00	3,654	9.18	37
67	12.00	3,907	9.18	43
69	12.00	4,159	9.18	46
71	11.00	4,412	9.18	45

Income Before Fixed Charges *(cont'd)*

73	8.00	4,664	9.18	34
75	7.00	4,916	9.18	32
77	6.00	5,169	9.18	28
79	3.00	5,421	9.18	15
81	2.00	5,674	9.18	10
83	1.00	5,928	9.18	5
	100.00			$370

Income Before Debt Service

Assumed occupancy levels	*Probability factors*	*Income ($000)*	*Incentive fee percentage*	*Probability × net income × incentive fee percentage ($000)*
53%	1.00	$1,296	11.85%	$ 2
55	2.00	1,542	11.85	4
57	4.00	1,783	11.85	8
59	5.00	2,027	11.85	12
61	6.00	2,270	11.85	16
63	9.00	2,513	11.85	27
65	11.00	2,757	11.85	36
67	12.00	3,001	11.85	43
69	12.00	3,245	11.85	46
71	11.00	3,489	11.85	45
73	8.00	3,732	11.85	35
75	7.00	3,975	11.85	33
77	6.00	4,219	11.85	30
79	3.00	4,462	11.85	16
81	2.00	4,706	11.85	11
83	1.00	4,951	11.85	6
	100.00			$370

Income After Debt Service

Assumed occupancy levels	*Probability factors*	*Income ($000)*	*Incentive fee percentage*	*Probability × net income × incentive fee percentage ($000)*
53%	1.00	($1,119)	46.90%	$ 0
55	2.00	(873)	46.90	0
57	4.00	(632)	46.90	0
59	5.00	(388)	46.90	0
61	6.00	(145)	46.90	0
63	9.00	98	46.90	4
65	11.00	342	46.90	18
67	12.00	586	46.90	33
69	12.00	830	46.90	47
71	11.00	1,074	46.90	55
73	8.00	1,317	46.90	49
75	7.00	1,560	46.90	51
77	6.00	1,804	46.90	51
79	3.00	2,047	46.90	29
81	2.00	2,291	46.90	21
83	1.00	2,536	46.90	12
	100.00			$370

The following is a summary of the line item incentive fee percentages calculated before and after adjustment for the probability of different occupancy levels and their effect on line item net income.

Line Item Net Income	*Incentive Fee Percentage Before Risk Adjustment*	*Incentive Fee Percentage After Risk Adjustment*
Income before fixed charges	8.4%	9.2%
Income before debt service	10.5%	11.8%
Income after debt service	29.7%	46.9%

The key to any type of risk analysis is the assignment of the probability factors. The weighted average occupancy level (the sum of the occupancy levels multiplied by the probability factors) used in this example was 68 percent, compared to the subject's stabilized occupancy of 73 percent used to calculate the incentive fee percentage before risk adjustment. As the weighted average occupancy level decreases from the stabilized level, the size of the risk factor will increase, with the largest increases occurring in the line items closer to the bottom of the income statement.

A second and distinctly separate procedure for reducing the exposure of a management company to the risk of not receiving adequate incentive fee compensation is to incorporate an accrual mechanism into the incentive fee structure. Under this type of arrangement, the incentive management fee is calculated as either a percentage of Total Revenue or a percentage of a high level line item such as Income Before Fixed Charges, but payment is subject to the availability of funds at a lower level line item, such as Income After Debt Service. Payment is made when enough cash is available to pay the incentive fee. If sufficient cash is not available, the portion of the incentive fee not paid is deferred and accrues until such time as funds are available to pay the fee. Under this arrangement, the incentive fees become a liability that will generally be paid over time, so the risk adjustment previously described is substantially reduced. Essentially, the operator only loses the time-value of the money owed. To reduce the risk even further and decrease the effect of the lost time-value of money, a number of management contracts stipulate that the deferred incentive management fee must accrue with interest.

This accruing procedure allows the operator to calculate the incentive fee component on a more easily achievable higher-level line item and provides assurance that over time the compensation will most likely be received. Owners also benefit from this arrangement by having a potentially significant operating expense deferred until adequate funds are available for payment. Lenders generally require this form of subordination to assure that monies will be available to cover debt service.

16.04 FINANCIAL REPORTING

The complete, accurate, and timely reporting of financial operating results is one of the most important services provided by a hotel management company, because it is the only real measure available to a hotel owner to evaluate the performance and effectiveness of the management company. Management contracts should detail (1) the types of financial reports that the operator must prepare, (2) how they should be prepared, and (3) when they should be submitted. Financial reports must be organized in a uniform manner and in sufficient detail so that results can be quickly evaluated and any deficiencies immediately spotted; they must be accurately compiled by

knowledgeable accountants and audited periodically; and they must be issued in a timely manner. Every day a report is delayed reduces the opportunity for correcting a problem. Owners and operators must communicate financial information quickly in order to manage effectively.

The first requirement of a financial reporting system is a uniform accounting procedure that allows for easy comparisons between financial reports within the same property, along with the operating results of other, similar hotels. To facilitate these comparisons, the hotel industry has adopted the *Uniform System of Accounts for Hotels,*[2] which is a standard chart of accounts detailing exactly how each item of revenue and expense should be posted. This system allows the comparison of operating statistics among one or more properties.

For example, assume Hotels *A* and *B* are located in the same market area, serve similar customer segments, and both follow the *Uniform System of Accounts for Hotels*. The respective management companies for the hotels report the following statistics pertaining to the operating expense account entitled "Administrative and General":

	Administrative & general	
Unit of comparison	*Hotel* A	*Hotel* B
Dollars per available room	$3,723	$4,120
Dollars per occupied room	$5,728	$5,493
Percent of total revenue	8.6%	7.8%
Percent of rooms revenue	15.4%	13.7%

Based on the unit of comparison, dollars per available room, Hotel *A* appears to have Administrative and General expenses under better control. This conclusion, however, is not supported by the rest of the data, which show Hotel *B* performing better in dollars per occupied room, percentage of total revenue, and percentage of rooms revenue. The reason for this is that Hotel *B* probably has a somewhat higher level of occupancy and is managing the Administrative and General expense category more efficiently.

The types and formats of financial reports prepared by the hotel company should be investigated during the operator selection process to ensure that sufficient financial data will be generated and that it will be presented in a usable format. Some of the financial reports typically provided by the management company include daily, monthly, annual, and miscellaneous reports.

- ☐ *Daily reports* should provide information regarding revenues and occupancy and should include details of all authorized complimentary rooms.
- ☐ *Monthly reports* should include an income and expense statement with full supporting schedules calculated on the accrual method and statistical data that details revenues by outlet, occupied rooms by market segments, food and beverage covers by outlet, and labor utilization by department. These reports should provide data for the current month, current month's budget, current year-to-date, current year-to-date budget, last year's month, and last year's year-to-date budgets, and in addition should provide a balance

[2] Hotel Association of New York City, Inc., *Uniform System of Accounts for Hotels* (8th ed.). HANYC, Inc. (1986).

sheet, identification of sources and uses of funds, details of capital expenditures, and a Manager's summary and overview of operations.

- ☐ *Annual reports* must contain an income and expense statement, a balance sheet, and documentation of the sources and uses of funds, all of which should be audited.
- ☐ *Optional reports to be issued at the request of the owner* include information regarding the aging of accounts receivable, schedules of payables, and schedules of supplies and inventory, as well as reports on occupancy, labor utilization, and insurance claims.

All financial reports should be prepared by the operator either locally on the property or centrally at the hotel company's central offices. The operator should maintain a strong control system in order to prevent theft and embezzlement and to ensure that all transactions are properly accounted for and reported. The entire system, along with all financial reports, should be audited at least annually, and more often if accounting problems are expected.

All financial reports need to be prepared on a timely basis in order to have the greatest value to the owner and operator. In most instances, the following schedule is adequate:

Type of report	*Deadline for submission to owner after period end date*
Daily reports	1 day
Monthly reports	15 days
Audited annual reports	45 days
Optional reports	Various

Financial reporting provisions are useful for both hotel owner and operator. Complete, accurate, and timely financial operating data is necessary for both parties because the information is critical for evaluating and improving operating efficiencies.

