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# HISTORICAL TRENDS HOTEL MANAGEMENT CONTRACTS

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## Hotel Management Contracts: Historical Trends

*Most hotels are managed by brands or independent operators - not their owners. The owner is generally responsible for providing funding for the operation of the hotel when necessary while the operator manages the hotel's day-to-day operation. The agreement between the two parties is often structured with the operator as a contractor using a contract that specifies duties, obligations, and liabilities.*

*This article, based on findings from an analysis of over 500 management contracts collected by HVS as well as a review of publications on the topic, provides an overview of typical terms for a hotel management contract and examines historical trends observed in the industry. The article is not meant to provide trend information on what is happening in any particular hotel management contracts currently being negotiated but analyzes aggregated data for contracts written during the past three decades in the United States.*

*The authors discuss provisions such as contract length, management fees, reserve for replacement, working capital, insurance, employment, dispute settlement, budgets and financial reporting, area restrictions, and early termination.*

### Why Management Contracts are Important

Management contracts allow investors with relatively little knowledge and experience in the hotel industry, or who cannot directly manage hotels for a variety of reasons, to invest in hotels. Because competitive supply is increasing, hotel investors have attempted to realize efficiency gains by assembling specialists to be responsible for the various components of their hotel investments. Specifically, owners frequently contract specialists – hotel brands and hotel operators – to help them maximize the returns on their investments.

Common responsibilities of the operator spelled out in a typical management contract include:

- Managing all of the hotel's departments such as: maintenance, front office, housekeeping, food and beverage, sales, etc.
- Recruiting, employing, training, supervising, and terminating employees
- Establishing prices and terms for hotel services
- Arranging and providing for public relations, advertising, and marketing
- Planning, purchasing, and supervising capital expenditures (e.g. furniture, fixtures, and equipment)
- Preparing monthly and annual financial statements and daily reports for the owner
- Purchasing supplies and entering into contracts and making payments for those services
- Operating the hotel in accordance with the approved annual budget and the terms of the management agreement
- Adhering to service and product standards required by any affiliation or brand

In broad terms, there are two types of hotel management companies: brand operators and independent operators.

**Brand operators:** In the case of a brand operator, the branding company is also the management company. By signing a contract with a brand operator, a hotel investor can contract for these specialized components of a hotel investment in one agreement to reap the benefits of a well-known brand and experienced management. The use of a brand operator is most common among larger, full-service hotels.

Hilton, Hyatt, IHG, Marriott, and Starwood are examples of brand management companies that operate hotels in addition to providing the flag. This arrangement does not imply, however, that all of their properties are operated by the brand; for example, most have both brand-managed properties and franchised properties that are managed by independent operators or the owners themselves.

Choosing a brand operator may give owners a competitive advantage. Owners who chose brand operators often anticipate modest savings because they do not have to pay a full franchise fee in addition to the base and incentive fees. These owners may also have a modestly easier time obtaining financing, as brand operators are generally perceived to be a somewhat less risky investment, although the terms of the agreement might otherwise negatively impact the value of the hotel when it is subsequently sold. Brand operators are typically less flexible regarding management fees and certain marketing expenditures than independent operators, so owners often end up not saving any money when all of the fees and expenditures are considered in aggregate.

**Independent operators:** In the case of an independent operator, owners obtain branding using a licensing agreement between the owner and a hotel brand. They obtain management expertise for the hotel by means of a management contract, or operating agreement, between the owner and an independent management company. The use of an independent operator is most common among small and mid-sized hotels, especially for hotels that are limited-service and select-service in nature.

The five largest independent hotel management companies in the U.S. include Interstate Hotels and Resorts, Pillar Hotels & Resorts, GF Management, White Lodging Services Corp., and Pyramid Hotel Group. Examples of other national and regional hotel management companies include Dora Hotels, First Hospitality Group, Hostmark, HVS Hotel Management, and Peachtree Hotel Group. There are several hundred hotel management companies with extensive experience operating hotels in the United States; these are just a few examples. These companies do not have a single hotel brand they operate; rather, they operate a broad range of hotel brands. These independent operators are generally less restrictive than brand operators when it comes to negotiating contract terms.

