Hotel Investment Library

Negotiating Hotel Management Contracts

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Property Management- Hotel Management Companies

¶ 19.01 INDIVIDUAL MANAGERS VS. MANAGEMENT COMPANIES

The financial success of any lodging facility is largely dependent on the skill and ability of on-site management. Hotel operators face a number of unique problems, ranging from booking convention business to running a high-energy lounge to installing night audit financial controls. While the skills needed to handle such problems can be acquired through college-level training and operational experience, it is the type of system used by management that usually determines how successfully personnel can apply their skills.

Historically, hotel owners have either hired individual on-site managers to operate their properties or have engaged the services of professional hotel companies through hotel operating agreements such as property leases or management contracts.

The employment of individual managers is the less expensive approach, but there are serious drawbacks to such arrangements. In terms of supervision of staff, overall management skill, and effective operational methods, management companies are frequently superior to individual managers.

[1] Supervision

All the employees of a lodging facility should be supervised to ensure that the integrity of the facility's financial control system is maintained. An individual general manager often cannot provide the necessary level of direct supervision, whereas the structure of a hotel management company generally provides several layers of control over this aspect of the business. Furthermore, an individual general manager can be abruptly hired away by a competitor, or may quit because of a dispute. A hotel management company, on the other hand, can provide the back-up staff, logistical support, and uninterrupted supervision that is essential for a 24-hour-a-day, 365-day-a-year business. Unless ownership can assume total operational responsibility for the hotel on short notice and for extended periods, an individual general manager is often not a viable alternative for property management.

[2] Expertise

Many professional hotel management companies offer a range of expertise and experience that individual general managers cannot match. Management companies can assist hotel owners with property development, acquisition, and operation by providing such services as national advertising and reservation systems, interior decorating, and property engineering. Management companies are often also able to provide counseling and representation for labor negotiations, permit and license applications, and zoning and property tax proceedings.

[3] Verifiable Past Performance

A successful hotel management company should be able to document its past performance and provide references regarding its operations currently under contract. Verifiable information of this kind provides hotel operators with a basis for selecting a qualified operator. Individual managers, on the other hand, generally cannot document the effect of their management on a particular hotel. As a result, the selection of a qualified general manager usually must be made with very little assurance that the individual will be capable of successfully operating the property. At the least, poor selection results in confusion and loss of momentum until another manager is located and brought in to take over the operation. While vulnerable to the same problem, a management company is better able to handle a transition between general managers because it can provide trained interim personnel who can quickly assume necessary responsibilities within an established system, permitting continuous operation of all essential controls and procedures.

[4] Established Methods and Procedures

The major advantage in hiring a management company is that it can provide established, functional methods and procedures that constitute a complete system capable of handling the complex job of operating a lodging facility. In instances in which a takeover must be made rapidly, established management companies can bring in top-level management staff from other properties to train local personnel and implement proper operating systems and controls. For new lodging facilities, management companies can often provide valuable advice in the layout and design of the physical plant, and once the facility is completed, can institute their mode of operation and quickly bring on-line a fully functioning lodging facility. This experience and expertise saves time and reduces costly mistakes.

Most hotel management companies have developed procedure manuals and

Hotel Management Contracts and Related Documents

¶ 20.01 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. 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. The author wishes to acknowledge the research and findings of management contracts contained in James Eyster's *Negotiation and Administration of Hotel and Restaurant Management Contracts,* p. 41,779.

¶ 20.02 CONTRACT TERM

The term of a management contract is the length of time for which 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 while allowing 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.

First-tier hotel companies generally insist on long initial contract terms because of the high start-up costs associated with such agreements. Therefore, contracts with first-tier operators usually run for an initial term of between ten and fifteen 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 three and ten 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.

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 the 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.

¶ 20.03 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 gross revenue, creating an incentive for the operator to in-

Management Contract Clauses

This appendix is a compilation of clauses from a number of actual management contracts. These clauses have been selected to provide a representative sample of the types of provisions included in a typical management contract. In addition to serving as a guide for an attorney drafting such an agreement, these clauses can help the parties negotiating the agreement by showing them how other contracts have been structured.

The clauses have been arranged topically into 11 different sections. In many cases, a number of different clauses are contained under one title in order to provide the reader with optional or alternative language. At the beginning of each clause is an indicator showing the orientation of the clause. Clauses can be owner-oriented, operator-oriented, or neutral. This identification of orientation should allow the reader to select the clauses that best represent his interests. Finally, many of the clauses are followed by editorial notes that provide additional insight into the content of the clause.

Section 1 PREOPENING MANAGEMENT SERVICES

1.1 Preopening Services—General

NEUTRAL In general, Operator will perform all activities necessary or reasonably required to open the Hotel for business, to see that the Hotel is properly staffed and equipped, and to see that there is in place, well prior to the Opening Date, a coordinated program for selling the room facilities and services of the hotel to the public.