Hotel owners should be aware that significant costs are involved in preparing financial reports and should refrain from needlessly burdening an operator with unnecessary requests for information. The level of financial reporting detailed in this section should not, however, negatively affect any competent hotel management company, which should have accounting systems and procedures in place that can handle normal requirements. If, during the negotiation process, the operator has any difficulty in agreeing to provide this level of financial reporting, there is then reason to question the overall competency of the company.

The bargaining power of either party should not play a part in determining the scope and quality of a financial reporting system. If, during the negotiation process, either the owner or the operator is not fully satisfied with the financial reporting requirements proposed by the other party, all attempts should be made to rectify the situation. If a satisfactory solution is unobtainable, it is probably best to look elsewhere for a deal.

16.05 ANNUAL PLANS

All well-run businesses prepare budgets, plans for future operations, and evaluations of past performance in order to facilitate financial planning and control costs. Such planning and analysis is especially important for lodging facilities operated by hotel management companies.

Given the terms of the management contract, the owner either will have no input in the budgeting process or, at the other extreme, will have the opportunity to exert a great deal of control over the operation through a strict review. Generally, the owner will have some power to approve the budget.

Under normal circumstances, a management company will submit an annual plan to the owner that comprises a number of budgets, reports, and plans detailing the expectations of the management company for the subject property over the following 12 months. Annual plans normally include a forecast of income and expenses, a capital expenditure budget, a repair and maintenance budget, a marketing plan, and reports on engineering systems, leasing plans for commercial space, staffing, and salaries.

[1] Forecast of Income and Expense

Perhaps the most important element of an annual plan is a month-by-month forecast of income and expense. This forecast should include full supporting schedules of each revenue and expense category. All standard budget items, including reserves for replacement, property taxes, equipment leases, and debt service, should be projected.

[2] Budgets for Capital Expenditure and Repair and Maintenance

The capital expenditure budget should contain a detailed listing of all necessary expenditures. Each entry in the listing should provide a full description of the expenditure, a concise explanation of why it is necessary, and an identification of the aspect of the property it will improve. In addition, the listing should include the manner in which the cost will be funded and a time frame for its occurrence. The repair and maintenance budget should contain the same sort of information as the capital expenditure budget, except that the items listed in it will relate to expenses contained in the repair and maintenance category of the income and expense statement.

[3] Marketing Plan

The marketing plan should be a comprehensive description of the operating company's marketing efforts on behalf of the subject property. The plan should contain the following:

- ☐ An analysis of the current status of the market position of the hotel, including:
  - Average rates and occupancies of all competitive hotels, including their market segmentations and the levels of food, beverage, and banquet competition that they generate.
  - Identification of new competition, either proposed or under construction.
  - An assessment of the economic health of the market area and its possible future effect on transient visitation and food and beverage demand.

- Descriptions of any other factors that could affect the local hotel and restaurant markets and that would be important for developing a marketing strategy.

☐ An analysis of the current status of any marketing efforts in progress, including:
  - A description of all marketing programs underway and an evaluation of their effectiveness.
  - The number of room-nights already on the books, broken down by month and market segment.
  - The reservation report from hotel chain or franchise system.
  - An analysis of food, beverage, and banquet marketing efforts.

☐ An overview of long-term marketing strategy for the next three to five years.

☐ A description of the marketing program for next 12 months, detailing:
  - Plans for enabling the short-term marketing program to meet the goals of the long-term strategy.
  - Marketing efforts, by month, for advertising and promotion, and staffing requirements for these areas.
  - Budget requirements, divided by month and broken down to show the exact manner in which the funds will be spent.
  - Projections of room-nights captured, by month, broken down by market segment, along with expected average rate.
  - Projections of food, beverage, and banquet covers, by month, by outlet, along with average checks.

[4] Other Reports

Among the other reports that the hotel management company must prepare and update annually for the owner are the following: (1) an engineering status report; (2) a leasing plan for commercial space; and (3) a staffing and salary report. The first of these, the engineering report, is issued by the engineering department and details the status of all engineering systems within the property and any expected maintenance or alterations that will be required over the next 12 months. The leasing report describes the status of any leased space on the property for which tenant leases will expire during the next 12 months. In addition to describing the current rent roll, the report should provide information regarding the market rent for similar leases in the local market area. The staffing and salary report should provide an analysis of current and contemplated staffing requirements along with recommendations for adjustments in pay scales and employee benefits. This report should also contain a review of the pay and benefit practices of other hotels in the market area.

16.06 BUDGET APPROVAL PROCESS

The budget approval process is the procedure by which hotel budgets are prepared, submitted to the owner, reviewed, modified, and put into effect. It is also the means by which the owner exerts influence over the expenditures of, and thus

the operation of, the hotel. This process is generally clearly defined in the management agreement.

The budget approval process generally begins about four months before the start of a new operational year, and, much like an annual plan, is put together by the hotel department heads and is supervised by the general manager. Most operators have a multi-step approval process that takes the proposed plan up their corporate ladder. The property owner generally has no input in the process during this initial preparation phase.

Once the annual plan has made it through the internal approval process of the management company, it is submitted to the property owner, usually within 60 to 90 days of the start of a new operating year. The property owner should require ample time to review the plan, develop a critique, and resolve any differences before the point in time when the budgets become effective. In practice, however, the owner approval process differs widely from one contract to another. In some cases, the owner is merely given a copy of the final annual plan and it becomes effective immediately with no approval required. This extreme gives the owner no input in the operation of the hotel of control over the management company. A procedure more oriented to the owner's interest allows the owner an opportunity to review the annual plan, make comments, and either approve certain specific aspects of the plan or the entire plan. This method can, and often does, result in disagreements.

The manner in which budgetary disagreements are resolved ultimately determines the degree of influence that the property owner can wield. In most management contracts that provide for owner approval of the annual plan, if the owner and operator cannot agree on one or more specific terms, the terms that both parties do agree on go into effect on the date required to implement the new plan. In lieu of the provisions that cannot be agreed upon, the terms from the preceding annual plan are used after they are automatically adjusted by a factor such as the Consumer Price Index (CPI). This procedure allows for the continued operation of the property under some form of budget while providing additional time for the parties to resolve their differences.

If, after a stated period of time (30–60 days), the parties still cannot agree on the annual plan, some contracts will give the deciding vote to one of the parties involved. Obviously, the so-called approval process under these types of management contracts are meaningless for the party that does not have the veto power.

[1] Arbitration Procedures

A more equitable arrangement for resolving disputes involving annual plans is some form of arbitration. Arbitration procedures have several clear advantages over litigation. Such matters can be settled relatively quickly because there is no wait for time in a court calendar, and all decisions are final, so there can be no appeal. Arbitration proceedings are not public hearings, so confidential information can be discussed without risk of its release to the public. The arbitrator can be chosen on the basis of specific experience and expertise in the area of the dispute. Last, but not least in significance, is that an arbitration hearing does not require legal representation or extensive preparation, so it is much less expensive than litigation.

The only occasional disadvantage to an arbitration proceeding is that it can take 15 to 30 days to organize and conclude. While not approaching the time involved in a court case, even this delay can sometimes create operational problems when important budget provisions are involved.

To make the arbitration process as efficient as possible, one or more of the following conditions should be incorporated into the clause that provides for such a procedure in the management contract:

- A definition of the specific qualification requirements of the arbitrator (e.g., a national hotel consultant with 15 years of experience).
- Time limits on the process (e.g., 5 days to select an arbitrator, 5 days to hear the case, and 3 days to render a decision).
- The use of the "best offer" approach: both parties are required to put their best offer on the table during the arbitration, and the arbitrator then must accept one offer and reject the other. By eliminating the option of "splitting the difference," the parties will come closer to an agreement.
- The use of a plan, provided by the American Arbitration Association (AAA), for conducting the entire arbitration process. This service is available for a nominal fee and is well worth using.