Independent operators may achieve lower expense ratios and thus generate relatively higher profit margins, but their aggregate management and franchise fees may, but not always, total more than the fees for a brand operator.<sup>1</sup> Still, owners may prefer to pay more for the costs associated with an independent operator in order to obtain a shorter initial term, looser termination provisions, and the belief that an independent operator may be more nimble in reacting to local market and economic factors in certain markets.

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<sup>1</sup> HVS Professional Development Session led by Steve Rushmore, November 12, 2009

## Contract Term Length

Management contracts specify the length of the initial contract term and successive renewal terms. Because so much effort is involved in the training and implementation of standards and procedures in a newly managed hotel, hotel operators require and owners commonly agree to multi-year contracts. While management companies typically prefer to extend the initial term as long as possible, owners prefer to have shorter terms or exit terms to minimize the risk of being tied to an agreement that they may eventually determine is not maximizing the value of their asset.

FIGURE 1: AVERAGE LENGTH OF TERM IS LONGER FOR BRAND OPERATORS (2000-2009 CONTRACTS)

	Brand Operator	Independent Operator
Luxury	21.2	15.0
Upper Upscale	16.9	11.0
Upscale	16.7	13.0
Upper Midscale	14.0	9.3
Independent		8.4
<b>Average</b>	<b>17.4</b>	<b>11.3</b>

Source: HVS Research

**Initial Term:** Initial terms have decreased since the 1980s. Today, initial terms for brand operators typically range between 10-30 years. Terms for independent operators are commonly 3-10 years in length, although some independent operators also have 10-30 year terms in special circumstances or in the case of publicly-financed properties. A property's chain scale influences term length as well.<sup>2</sup> For example, upper-upscale and luxury hotels tend to have longer contract terms than upper midscale hotels.

*Since the 1980s, the average length initial terms has decreased for both brand and independent operators.*

As more management companies entered the marketplace, competition for management contracts has increased and terms have shortened. During the period of 2000-2004, the average initial term for both brand and independent operators dropped to a low of 16.3 and 9.6 years, respectively, as shown in Figure 2. Additionally, performance hurdles that allow the owner to cancel mid-term have become more common; however, they can be more difficult to analyze and negotiate.

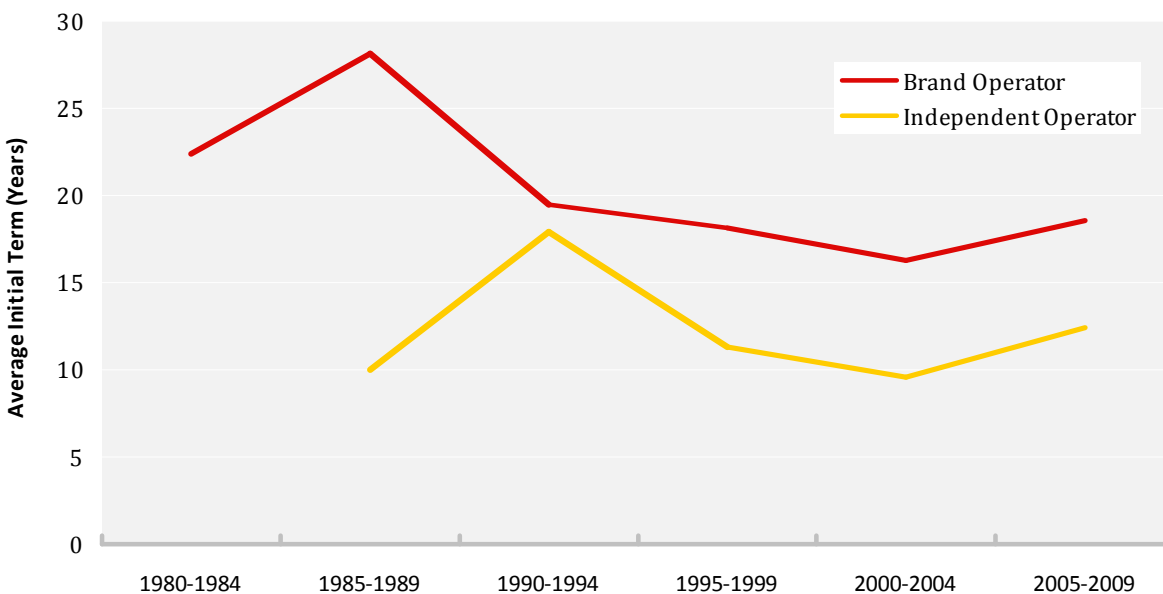
Issues related to the Tax Reform Act of 1986 may also partially explain this trend. Prior to the act, hotel investors were able to take advantage of accelerated, 18-year depreciation schedules that caused hotels to operate at a loss for tax purposes, providing significant tax shields for owners. When the act went into effect, depreciation schedules increased to 31.5 years, the investment tax credit was repealed, and earnings from other income sources could no longer be shielded from losses on investments.<sup>3</sup>

