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Performance termination clauses in hotel management agreements - by Joshua Bowman

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While hotel owners and operators have many areas of common ground, their interests are not always 100% aligned. For example, with few exceptions, the owner will end up with the lion's share of the profit. This is because in most cases, base management fees are calculated using gross revenues (i.e., top line revenue). So, it is only natural for the owner to be more focused on the hotel's bottom line than the operator. Hotel operators (whether independent or part of a brand), on the other hand, often benefit from increasing their distribution networks by signing up as many long-term management agreements as possible. Doing so improves their brand recognition, standardization and ability to spread costs. However, focusing on growing a large distribution network can result in an operator failing to give adequate attention to the performance of each individual hotel in its portfolio.

The fact that the interests of hotel owners and operators are not always 100% aligned does not mean that either is ill intentioned. However, it does provide a good reason for a prudent owner to have the ability to terminate a long term hotel management agreement (HMA) if the operator is not performing. Such provisions are typically referred to as performance termination clauses.

So what does a typical performance termination clause look like? The answer depends on the particular hotel, owner and operator. Each situation is different. However, the most common form of performance test allows the owner to terminate the operator without paying a termination fee if certain pre-approved levels of budgeted profitability and/or performance relative to other comparable hotels are not achieved.

The typical budget test allows for HMA termination by the owner if the hotel does not achieve an agreed upon percentage of the gross operating profit (GOP), usual as projected in the annual operating budget. The budget is typically proposed by the operator and approved by the owner each year, so in that sense both parties agree upon the expectation. The budget test is usually set at 10%-20% below the actual projected GOP, so as to leave a reasonable margin of error for the operator. While using GOP is the most common approach (since it excludes fixed expenses outside

the operator's control), sometimes EBIDTA less Replacement Reserves (f/k/a NOI) is used instead of GOP; and sometimes instead of using the numbers in the annual operating budget, the parties set the minimum levels of annual profitability for the budget test at the time that the HMA is signed, so as to dissuade the operator from sandbagging the annual budget.

The second prong of the most typical type of performance test is the so-called RevPAR test. Such test benchmarks the performance of the subject hotel with the performance of comparable hotels in the Competitive Set (the Comp Set) by examining so-called RevPAR penetration. A RevPAR test requires the owner and operator to first agree upon the Comp Set, which is the group of comparable hotels that the subject hotel will be benchmarked against. A typical Comp Set will contain an agreed upon minimum number of hotels, in order to ensure confidentiality and anonymity of the hotel data participants, as well as ensuring there is a reasonable sample size of data. The HMA should allow for changes in the future to the Comp Set, as new supply enters the market and/or older hotels exit. RevPAR tests require the parties to obtain data on how the RevPAR of the subject hotel compares to the RevPAR of the other hotels in the Comp Set. Such data is usually provided by a third party data source, such as Smith Travel Research, via periodic reports called STAR Reports. Finally, the owner and operator have to agree on where the RevPAR of the subject hotel must fall relative to the Comp Set in order to pass the RevPAR test.

From the operator's perspective, the performance test should be as difficult to fail as possible. For that reason, most operators negotiate performance tests that require a failure of both prongs of the test (budget and RevPAR) before the owner has the right to terminate the HMA without paying a fee. Thus, if the hotel does not achieve the minimum GOP in the budget test, but has passed the RevPAR test, or vice versa, the operator would not fail the performance test. From the owner's perspective, given the significant margins of error typically baked into each prong of the performance test (and the many exceptions from compliance described below), failing only one prong of the test should be sufficient to allow for termination.

Hotel operators also often try to negotiate exceptions to the requirements of the performance test. For example, operators often ask for a reasonable stabilization period for newly constructed hotels before the performance test kicks in, and to get a pass if the operator fails because of factors outside of the operator's reasonable control. Such factors might include anything from a large renovation of the hotel, to a terrorist attack, to a default under the HMA by the owner. In addition, to mitigate the impact of an isolated bad year of performance, many operators ask for a multiple year "test period." Another common request is the right to cure a failure by writing a check to the owner for the delta between the actual GOP and the GOP necessary to pass the budget test. Such cure rights can get quite complicated, and arguably fail to mitigate the true harm to the owner of poor performance. The value of a hotel will go down due to low GOP. Such value will not be enhanced just because an operator writes a check to the owner.

In conclusion, HMA performance termination clauses can be a useful tool for balancing the competing interests of the hotel owner and operator under the HMA. Like guardrails on the side of the road, a well drafted performance termination clause can keep the operator from driving into the proverbial ditch. However, such provisions are often quite complicated and require a significant

amount of experience and consideration to properly negotiate.

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