[2] Ownership Control

The extent of control by the owner of the final form of the annual plan has a bearing on the operation of the hotel. For example, if the owner has veto power over important expenditures, it can maintain a certain amount of financial control over the management company and ultimately gains a greater say in the overall operation.

The fact that the approval of the owner is necessary for implementing the annual plan does not by itself result in ownership control. To accomplish this, specific restrictions that prevent the management company from operating in variance with the budget must be established. For example, if the owner turns down a guestroom refurbishment program proposed in the annual plan, but the operator can circumvent the disapproval by merely increasing the property operations and maintenance expenditures (even if doing so exceeds the approved budgeted amount) and thereby accomplish the same upgrade, then the threat of a budget rejection carries little weight.

Control over the annual plan is one of the key provisions owners should attempt to secure when drafting a management agreement. Veto power over the use of funds can often swing operational control away from the operator and to the owner. First-tier management companies will seldom, however, allow owners to have such power over annual plans. Occasionally, first-tier companies will permit arbitration, but not for every item in the budget. For example, they might arbitrate a disagreement over how much should be spent on newspaper advertising, but would demand total control over funds derived from the reserve for replacement. Second-tier operators, who generally have much less bargaining power, are much more likely to allow greater ownership participation.

As stated previously, the budget process usually commences about four months prior to the start of a new operational year when the operator prepares and delivers to the owner the proposed annual plan. The timing of this delivery is important. The owner must have sufficient opportunity to thoroughly review the findings and recommendations contained in the plan and must have enough additional time to negotiate any necessary changes. The lead time for submitting the annual plan to the owner can range from 30 to 120 days. In general, second-tier operators must submit their plans slightly earlier than first-tier operators.

Once the annual plan is approved, the management company must operate within its budgetary limits. However, certain circumstances, such as unforeseen events and emergencies, may cause the operator to exceed such limits. Many management contracts have some form of restriction on spending over and above the amounts specified in the annual plan. In some instances, the agreement requires the owner's approval for any expenses in excess of the budgeted amount. Other agreements specify a percentage (usually between 5 and 25 percent) by which the operator may exceed a budgeted amount without owner approval. A specific dollar amount (e.g., $50,000) can be used in place of a percentage, but such an amount must be regularly revised to account for inflation.

16.07 OWNER APPROVALS

Some hotel management contracts require virtually no approvals from hotel ownership; others contain numerous opportunities for owners to provide input into the decisions involved with managing a lodging facility. As with budgets, most operators prefer to restrict any provisions requiring any form of approval and owners generally attempt to exert as much control over management in the form of approvals as possible. The following list contains some of the elements of a hotel operation that may be subject to approval by the owner.

- Expenditures for non-capital expenses (generally, those exceeding a specified level)
- Expenditures for capital items (generally, those exceeding a specified level)
- Plans to renovate the facility
- Expenditures not covered in the annual plan
- Use of the operator's central services, the cost of which is not included in the normal management fee
- Use of outside consultants
- Expenditures for service contracts
- Changes in room rates and food and beverage pricing
- Leases and concessions
- Plans to dispose of property
- Initial salaries, raises, benefits, and labor negotiations
- Changes in key operating personnel
- All initial operating policies and subsequent changes
- Selection of a depository bank
- Size of the working capital account
- Withdrawal of funds from operating accounts
- Credit policies
- Insurance coverage
- Use of insurance or condemnation proceeds
- Legal proceedings
- Assignment of the management contract by the operator

In most instances, the approval process is one-sided; that is, the owner is required to approve a request from the operator rather than the operator approving a request from the owner. As a result, any approvals contained in a management contract usually create an advantage for the owner.

Most first-tier hotel companies provide the owner with very few opportunities to review and approve their actions. Second-tier operators are generally more accommodating in allowing for owner approval of some of the operational elements outlined above. As with the budget approval process, the more control an owner can exert over a management company, the greater say it has in the hotel's overall operation.

16.08 TERMINATION OF AGREEMENT

When two parties enter into an agreement such as a hotel management contract, the implicit belief is that the relationship will continue for the full term. Often it does, but occasionally one of the participants fails to meet its contractual obligations and the agreement must be terminated. To protect both parties from these types of situations, hotel management contracts often incorporate specific provisions that allow one or both of the parties to terminate the agreement. Circumstances that can trigger termination by the owner include

- Bankruptcy of the operator
- Failure to achieve specific level of performance (usually a defined profit)
- Operator buy-out
- Operator's material breach of the contract
- Operator's misconduct or fraud (such as misappropriation or diversion of funds)
- Operator revocation of license
- Operator termination of the franchise
- Cessation of operator activity in the hotel business
- Condemnation or casualty

Events that can bring about termination proceedings by the operator include

- Bankruptcy of the owner
- Owner's material breach of the contract
- Owner revocation of license
- Owner's failure to provide adequate funds (or nonpayment of the operator)
- Mortgage or lease default
- Condemnation or casualty
- Foreclosure

The key to any termination clause is that it allow for the rapid and conclusive removal of the party at fault. A drawn-out termination by either the owner or the operator is to be avoided as it can have a devastating effect on the current and future operating results of the property.

[1] Bankruptcy

Although most management contracts permit either party to terminate the agreement in the event the other enters into bankruptcy, it is usually the bankruptcy court that ultimately decides whether the operator will continue or be replaced, since the court can override the terms of the contract. Any time a hotel is involved in a bankruptcy, its reputation suffers, and the long-term negative effect can often be difficult to overcome.

[2] Material Breach of Contract

The material breach of one or more contract provisions by one party usually allows the other party to terminate the agreement. In most instances, notification of the breach must be sent to the party within 10 to 20 days of the breach; the party then has 30 to 45 days to cure the breach. If the breach is not cured, the other party may then terminate the contract immediately, or in some cases must again notify the party at fault that the termination is effective. This extensive notification procedure is necessary to protect the rights of the party at fault, but it does draw out the process, which can negatively affect the hotel operation.

[3] Revocation of License or Franchise

Most management contracts contain provisions protecting licenses and franchise documents by holding either party to be in default for causing a license or franchise to be revoked. Both the owner and operator should monitor this provision carefully to ensure that a potential default caused by the other party is corrected before final action takes place. Notice of a default in any critical license or franchise should be sent to both parties so corrective action can be taken.

[4] Condemnation or Casualty

The taking of a hotel through eminent domain or by some form of destructive casualty generally permits either the owner or operator to terminate the agreement. A partial taking or casualty produces several issues that must be addressed when the management contract is drafted:

- At what point is a hotel rendered unusable by a partial taking or casualty?
- Does the owner or operator decide whether the facilities should continue to be operated?
- Is the operator entitled to a portion of the condemnation award or insurance proceeds?
- Is the operator entitled to collect a contract termination fee in the event the property is rendered unusable by a condemnation or casualty?

Some contracts allow either the owner or operator to determine whether the hotel has been made unusable, while others set forth certain criteria for reaching this conclusion. Some contracts, for example, cite circumstances such as those in the follow-

ing list, that would render a hotel inoperative and thereby allow either the owner or the operator to terminate the agreement.

- The cost of necessary repairs exceeds 85 percent of the hotel's replacement cost.
- The food and beverage facilities are rendered unusable during the last 18 months of the contract term.
- Fifty-five percent of the guestrooms are destroyed within the last five years of the contract term.
- Forty percent of the guestrooms are destroyed within the last four years of the contract term.
- Thirty percent of the guestrooms are destroyed within the last three years of the contract term.
- Twenty percent of the guestrooms are destroyed within the last two years of the contract term.
- Ten percent of the guestrooms are destroyed within the last year of the contract term.
- More than 30 percent of the hotel is destroyed by an uninsured casualty.

In most instances, operators will attempt to reopen a lodging facility that has been partially condemned or destroyed by a casualty. When negotiating the contract, owners should be aware of this inclination and insist that the agreement be worded in such a way so as to prevent the rebuilding of a facility when doing so does not represent the best use of the condemnation or insurance proceeds.