The number of rooms in the United States grew 37% between 1979 and 1987 as investors sought to complete their hotel projects prior to new tax rules taking effect.<sup>3</sup> This surge in supply included a broad range of investors who did not want hands-on oversight of their hotel investments. As these owners sought to outsource management to independent operators, demand for such services increased, and a large number of independent management companies entered the industry, eventually leading to a highly competitive environment when the hotel development pace moderated.

<sup>2</sup> Chain scales defined by STR Global: [http://www.str.com/documents/STR\\_US\\_Chain\\_Scales.pdf](http://www.str.com/documents/STR_US_Chain_Scales.pdf)

<sup>3</sup> LaFleur, Bob. "The Historical Development of the Lodging Industry from the Period following World War II until 1999." *Bear, Stearns & Company Lodging Primer 2000*

FIGURE 2: INITIAL TERM LENGTHS HAVE DECREASED SINCE THE 1980s



Source: HVS Research

**Today, brand operators command longer initial terms than independent operators, and owners favor shorter terms.**

Brand operators are usually well-established and have strong reputations, so owners are more willing to make a long-term commitment to them (sometimes decades). Independent operators such as Interstate Hotels & Resorts and White Lodging Services, who have proven track records, also tend to have longer initial terms than their smaller counterparts. Owners who opt to settle for long initial terms often have longer-standing relationships with the selected management company, however, and they ensure that acceptable termination provisions are included in the contract.

In most cases, owners prefer a short initial term with several renewal terms.<sup>4</sup> Shorter contract terms have become more favorable as owners seek to mitigate risk by allowing them to back out if their goals are not achieved. This trend is especially true for owners who do not have an existing relationship with their selected management company. If a management company does not perform up to the owner's standard as expressed in various ways in the management agreement, the owner can wait out the short initial term or exercise various termination rights instead of terminating the agreement early or selling the hotel, which usually require payment of a termination fee if the buyer does not assume the contract. Additionally, changing management at the end of a brand-managed contract could involve very large costs due to name change if a franchise with the existing brand is not available. Changing independent operators at the end of a contract is generally less transparent to guests and much less disruptive to the hotel from a marketing and branding perspective.

<sup>4</sup> Rushmore, Steve. "Hotel Management Contracts and Related Documents." *Hotel Investments Handbook*. 2002.

As shown in Figure 2, initial terms for independent management contracts tend to range from about 5.0 years to 15.0 years, depending on the quality and size of the hotel. In recent years, the initial term for an upper-midscale hotel, such as Hampton Inn or Holiday Inn Express, has been 9.3 years on average. By comparison, the initial term for an upscale hotel, such as Courtyard by Marriott or Hilton Garden Inn, has been 13.0 years on average.

