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Front end alignment: The case for a hotel management agreement tune-up

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If you are riding in the car and notice that it veers either right or left when you happen to take your hands off the wheel, you are likely to need a front end alignment. Such is the case with the many forms of hotel management agreement in use over the last few years. Hotel management agreements in current use by hotel brands and by third party managers are oftentimes long term, no-cut, contracts ceding exclusive authority to the manager for all the most critical aspects of operation of the owner's hotel. Achieving a fair alignment of interests between the owner and the manager is therefore critical to the success of both parties, a task best accomplished at the front end in negotiation of the management agreement. The current economic downturn has revealed a number of areas where adjustment in standard terms may be appropriate in order to set the relationship on a balanced trajectory.

Employees

Payroll comprises approximately 75% of a typical hotel's entire operating budget. The manager has near-total control of hiring, firing, staffing levels and employee compensation, while the owner may only have a say in the hiring or pay of the hotel's general manager or other members of its executive staff (e.g., controller, director of human resources, or director of sales and marketing). Liability for any employment matters is allocated to the owner, absent the gross negligence or willful misconduct of the manager.

Many hotels are currently unable to meet operating expenses, let alone service debt (and forget about the equity). If occupancy is down and not all the current employees are needed to run the hotel, why not cut staff and reduce expenses? The manager, especially if it is a luxury or upper upscale brand, will have "standard" staffing requirements dictated by the nature of the hotel, rather than by its economic performance, and may be unwilling to compromise for fear of a negative impact on public perception of the brand's quality. The owner may think one or more of the hotel's executive staff is doing a lousy job, but there is nothing the owner can do unless the manager agrees. The management agreement contains no way for the owner to force the manager to alter payroll, other than in connection with a disapproval of the manager's proposed annual operating budget. Owner's disapproval can only happen once a year and may not survive the inevitable arbitration given the language of the management agreement. Worse still, the owner is obligated to fund shortfalls whether or not it believes the hotel's employee roster is overloaded. Often, the owner's obligation is guaranteed by an affiliated entity with substantial net worth so that the owner does not have the option to withhold funding.

Tension between the "brand standard" employment requirements and an owner's need to control payroll expenses could be resolved in several ways. Introduction of metrics having reference to the economy at large and to the specific performance of the hotel itself offers a fair method of risk allocation between owner and manager. Many management agreements already have incentive fee calculation formulae and performance termination tests which could be adapted to the purpose of balancing both parties' concerns.

If overall economic conditions trip a metric in the agreement enabling the owner to request cuts in payroll, let the manager decide either to implement the cuts or to fund the excess payroll by deferring and accruing a portion of its fee compensation until the same can be paid out of operating funds. If the hotel's own performance by reference to other similar hotels or projected operating profit trips a metric akin to that which would enable owner to terminate the management agreement itself, let the owner have the right to require the manager to replace members of the executive staff, perhaps with specific candidates suggested by owner and reasonably approved by manager. The manager would be entitled to the protection of a strong indemnity from owner against any consequences arising from compliance with owner's directives regarding specific employees.

Sales and Marketing

Managers have increasingly shifted from providing sales and marketing services on-site at each hotel to regional or centralized services. Do these remote teams understand the specific needs of the hotel as well as the owner would like? Are they selling all of the brand hotels within the owner's region, including those which compete with the owner's hotel? Does the owner have any contact with the real decision-makers regarding sales and marketing? Owner and manager share the goal of maximizing the success of the hotel through effective, efficient sales and marketing. Enhanced collaboration between manager's team and owner will further realization of that goal.

Owner could negotiate for the right to have periodic (e.g., quarterly) meetings with the manager's senior marketing personnel and those having specific responsibility for the hotel. Owner's input regarding the hotel's marketing strategy would be considered in good faith by manager's team, within the overall constraints of the management agreement and applicable brand standards. If any such meetings involved travel by owner or any members of manager's team, the expense involved would fairly belong to owner.

Financing the Hotel

If the terms of the management agreement hamper owner's efforts to obtain reasonable financing for the hotel, the owner has a serious problem and so, arguably, does the manager. Manager is entitled to appropriate protection against interference by owner's lender, but owner's lender should be able to obtain all of the elements of a properly underwritten and secured loan. The management agreement should address the flow of hotel funds into and through the various hotel accounts and anticipate lender requirements with regard to security interests and control agreements. While the lender may have a perfected interest in hotel funds, the manager should continue to have use of those funds in accordance with the management agreement. Given the significant civil and criminal penalties which attach to failure to meet payroll, both owner and manager share an interest in segregating an account for payroll, owned not by the owner but by the manager and in which the lender obtains no interest.

Owner should require that the management agreement specify the order of payment of expenses from available funds. The preferred order is operating expenses, fixed charges (e.g., real estate taxes and insurance), management fees, and balance to owner. If the agreement allows the manager to pay itself fees first and leave a shortfall in operating expenses or fixed charges, the owner is at risk of triggering "carve-out" provisions in its loan documents giving rise to personal liability for owner.

Convert or Mothball

What if it no longer makes economic sense for the hotel to remain open, or if the hotel would better perform in a different chain scale segment within the same brand family? Consideration should be given to establishing metrics in the management agreement giving owner the option to stop the bleeding through mothballing the hotel or by converting the hotel to a lesser brand within the same family. Alternatively, if the hotel is doing well, but could do better by converting up-market, the owner could elect to do so. To the extent the manager is willing to allow owner to have the benefit of such rights, the manager will be entitled to protection or waiver with regard to radius restriction provisions in the management agreement.

Few, if any of the changes suggested in this article are likely to be made on a case by case basis. Individual owners do not typically have the negotiating strength. Rather, if change comes, it is more likely to come on an industry standard basis. Management companies hungry for new engagements as the hotel industry emerges from the current gloom are in the best position to gain competitive advantage by taking steps to revise their own standard forms.

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