[5] Operator's Failure to Achieve Performance Levels

One of the most important provisions from an owner's point of view is a performance clause that sets specific operating standards that the management company must meet in order to remain as the operator of the property. Generally, the best measure of operating performance is profitability. Owners invest in hotels in order to realize profits, and the ultimate test of the management company is whether profits are actually made. A well-written performance clause protects the hotel owner from an incompetent operator, while at the same time assuring the management company that it will not be terminated for circumstances beyond its control. Among the important issues that should be addressed in a performance clause are the following:

- ☐ Performance criteria should be clearly defined so that both the owner and operator understand the specific goals. Stating, for example, that the hotel must be operated in "a profitable manner" does not provide the operator with a specific level of performance.
- ☐ The failure to achieve the desired level of performance should be recognizable early enough to prevent the hotel from suffering undue financial hardship from an incompetent operator. The performance criteria should also, however, address the possibility that the operator is a competent manager but external circumstances, such is a declining economy or overbuilt market, makes the performance level impossible to reach.

☐ The performance criteria should take into account unique circumstances, such as that a new hotel typically experiences a period of build-up, during which both occupancy and profits grow; that a seasonal hotel is often less profitable than one that operates year-round; and that unions, high energy costs, excessive property taxes, and difficult maintenance problems are unpredictable elements that will often reduce profits.

☐ The termination process should provide the operator with an opportunity to remedy the lack of performance by contributing or lending the necessary funds to the owner in order to correct the deficiency and bring the level of performance in line with the stated criteria.

☐ The performance criteria should reflect the fact that a management contract generally runs for an extended period of time and as the financial structure of the property (i.e., financing, equity and ownership) changes, the intended performance provisions should remain intact. For example, if the performance criteria establishes a level of profit after debt service, and at some time in the future the mortgage is restructured, thereby reducing the annual payments, the operator will directly benefit because the margin of profit will automatically rise through no effort on the part of the operator.

Setting specific performance criteria often becomes one of the key elements in the management contract negotiation process. The operator generally opens discussions by stating that any form of operator performance criteria is inappropriate and unnecessary. The owner generally counters with provisions that permit swift operator removal for any deficiency in performance. The final contract, which will reflect the bargaining power of each party, will be the result of some compromise between these two opening positions.

From the owner's point of view, the easiest way to establish appropriate criteria for operating performance is to use the income and expense projections developed by the operator during the request for proposal (RFP) stage of the management company selection process. Owners assume that if the management company was attempting to sell its services based on such projections then it should be willing to have them used as a performance standard. Management contracts that use this approach typically set forth a defined level of profit, such as income before debt service, and list by year the minimum dollar amount that the operator must generate in order to conform with the performance standard. Other performance criteria sometimes used in hotel management agreements include:

☐ *Revenue figures from a market study performed by a hotel appraisal firm.*

☐ *The income after debt service realized by the subject property.* This performance standard requires the operator to generate a net income that covers, at a minimum, the debt service for the property. The specific amount of debt service should be set forth in the contract, because with floating loans, refinancing, and subordinate mortgages the actual payments may vary over the life of the contract.

☐ *Specified return on equity funds.* This criterion is similar to the income after debt service standard except that the operator must generate a sufficient profit to not only cover debt service but also provide a minimum return on equity. In the event that additional equity funds must be invested in the property, such as monies to cover initial cash shortfalls, this type of clause allows the owner to impose a higher standard on the operator.

- ☐ *Room rate multiplier.* This performance standard requires the level of gross operating profit to be not less than a certain multiple (e.g., 150) of the average rate per occupied room multiplied by the number of rooms in the hotel. This criterion is based on an industry rule of thumb that states that the value of a hotel can be estimated by multiplying the average room rate of the property by the number of guestrooms by 1000. Care must be taken when using this formula that the multiple that is chosen is appropriate for the type of property.
- ☐ *Percentage of gross operating profit.* This standard establishes the right of the owner to terminate the agreement if a certain percentage (e.g., 80 percent) of the gross operating profit does not equal a certain percentage (e.g., 15 percent) of the equity funds invested in the hotel.
- ☐ *Percentage of an approved budgeted amount.* This standard is based on an approved operating budget and holds that the operator must achieve a certain percentage of a stipulated profit line in the budget, such as 80 percent of the gross operating profit. The key to this criterion is the budget approval process and how much input the owner has in establishing a realistic level of performance. The advantage of this procedure is that the performance criteria can be adjusted on a yearly basis (through the annual budget approval process) to reflect local market and operating cost conditions.

Performance criteria generally do not become effective for two to four years after the opening of a hotel. This delay is particularly important for newly opened properties, whose operating performance is difficult to judge during the first few years as the business builds up. In addition to a delay for the start-up period, most performance clauses allow a new operator two to three years to achieve the necessary level of profit. A typical performance clause will, for example, state that the owner may terminate the agreement if the operator fails to achieve a positive income after debt service after three consecutive years. Often, the management company must fall short of the performance standard for two or more consecutive years before the owner can terminate for poor performance. In general, performance standards start later and require more consecutive years of nonperformance for first-tier operators than for second-tier operators.

If an operator agrees to a performance termination clause, it usually insists on receiving the right to cure. A right to cure clause allows the management company to provide the capital necessary to make up any difference between the hotel's actual level of performance and the performance level set forth in the management contract. by advancing the needed capital, the operator is allowed to continue managing the property until another performance test is made (usually one year later). The monies funded by the operator may take one of two forms: they may be treated as merely cash advanced with no provision for repayment, or they may be loaned by the operator (with or without interest) to be repaid at some future date. Any repayment of funds advanced by the operator to meet a performance criteria is generally subordinated to debt service as well as a return on equity funds.

To protect the operator from external circumstances that could adversely affect a hotel's operating performance and thereby subject the management company to termination, some contracts contain an arbitration provision that allows the operator to prove that the failure to meet the performance standard was due to causes or conditions beyond the operator's control.

[6] Operator Buy-out

A buy-out clause enables the hotel owner to terminate the managemment contract at any time for any reason by merely paying a specified dollar amount. This provision is important to owners for several reasons:

- It allows the hotel to be sold unencumbered by a management contract, generally permitting a quicker sale and usually producing a higher selling price.
- An incompetent operator can be removed in less time than that usually provided for in performance termination clauses.
- Occasionally, an owner may find it advantageous to buy out the operator and manage the property independently, thereby saving the management fee.

Although a buy-out clause can greatly benefit the owner, such provisions are rarely available from first-tier operators. Hotel chains with a recognized trade name are often reluctant to enter into agreements that could be easily terminated by the owners and possibly create adverse customer publicity.

The actual termination charge reflects the value of the management contract to the operator. Theoretically, the amount of the payment should approximate the discounted value of the anticipated management fee income over the contract's remaining term. Typical termination charges range from two to four times the total management fee paid to the operator over the previous 12-month period. This calculation equates to a 25 to 50 percent discount rate, which is generally appropriate for gross rather than net income to the management company.

The termination charge can also be based on a sliding schedule, such as the following:

Years 0–10	No termination
Years 11–15	200% of total fee for prior 12 months
Years 16–17	100% of total fee for prior 12 months
Year 18+	No fee

This schedule takes into account the greater cost of termination, in terms of lost profits and start-up costs, to the operator in the early years of the contract. A specific dollar amount (e.g., $75,000) can be used in place of a percentage, in both a standard fee provision and a sliding schedule, but such an amount must be regularly revised to account for inflation.

[7] Operator Misconduct or Fraud

Any operator misconduct, including fraud or the misappropriation of funds, constitutes a major breach of trust and warrants the operator's immediate termination. Care must be taken to determine that such an occurrence was attributed to the operator rather than to an employee acting without the management company's knowledge or approval. Individual breaches should be insured against by appropriate fidelity bonds.

[8] Cessation of Operator Activity in the Hotel Business

Management contracts can sometimes extend for 30 to 50 years, so owners usually seek to protect themselves from operators who become significantly less active in managing hotels and, by doing so, reduce the benefits of being part of a lodging chain. Some contract clauses allow the owner to terminate if the operator ceases to manage a specified number of hotel properties. Other clauses stipulate a dollar volume amount that hotel operations must represent as a percentage of the company's total revenue.