**The brand a property adopts may influence the length of the initial term.**

The higher up a brand is on the chain scale ratings, the longer its initial term tends to be. In the luxury segment, for example, brand operators for the Fairmont, Park Hyatt, and Ritz-Carlton sometimes are able to secure longer initial terms to reflect the higher investment levels required for these properties and the longer expected economic life of such assets. Owners also invest more money in luxury properties and may wish to avoid a costly brand conversion that could coincide with terminating a brand operator contract, so they are often willing to risk longer initial terms.

**Renewal Term:** At the expiration of the initial term, both parties may have the option to renew the agreement. Renewal terms are usually automatic upon mutual agreement of the owner and operator and can last anywhere from 1 to 10 years. Management contracts specify the number and length of renewals or offer an unlimited number of renewals that continue until either party terminates the agreement. Figure 3 shows the total possible term length for recent contracts, assuming all renewal terms are exercised.

**Management Fees**

Hotel operators typically receive compensation in the form of base and incentive management fees. Owners may also be responsible for additional fees such as centralized administrative services provided by the management company and fees for marketing or direct sales services.

**Base fees:** Base fees often make up the majority of a management company's compensation, and they are a fixed percentage of gross revenue – commonly 2% - 4% across segments (Figure 5). In some cases, brand operators have higher base fees that include fees related to the branding and centralized services instead of requiring the owner to pay a separate royalty fee. Because they are tied to revenue performance, base fees encourage operators to maximize revenues rather than net income. To address this concern, some owners and operators structure a portion of the fees in such a way that incentivizes the operator to maximize profit.

**FIGURE 3: TOTAL POSSIBLE TERM LENGTH (INITIAL + RENEWALS) VARIES BASED ON STR CHAIN SCALE (2000-2009 CONTRACTS)**

	Brand Operator	Independent Operator
Luxury	36.6	31.7
Upper Upscale	33.0	20.2
Upscale	32.9	23.3
Upper Midscale	28.0	14.0
Independent		14.0
<b>Grand Total</b>	<b>33.5</b>	<b>19.8</b>

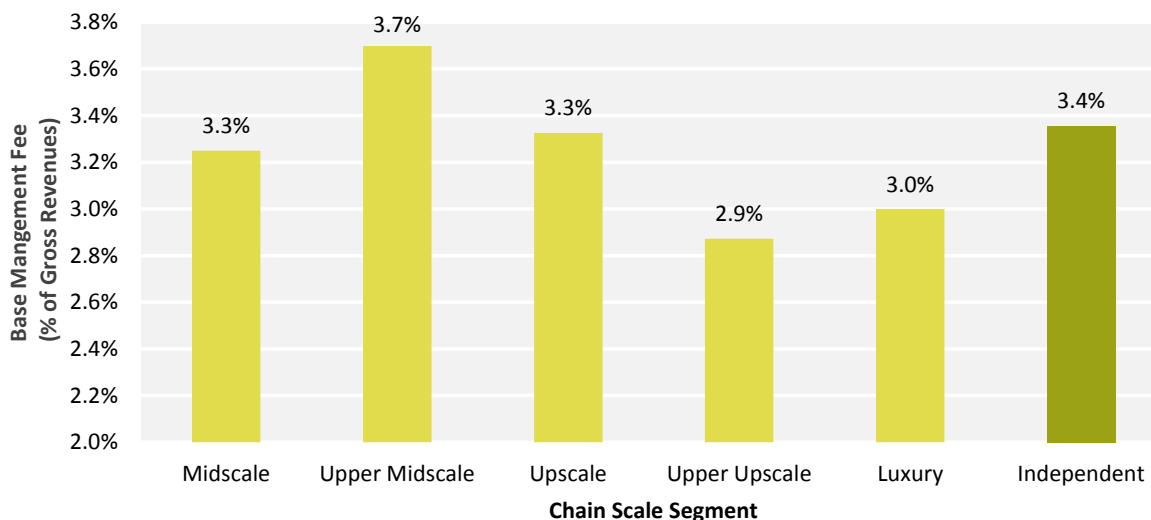
*Source: HVS Research  
Contracts with unlimited renewal terms were omitted*