NOTE: **The contract should set forth in detail the preopening duties and responsibilities of the Operator.**

[*Alternate Clause*] OWNER As part of the Preopening Services, Operator will:

A. Recruit, train, direct, and employ an initial staff for the Hotel;

B. Initiate and conduct such promotion, publicity, and other like programs as Operator may deem necessary to attract guests to the Hotel on and after the Formal Opening Date;

C. Negotiate for and enter into agreement for leases, licenses, and concessions for stores, office space, and lobby space at the Hotel, in Owner's name subject to Owner's prior written approval, as agent for Owner;

D. Apply for, process, and take all necessary steps to procure, in Owner's name or in name of an operator or an individual on its behalf or any combination thereof as may be required by the issuing authority, all licenses and permits required for the operation of the Hotel and its related facilities, including, but not limited to, liquor and restaurant licenses;

E. Purchase or contract for the purchase of all initial inventories and operating supplies, which shall be paid for out of the Initial Working Capital furnished by Owner;

F. Assist in coordinating the efforts and activities of the architect, interior designer, and all other consultants retained by Owner in connection with the planning and development of the Hotel;

Management Contract Terms

Property	Number of Rooms	Date of Contract	Initial Term	Renewal Term	Management Fee Base	Management · Fee Incentive	Reserve for Replacement
First-class commercial hotel-Illinois	320	1983	20 years		4.5%	20% GOP subordinated to debt service and $1.25-million partner distribution	Years 1-2: 2% Thereafter: 3%
First-class commercial hotel-Illinois	400	1981	50 years		3% of gross revenue	20% of GOP provided 80% of balance equals or exceeds defined investment basis	Year 1: 1% Year 2: 2% Years 3-5: 3% Years 6-10: 4% Thereafter: 5%
First-class historic inn (independent)-Maryland	120	1985	5 years	None	2.5% of GOP	None	Year 1: 1% Year 2: 1.5% Add .05% each additional year
First-class resort hotel-Illinois	400	1983	2 years	7 terms, total of 60 years (operator's option)	3% of gross revenue	20% adjusted house profit until payback then 25%	Years 1-8: 3% Years 9-11: 4% Thereafter: 5%
First-class resort hotel (independent)-Florida	300	1975	10 years	10 years	3.5% of gross revenue or $65,000	12% GOP	Cash reserve, $75,000
First-class commercial hotel-Illinois	850	1988	20 years		3% of gross revenue	25% of net cash flow after return to partnership equal to debt service	Year 1: 0.5% Year 2: 1% Year 3: 1.5% Year 4: 2% Year 5: 3%
First-class airport hotel-California	450	1981	25 years		3% of gross revenue plus 10% house profit, cap. equals 4% gross revenue		

MANAGEMENT CONTRACT TERMS

Property	Number of Rooms	Date of Contract	Initial Term	Renewal Term	Management Fee Base	Management Fee Incentive	Reserve for Replacement
First-class convention hotel—Illinois	1,500	1984	20 years	1 period of 10 years	3% of gross revenue	15% of total adjusted income before fixed charges	Years 1–3: 3% of gross revenue Thereafter: Negotiated
Midrate commercial hotel—Texas	250	1974	5 years	3 periods of 5 years (operator's option)	1.75% of gross revenue	—	—
First-class commercial inn—Illinois	250	1984	20 years	—	3.5% of gross revenue	0%: IBFC<$1 million 2.5%: IBFC $1 million to $1.5 million 5.0%: IBFC $1.5 million to $2 million 7.5%: IBFC $2 million to $2.5 million 15.0%: IBFC $2.5+ million	—
Midrate commercial hotel—Georgia	150	1974	1 year	Annually	1.75% of gross revenue	—	—
First-class conference hotel—Virginia	350	1987	10 years	5 periods of 5 years (operator's option)	Year 1: greater of $15,000/ month or 4% of gross Thereafter: 4% gross	15% of cash flow after defined deductions	Negotiated, or 2% per year
Midrate airport hotel—New York	300	1987	25 years	—	4% of gross	—	—
First-class commercial hotel (independent)—New Jersey	250	1987	—	—	3% of (room + food + other revenue)	—	—
First-class commercial hotel—Tennessee	400	1972	30 years	2 periods of 10 years (operator's option)	3% of gross revenue	2% of adjusted NOI subordinated to debt service	4% of gross revenue
First-class commercial hotel—Maryland	400	1982	30 years	—	4% of gross revenue	20% of profit	Year 1: 1% Years 2–3: 2% Thereafter: 3%
First-class commercial hotel—Massachusetts	350	1987	10 years	5 years (operator's option)	1% of total revenue	5% GOP plus all F&B profit	—