[9] Owner's Failure to Provide Adequate Funds

Under a management agreement the operator generally has no responsibility to provide operating capital for the hotel. All funds either come from the property's cash flow or are contributed to the operation by the owner. To provide adequate management services, the hotel company must have access to sufficient financial resources to pay bills and other liabilities. Lack of necessary funds puts undue pressure on the operator, making it difficult to manage effectively. In addition to their concern regarding access to sufficient capital to operate the property, management companies obviously want assurance that owners have the resources necessary to pay their management fees.

Adequate funds are typically defined in the management contract as a specific dollar balance that is to be maintained in the property's operating bank account. When cash drops below this pre-established level, the owner must deposit more funds or the agreement goes into default.

[10] Mortgage or Lease Default Including Foreclosure

Provision for termination because of a mortgage or lease default is often tied in with the operator's right of termination in case of the owner's failure to provide adequate funds. Operating under the threat of either a lender foreclosure or a landlord eviction is difficult for a hotel management company. Such situations not only result in adverse publicity, they also have a damaging effect on the staff, suppliers, and customers. As with a bankruptcy, the reputation of the management company, particularly first-tier chains, can be quickly tarnished, affecting the image of the entire company.

Most operators want the option to remove themselves from such circumstances. At the same time, lenders also want the option to either remove the operator or continue under the same management in the event of foreclosure on the owner's mortgage. Depending on the negotiating power of the respective parties, the clause providing for termination because of a mortgage default can be written to favor either the hotel operator or the lender.

16.09 OPERATOR INVESTMENT IN PROPERTY

Many hotel owners attempt to negotiate some form of financial commitment to the property on the part of the management company in the belief that having the operator financially tied to the success of the project will create additional incentive to

manage in a profitable manner. This practice is more common with first-tier operators than with second-tier operators. Hotel management companies generally pursue one of the following options if an investment in the property is required:

- ☐ *Deferred incentive management fees.* The deferral or outright forgiveness of all or a portion of the incentive management fee is actually a form of capital investment on the part of the operator. Most management companies are willing to accrue the incentive portion of the fee in instances where cash flow is insufficient to cover debt service. If this portion accrues at interest and is ultimately repaid some time in the future, then the actual cost to the operator is minimal. If the deferred incentive fee accrues without interest, the operator loses the time value of money but generally receives full payment at some point in the future. Occasionally, fee structures are negotiated that stipulate than any unpaid incentive fee will not accrue and that the operator forfeits all monies owed. This structure is the most likely one to induce a meaningful investment from the operator.
- ☐ *Preopening services.* Owners are often able to negotiate reduced charges for the pre-opening services of operators in the case of a new hotel.
- ☐ *Working capital.* All hotels require working capital to purchase inventories and operating supplies and to fund other types of start-up costs. This money often comes from the hotel management company.
- ☐ *Initial operating fund.* This fund is used for operating supplies, inventories, and house banks and cash. The operator is not usually responsible for maintaining working capital balances. These costs typically range as follows:

Class of hotel	*Amount per room*
Economy	$1,100 to $1,500
Standard	$1,500 to $2,600
First	$2,300 to $3,200

- ☐ *Furniture, fixtures, and equipment (FF&E).* Occasionally, the operator will fund the purchase of part or all of the hotel's FF&E. This outlay can represent a significant investment on the part of the operator. FF&E costs typically range as follows:

Class of hotel	*Amount per room*
Economy	$ 5,200 to $ 9,100
Standard	$ 9,800 to $17,000
First	$13,800 to $30,900

- ☐ *Outright payment of key money.* In some highly desirable hotel markets such as New York City, hotel management companies sometimes pay what is known as key money to obtain the right to put their name on and manage a hotel. In effect, the company purchases the management contract for the hotel.
- ☐ *Other operator investments.* Management companies sometimes provide funds in the following formats: reduced fees, group purchasing advantages, and profit guarantees.

The fact that a management company is willing to make a capital contribution is sometimes meaningless when the form of the contribution does not expose the operator to any monetary loss. For example, if the contribution of capital takes the form of a loan that is repaid over time with interest, the operator has not really made a significant investment. This may also be the case even if the loan does not accure interest, in that the operator has lost nothing other than the time value of money. Only when the operator actually contributes capital (in the forms described above), with the expectation of receiving a return pari passu to the other equity funds, can the investment be considered meaningful. The usual forms of operator capital contributions are as follows:

- ☐ *Loan of capital.* The operator contributes capital in the form of a note that is repaid with interest, generally out of cash flow. The note is usually unsecured and subordinated to mortgage debt service.
- ☐ *First take-out of equity.* The operator receives all of the property's cash flow after debt service until the equity contribution is recovered. The owner then receives the cash flow until the remainder of the equity investment is recovered. Any subsequent cash flow is divided according to an agreed upon percentage.
- ☐ *Outright equity contribution.* The operator and owner enter into a joint venture partnership and split all cash flow after debt service in accordance with an agreed upon percentage.

While a capital contribution on the part of the operator may sound appealing to an owner, it can represent very expensive money. From the owner's standpoint, if capital is urgently required for the operation of a property, the most reasonable form of capital contribution by a management company is, first, the subordination of management fees and, second, the loan of capital. The primary advantage for an owner in obtaining funds from the operator in the form of a loan is that the overall cost is relatively low. Interest on the funds loaned is usually tied to the prime rate or a specified percentage in excess of that rate (generally no more than 2 percent), but amortization based on cash flow can be very rapid. An operator's capital contribution in the form of equity, which carries no stated rate of return, can also be costly. Since many operators have limited resources to invest in hotel properties they generally seek cash-on-cash returns on their equity of 12 to 20 percent.

16.10 OPERATOR EXPENSES

Hotel management companies generally incur two types of expenses during the process of operating hotels either for their own account or for third parties. These expenses are known as home office expense and system reimbursable charges.

[1] Home Office Expenses

Home office expense includes all the costs of operating the home and regional offices of the management company. These consist of salaries and benefits for executive personnel and support staff, office operating expenses such as rent, office equipment, telephone and supplies, and administrative expenses including insurance, bookkeeping, and legal, which are limited to the administration of the management

company rather than the hotel properties themselves. Depending on the size of the management company and the types of management services provided, the extent of the home office expense may range from modest to extensive.

[2] System Reimbursable Charges

System reimbursable charges are expenses paid by the hotel owner for centralized services provided by the management company. Centralized services include system-wide advertising, national and regional sales offices, reservation accounting, management information and purchasing systems, and education and training programs. Most first-tier management companies offer extensive centralized services, while second-tier operators generally have limited capabilities.

[3] Payment of Expenses and Charges

Home office expenses are typically included in the management fee and are not charged or allocated to any of the properties under contract. These costs represent the normal overhead expense of operating a hotel management company. While home office costs are not usually allocated among the chain's hotels, some operators will charge individual properties the travel expense when home office personnel make periodic visits. Occasionally, the salaries of these individuals may also be charged to a hotel when specialized services are being performed.

When negotiating a management contract, the hotel owner should request a detailed description of the home office expenses that will be included in the management fee and those that will be charged to the property. Some operators attempt to allocate a portion of the normal home office overhead to individual properties through excessive charges for home office services. This procedure allows hotel companies to offer fee structures that appear extremely competitive but, when the total costs are calculated, are often economically unattractive.

System reimbursable charges are generally allocated to all the properties within the system according to a specified formula. Some of the methods currently in use include:

- ☐ *Percentage of revenue.* The cost of a centralized reservation system is often allocated on the basis of a percentage of revenue—usually rooms revenue, which reflects three important operational variables: the property's room count, occupancy, and average room rate. This method can be somewhat unfair to hotels that do not receive an adequate share of reservations from the centralized system but nevertheless must pay the formulated portion of this expense.
- ☐ *Per available room.* Allocating centralized services on the basis of the room count in the subject property divided by the total room count in the chain is a common procedure that is simple to administrate and does not involve communicating confidential information such as occupancies and average room rates. It can, however, produce an allocation that is more unfair than the percentage of revenue method because it does not account for the actual operating performance of a property. For example, using the per available room basis of allocating centralized advertising, a 300-room hotel operating at 75 percent occupancy with a $100 average rate would

pay the same amount as a 300-room hotel with a 60 percent occupancy and a $85 average rate. Furthermore, this method also does not take into account the actual usage and benefit an individual hotel might or might not receive from the centralized advertising program.

- *Per service received.* This method of allocation tends to produce the fairest results because it divides the centralized costs based on actual usage and benefit derived. For example, the cost of centralized reservations may be allocated on the basis of $4.50 per reservation received. Properties that obtain a greater number of reservations from the system pay a larger share of the centralized costs. Care must be taken when using this allocation method to make some provision for no-shows, that is, reservations made and thus charged to the property that represent customers who either subsequently cancel or do not show at the property. Administration of this method of centralized expense allocation is obviously more difficult.

The methods used by a hotel management company to allocate system reimbursable charges are generally preestablished by the management company and subject to negotiation for individual management contracts. The property owner should request documentation as to the management company's historical allocation procedures and costs for these charges so that projections can be made for the subject property.

16.11 TRANSFER OF OWNERSHIP

The ability of both the hotel owner and the hotel operator to easily transfer ownership (i.e., by the owner selling the hotel or the operator selling the management company) is desirable because it allows the selling party to actually realize the value of the enterprise. Any prohibitions that make a sale more difficult can reduce the obtainable value. There is good reason for establishing conditions to a transfer, however, because the party remaining after a sale is dependent on the abilities and resources of the new owner for future success. To protect the hotel owner and operator, many management agreements incorporate specific restrictions on the transfer of ownership. There are basically two types of such restrictions: approval requirements and the right of first refusal.

The remaining party can receive protection through a variety of approval requirements to which both the parties buying and selling must adhere in order for the transaction to take place. Generally, the more protection the remaining party receives, the more restrictive the transfer process becomes. Transfer approval requirements can generally be divided into three levels depending on the degree of restrictiveness imposed by the remaining party: those that give the remaining party total veto power; those that establish specific approval criteria; and those that stipulate that approval cannot be unreasonably withheld.

A total veto provision gives absolute power to the remaining party to either accept or reject the buyer proposed by the seller. This level obviously provides the greatest protection to the remaining party, but it can seriously inhibit the marketability of the enterprise should the veto be used in an unreasonable manner.

Some management agreements incorporate specific approval criteria that must be met before a transfer is approved. Depending on whether the transfer is made by the owner or operator, the criteria can relate to items such as net worth, integrity,

experience, references, or possible conflicts of interest. By establishing specific approval criteria, both the seller and a qualified buyer are able to move towards a transaction knowing that they will be approved by the remaining party.

A common provision in management agreements is that a specific approval cannot be unreasonably withheld. While this stipulation might provide some comfort to the prospective buyer and seller, the interpretation of ''unreasonably'' can subject the entire transaction to ruinous litigation.

In addition to specific approval requirements on the transfer of ownership, most hotel management contracts contain a right of first refusal. Under a right of first refusal, the party to remain with the hotel has the right to match the offer made by the buyer and accepted by the seller. This provision not only allows the remaining party to acquire a full interest in the property, but alleviates the need to invoke one of the approval requirements in the event the remaining party does not want to become a partner with the potential buyer. While the right of first refusal should not take the place of specific transfer approval requirements, it provides another form of protection.

A right of first refusal can by itself inhibit the sale of a hotel. Potential buyers, knowing that they may not ultimately succeed in purchasing a property because of the rights vested in the remaining party, may not spend the time and effort necessary to pursue the transaction. This may limit the number of potential buyers, which can in turn adversely affect the marketability of a property.

An important component of a right of first refusal provision is the length of time the remaining party has to consider matching the offer of the buyer. Naturally, the seller wants this time period to be kept to a minimum while the remaining party wants as much time as possible to review the offer and secure necessary financing. The length of time allowed to consider such offers generally ranges from 45 to 90 days, but in most instances, the remaining party is permitted 60 days to consider an offer.

While the transfer of ownership is generally not an immediate concern when a hotel management agreement is drafted, the structure of these provisions can have a significant impact on both the residual value of the property and the ongoing relationship of the parties to the agreement. Care must be taken to view a transfer from the standpoint of all parties involved in order to achieve an equitable contractual structure.

16.12 EXCLUSIVE RIGHT TO DEVELOP OR OPERATE

Most hotel developers and operators are interested in new opportunities to develop or manage properties. One way to generate new business is to enter into management agreements that give the management company the exclusive right to operate all the hotels of the owner and the owner the right to develop all of the hotels operated by the management company.

While this type of provision generally does not extend beyond the local market area, it provides a way for reducing the adverse effect of competition. However, such a provision must be carefully considered, because as circumstances change, business relationships that are appropriate today may not be so in the future.

An exclusive right to develop or manage should be structured more as an option than as a right. If the developer decides not to build another hotel for the operator, then the operator should be free to pursue other opportunities within the market area.

If the operator believes it is not suited to operate a particular type of hotel for the developer, then the developer should be permitted to find an alternative.

16.13 INSURANCE AND CONDEMNATION PROCEEDS

After a casualty or condemnation, the property owner is generally compensated for the loss by either the insurance company or the condemning authority. In the event of casualty, depending on the type of insurance coverage, the owner usually receives the replacement cost of the property destroyed, so that the damaged hotel can be reconstructed. In a condemnation, the compensation is typically based on the market value of the property taken. Business value is rarely considered by either the insurance company or the condemning authority, with the exception of insurance that covers a business interruption.

Most hotel operators want management contract provisions that require insurance and condemnation proceeds to be used to reconstruct the hotel. Some management companies, however, want to receive a portion of any insurance or condemnation proceeds as compensation for the loss of management fee income along with the other benefits of operating the hotel. For example, an agreement may stipulate that the operator receive a portion of the residual compensation left after the property is rebuilt, calculated by taking 20 percent of the fraction of which the numerator is the number of years remaining in the management contract and the denominator is the number of years in the hotel's remaining useful life, and multiplying this percentage by the residual compensation. Although management companies with strong bargaining positions are sometimes able to obtain these types of provisions, the sharing of insurance or condemnation proceeds is usually not justified unless the insurance company or condemning authority makes an unusual special award for a business-related loss.

Hotel owners generally insist on retaining all the proceeds from an insurance or condemnation award. If this right is unacceptable to the operator, a compromise provision is sometimes agreed to that allows the management company to make its own claim for compensation, but only if the owner can be satisfied that such a claim may be made separately and any award would not adversely affect the timing or amount of the proceeds to which the owner is entitled.

Although a destructive casualty or condemnation is an unlikely occurrence during the life of a management contract, any clauses relating to these events become extremely important if in fact the property is destroyed or taken. Both parties must be aware of how insurance or condemnation compensation is calculated so an agreement can be properly structured.

16.14 EMPLOYEES

One of the major issues in management contract negotiations relates to whether the personnel employed in the hotel are to be employees of the owner or of the management company. Owners generally want the workers to be employees of the operator and operators want the owner to be the employer. The basis of this issue is primarily liability; the employer is directly responsible for withholding taxes and social security and, ultimately, making timely payments to the IRS. Sometimes, when cash flow is tight, the money for these federal taxes is diverted to other, more pressing uses. If

the cash flow does not recover in time to allow the fulfillment of the government obligations, the employer becomes subject to penalties, interest, and even criminal prosecution. In addition to this employee tax liability, an employer faces various types of personnel liabilities, such as employee theft, assault, discrimination, and negligence.

Under most hotel management contracts the hotel owner is usually responsible for providing any funds needed to cover cash flow shortfalls, so most operators contend that they should not be the employer when they do not have total control over the availability of capital. On the other hand, since the operator usually has direct responsibility over employee hiring practices and should be in a position to monitor the quality and integrity of the personnel, many owners feel that the operator should be the employer.

From the perspective of the management company, another cause for concern regarding the employee issue arises when a company finds itself in a hotel ownership position on a short-term basis. For example, when a lending institution forecloses on a hotel and becomes the employer of the property's personnel, it may be forced to provide pay and benefits equal those received by other employees of the bank. These benefits can be very expensive and are not a desirable option for a short-term owner.

Occasionally, the management company will request that top-level personnel be employed by the operator while all others work for the owner. This agreement allows top management to participate in the chain's benefit programs while restricting the inclusion of all other employees. It also provides the operator additional control over the key executives.

16.15 RESERVE FOR REPLACEMENT

A reserve for replacement is a fund set up to accumulate capital for the periodic replacement of FF&E. Hotel FF&E should generally be replaced on an average of once every eight to ten years, so the reserve for replacement must be of adequate size to meet these requirements. Hotel owners that are also operators usually do not actually establish a fund for this purpose, but rather contribute capital at the time that FF&E replacements are required. Depending on the owner's financial situation at the time FF&E funds are needed, they may come from the hotel's cash flow, additional borrowings, or new equity contributions. Occasionally, these sources of funds are not available and the FF&E replacements must be postponed.

A hotel management company has a vested interest in maintaining the hotel in top physical condition, so it does not want to be in a position where adequate funds are not available to make necessary replacements. A worn-out facility negatively affects profitability as well as the image and reputation of the operator. To provide protection against such an occurrence, hotel management companies generally require that an actual reserve for replacement fund be established, coupled with contractual obligations for regularly depositing capital. The management company typically opens a separate reserve for replacement bank account and administers its activity. Deposits are made by the operator directly from cash flow (or from ownership short-fall capital if cash flow is insufficient). Withdrawals from the fund are to be used only for replacement of FF&E and generally only with the approval of the operator. Depending on how the budgeting process is structured, FF&E replacement may require ownership approval or it may be at the operator's sole discretion.

Many different formulas are used to establish the amount of money that must be contributed each year to the reserve for replacement fund. The primary objective of any of them is to create a fund that adequately covers future replacement needs without needlessly putting aside too much money. The following list describes some of the formulas used for this purpose by hotel management companies.

- ☐ *Percentage of revenue.* Most hotel management contracts base the annual reserve for replacement contribution on a specified percentage of total revenue. This advantage of this formula is that it automatically adjusts for different factors, such as varying occupancy levels, changes in average room rates, increases or decreases in food and beverage volume, and external inflationary factors. For example, if a hotel experiences higher levels of occupancy, the total revenue increases and the reserve for replacement based on a percentage of revenue follows suit. The reserve fund grows more rapidly and replacements can be made sooner to offset the effects of the greater use.

  The actual percentages used in this formula generally range from 1 to 5 percent of total revenue (rooms, food, beverage, telephone, and other income). Some contracts call for a fixed percentage that stays constant over the life of the agreement, while others use differing percentages that increase periodically. The fixed percentage formula works well for both new and existing hotels. The step percentage is generally used for new properties.
- ☐ *Annual fixed dollar amount.* Some management contracts specify that a fixed dollar amount be contributed to the reserve for replacement fund on an annual basis. The size of the annual contribution is calculated by estimating the total future replacement cost in today's dollars and dividing this amount by the number of years remaining until the replacement is required. In order to adjust for inflation, a factor based on the Consumer Price Index (CPI) is usually incorporated into the calculation. The difficulty with this approach is estimating the number of years between replacements. A particularly successful hotel with a high occupancy may require an FF&E replacement long before the originally scheduled date. If this occurs, the fund would not be sufficient to complete the necessary replacements. This method is rarely used alone. Instead, it is commonly used in conjunction with the percentage of revenue method.
- ☐ *Negotiated yearly amount.* Some management contracts structure the reserve for replacement contribution on the basis of an annual amount negotiated between the hotel owner and operator. However, most operators want a more definite formula that provides assurance that an adequate reserve fund will be available to make necessary replacements.

Because items of FF&E have a relatively short life, contributions to the reserve for replacement fund must be made annually starting with the first year of operation. Some owners of new hotels attempt to negotiate a formula that incorporates a waiting period, thinking that early contributions are unnecessary because the FF&E is in new condition. If this approach is used, it is likely that there will not be sufficient capital in the fund when short-life replacements must be made. What must be realized is that even though FF&E has an average useful life of eight to ten years, many of the components have lives that are much shorter. The following table shows the typical useful lives of various FF&E components:

Item	*Years of Useful Life*
Furnishings	
Lobby	5–12
Restaurant	5–12
Guestrooms	
Casepieces	8–15
Mattresses	5–18
Carpet	
Lobby	3–6
Corridor	2–4
Guestrooms	4–8
Drapes	4–8
Bedspreads	3–6
Kitchen equipment	8–25

As this table shows, FF&E replacement could start as early as the second year for a new hotel. Additional replacements are then necessary almost every year thereafter. Replacement is an ongoing process, so the accumulated dollar amount in the reserve fund is generally minimal; this means that a sinking fund arrangement (i.e., the use of segregated assets and their proceeds to fund the replacement) is inappropriate because the yearly fund balance is probably insignificant and the compounding interest benefit does not generate any appreciable growth.

Both the hotel owner and operator should recognize that the fund must be of adequate size to meet the replacements required without being excessively large to tie up capital unnecessarily. In order to put the concept of a reserve for replacement into its proper perspective, the management contract should contain a clause such as the following:

> The percentages for the reserve for replacement fund are estimates. If, in good faith, Operator believes that such percentages have become excessive, given the needs of the hotel, such percentages shall be reduced at the option of Owner. On the other hand, as the hotel ages these percentages may not be sufficient to keep the reserve for replacement fund at levels necessary to make the expenditures required to keep the hotel in first-class condition. In such an event, Operator may adjust the percentages upward.

16.16 AREA RESTRICTIONS FOR OPERATOR

Competition among different hotel chains within the same market area can adversely affect the operating results of a particular property. Competition from hotels with the same chain affiliation or management can be even more devastating. Hotels with identical names operating in the same market area and going after the same market segments can produce a competitive environment that is not only confusing to the market but counterproductive in capturing room-night demand.

To prevent a situation in which a hotel chain establishes too many hotels within a market area, some hotel management contracts provide for area restrictions. Basically, area restrictions limit a hotel company from owning, leasing, operating, or franchising other lodging facilities within a defined geographic area surrounding the subject property. This owner-oriented provision is most important when the operator is a first-tier management company whose corporate name has a public identity. The act of placing the chain's name and trademarks on other hotels within the same mar-

ket area can dilute potential room-night demand and reduce operating levels for existing properties. Second-tier hotel operators, without a recognizable brand name identity, have much less of an effect on their existing properties when they take over additional hotels in the same market area. However, even if the public is not aware that two hotels of differing chain names are under identical management, the potential for a conflict of interest and favoritism is always present. This is particularly true if the management company has an ownership interest in the competitive hotel. For these reasons, hotel owners generally attempt to negotiate some form of area restriction.

Restrictions on a management company to own, lease, operate, or franchise other lodging facilities within a defined market area should be structured so that they protect an existing property from adverse competition but, at the same time, give the operator the opportunity to expand when demand allows. An area restriction clause must provide two important pieces of information. First, the primary market area must be clearly defined so there is no spill-over into other nearby areas that are not directly competitive. Several formats are available to achieve this objective. Some contracts utilize a specific radius to outline the perimeter of the market area. Other contracts provide street names to outline the protected territory or use the boundaries of a city or other established area. Second, the clause must specify the duration of the restriction. Restricted market areas are sometimes redefined over time. A circle with a radius of ten miles might be used for the first five years, shrinking in size to a five-mile radius for the next five years and then eliminated for the remaining term of the agreement.

Operators who consent to an area restriction generally look for ways either to have the protected territory reduced in size over time or to incorporate a provision that will allow the restriction to be lifted if sufficient local area demand can be proven. The best way to demonstrate that the impact of another hotel carrying the operator's trade name or management will be minimal is to establish a minimum level of occupancy requirement before the operator is allowed to enter the market with another property. For example, a clause might give the operator permission to add another hotel any time after the existing property has achieved an occupancy level of at least 75 percent for two consecutive years. Whatever the occupancy level selected, it should be high enough to demonstrate that there is sufficient area lodging demand to support another property carrying the same trade name.

Some hotel companies use the services of hotel consulting firms to perform impact studies that assess the negative effect on the subject property if the operator adds another lodging facility to the market area. As with any study of this type, the quality of results are directly related to the skills of the consultant performing the work and the ultimate determination is still largely subjective and prone to dispute.

16.17 INDEMNIFICATION

Most hotel management contracts contain clauses that indemnify each party from various liabilities and losses. Owners and operators face different risks in their respective capacities, so indemnification provisions are variously structured in order to meet each party's need to reduce their exposure. The major types of indemnification clauses are as follows:

- ☐ *Indemnification provided by the owner.* Generally, the operator wants indemnity from all liability, loss, damage, cost, or expense relating to or

arising from the operation of the hotel. This coverage usually also includes any act or omission, negligence, tortious or otherwise, of any agent or employee of the operator. It typically requires the owner to assume the cost and expense of the defense of any legal proceeding arising out of the allegation of any such act or omission. In most instances, the indemnification provisions protecting the operator are not totally absolute; they usually contain exceptions for circumstances such as: willful operator misconduct, gross negligence, fraud, theft, malicious conduct, and breach of trust. During the negotiation process hotel operators try to limit these exceptions by using modifying terms such as "gross" negligence, while owners try to broaden the exceptions so that no indemnification would be required if the operator was merely negligent. Most management contracts include some sort of indemnification for the operator.

☐ *Indemnification provided by the operator.* Most management contracts contain provisions that require the operator to indemnify the owner from liability, loss, damage, cost, or expense caused by the operator's breach of the management agreement. In addition, the hotel company is sometimes required to also indemnify actions outside the scope of the agreement, including gross negligence, willful misconduct, fraud, or breach of trust. Operators attempt to modify the impact of these clauses by adding modifying terms, such as "material" breach of the management contract and "willful" misconduct.

The use of indemnification provisions in hotel management contracts requires extensive local legal knowledge. The parties to the agreement should consult with their attorneys before approving any indemnification clause.

16:18 PREOPENING MANAGEMENT SERVICES

Since most hotel management agreements are structured primarily for operating lodging facilities, hotel companies that are taking over a newly-constructed hotel will generally draw up an additional contract to cover preopening management services. The period known as the preopening phase of a hotel's development generally begins with the employment of a sales staff or the general manager and extends to the actual opening day. Depending on the type of hotel and the need for preopening sales activity, the pre-opening service can start between three months to three years prior to the opening. Convention hotels, which attract groups that book several years in advance, usually require long lead times in their sales efforts. Some of the services the hotel operator typically provides during the preopening period include:

- *Preopening budget*—Preparation of comprehensive, detailed estimates as to what capital is required to fund all the pre-opening services.
- *Personnel services*—Recruiting, training, directing, and employing the initial staff.
- *Advertising and promotion*—Initiating and conducting such advertising and promotion necessary to attract guests to the hotel.
- *Leases and agreements*—Entering into agreement for leases, licenses, and concessions for stores and other rental space in the hotel.

- *Licenses and permits*—Application for and procurement of all licenses and permits required for the operation of the hotel and its related facilities, including liquor and restaurant licenses.
- *Purchasing*—Purchase of all initial inventories and operating supplies.
- *Installation*—Supervision of the delivery, installation, and acceptance of operating equipment, furnishings, equipment, and consumable supplies.
- *Sales and marketing*—Hiring and supervision of the hotel's sales staff and conducting the sales and marketing efforts, including developing a marketing plan.
- *Financial systems and controls*—Setting up all financial accounting systems and controls, including developing initial budgets and operating projections.
- *Coordination*—Assistance in coordinating the efforts and activities of the architect, interior designer, and all other consultants retained by the owner in connection with the planning and development of the hotel. If the operator is required, in addition to coordinating the various consultants, to review and critique their output, a separate contract, known as a technical services agreement, is generally used.[3]

Compensation for preopening services can be structured in a number of different ways. It is difficult to define a typical preopening fee, because many operators are willing to provide these services at or near their cost in order to obtain a long-term management contract, so provisions for them are generally negotiated concurrently with the management contract. The following is a list of several formats commonly used for establishing the compensation for preopening services.

- *Amount per room*—A schedule of preopening fees based on a certain amount per room that provides increased compensation as the hotel gets larger. It also sets a standard fixed rate for the fee, which need not be negotiated with each transaction thereafter.
- *Flat amount*—A lump sum for all preopening services determined through negotiations, generally paid in several installments. The primary advantage of the amount per room or the flat amount relates to the fact that the compensation is established and fixed at a specific level that provides a firm budgeted amount and forces the operator to absorb any preopening cost overruns.
- *Actual costs*—A provision that the operator will be reimbursed for all expenses incurred during the preopening phase of the hotel development. These costs generally include the payroll of the management company personnel assigned to the specific hotel.
- *Actual cost plus*—Same as actual cost, but with the addition by the operator of a profit factor, such as 2.5 times the payroll expense.
- *Percent of cost*—A percentage of the total project cost.
- *Per month or per diem*—Compensation based on a specific amount per month, per day, or per hour.

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[3] See 16.19.

16.19 TECHNICAL SERVICE ASSISTANCE

One of the additional services provided by some hotel management companies prior to and during the preopening phase of a hotel development is called technical service assistance. These activities encompass the technical aspects of hotel layout, design, construction and furnishing. Some of the technical assistance offered by hotel management companies who have this specialized in-house capability are as follows:

- ☐ *Initial design*—Providing the property owner with guidelines and specifications relating to the hotel's concept, layout, design, and decor, and recommendation and sizing of facilities.
- ☐ *Architecture and facilities design*—Working with the project architect, engineer, designer, and other development consultants to create working plans and specifications. Specific areas to be covered include:
  - Architecture
  - Mechanical work
  - Electrical and plumbing systems
  - Interior design
  - Operational design
  - Communications
  - Fire safety
  - Computer systems
  - Telephone systems
  - Food facilities design
  - Laundry design and equipment
  - Lighting
  - FF&E specifications
- ☐ *Final design*—Review by the operator of all plans and specifications prepared by the various development consultants. Based on the critique and recommendations made by the operator, the plans and specifications are revised and approved when acceptable.
- ☐ *Project supervision*—Provision by the management company of some level of project supervision to see that the plans and specifications are followed during the actual construction of the hotel. This supervision also includes the installation of furniture, fixtures, and equipment. The project supervision offered by a hotel management company will only rarely suffice to replace a full-time project manager, general contractor, or developer.
- ☐ *Other services*—Other technical services sometimes offered by the operator, including:
  - *Project feasibility*—Either preparing or reviewing market studies and appraisals
  - *Franchise affiliation*—Assistance to the owner by second-tier management companies in obtaining a franchise affiliation
  - *Project financing*—Assistance in securing debt and equity financing

Not every hotel management company has the in-house capability and expertise to provide technical assistance. It should also be pointed out that operators offering this type of assistance are not attempting to take over the development responsibili-

ties of creating a hotel—they are merely another consultant providing overall project review, critique, recommendations, and approval. Compensation for technical service assistance is generally a negotiated flat fee paid in stages over the development phase. These services are usually considered separate and distinct from the preopening services because they require a specialized level of expertise.

The hotel owner should exercise particular care when entering into a technical service agreement with a hotel management company. The in-house capabilities of the operator must be carefully evaluated in order to be sure that the technical services will be performed by knowledgeable experts. The operator must also have a sufficient number of personnel providing these services so that critiques, recommendations, inspections, and approvals can be made on a timely basis. Some hotel companies overextend themselves in the development area, thereby causing costly delays. Owners should also realize that hotel management companies are primarily interested in obtaining long-term management agreements and will at times consider preopening and technical services a loss leader or giveaway in order to secure the contract.