**FIGURE 4: BASE FEES AS A PERCENTAGE OF GROSS REVENUE ARE GENERALLY HIGHER FOR BRAND OPERATORS**

	Low	Mean	High
Brand Operator	1.00%	3.80%	7.00%
Independent Operator	.70%	2.95%	4.50%

*Source: HVS Research*

FIGURE 5: AVERAGE BASE FEES ARE SIMILAR ACROSS SEGMENTS



Source: HVS Research

**Incentive fees:** Incentive fees are additional fees paid to the operator for meeting specific benchmarks, typically related to profit rather than revenue. While base fees are a flat percentage of revenue, incentive fees are based on performance measures such as gross operating profit, net income, or similar measures, often after adjustments. In effect, they incentivize the management company to operate the hotel efficiently and strive to both increase revenues and minimize expenses – doing so will increase a hotel’s bottom line income and maximize the management company’s incentive fee earning potential. This arrangement, in turn, maximizes the hotel’s cash flows to the owner, thereby aligning the operator’s goals with the owner’s.

Although incentive fees vary widely from contract to contract, they are often structured according to one form of, or combination of, the following measures:

- **Available Cash Flow after Owner’s Priority:** The management company receives a percentage (typically 15%-30%) of operating profit in excess of the owner’s priority, or return on investment. The owner’s priority is typically defined as a minimum return on the owner’s investment in the hotel, for example, and it often ranges from 10% - 12% cash-on-cash return, but can change considerably as returns in other asset classes change.
- **Operating Cash Flow (Income before Income Taxes):** The management company receives a percentage (typically 10% - 20%) of the hotel’s operating cash flow after deducting an owner’s priority and funds deposited into the reserve for replacement. Depending on the definition of owner’s priority, this percentage could be higher.
- **Gross Operating Profit over Incentive Fee Threshold:** The management company receives a percentage (typically 10% - 20%) of the gross operating profit, or other defined “profit” over a specified dollar amount known as the incentive fee threshold or hurdle amount.
- **Positive Variance from Budget:** The management company receives a percentage of the amount by which gross operating profit exceeds the budgeted gross operating profit for the year.

- **Positive Variance from Prior Operator:** This approach assumes that the operator took over from another management company because the owner was seeking to improve the hotel's performance. In this case, a profit line (e.g. gross operating profit, or income before fixed charges, or operating cash flow) in the baseline year, or average of several, before the management company assumed management would be established. The operator would then receive an incentive equal to a percentage of the amount by which their future year profits exceed the baseline amount.

**Other fees:** Owners may also be responsible for paying additional fees, some examples of which are listed below.

- **Group marketing fee:** The group marketing fee, which can be structured as a fixed dollar amount per room booked or a percentage (say, 1% - 3%) of gross room revenues, helps pay for the brand or management company's national advertising efforts. Very few independent operators have this fee because they don't have national advertising. This type of fee is more common for independent operators with niche brands.
- **Accounting fee:** Owners may be required to pay the manager a monthly accounting fee of \$5 - \$25 per room in cases where centralized accounting services are provided.
- **Project management fee:** In exchange for project management services during major renovations or expansions, the owner may agree to pay a management company a percentage of the cost in exchange for managing and overseeing the project, perhaps in the range of 3% - 10% of total project costs. Generally, this does not apply to management of improvements associated with the annual capital budget.
- **Reservation fee:** Owners may be required to pay central reservations and channel (GDS & OTA) fees of up to \$10 or more per booking to the brand, management company, third parties, or a combination of those.

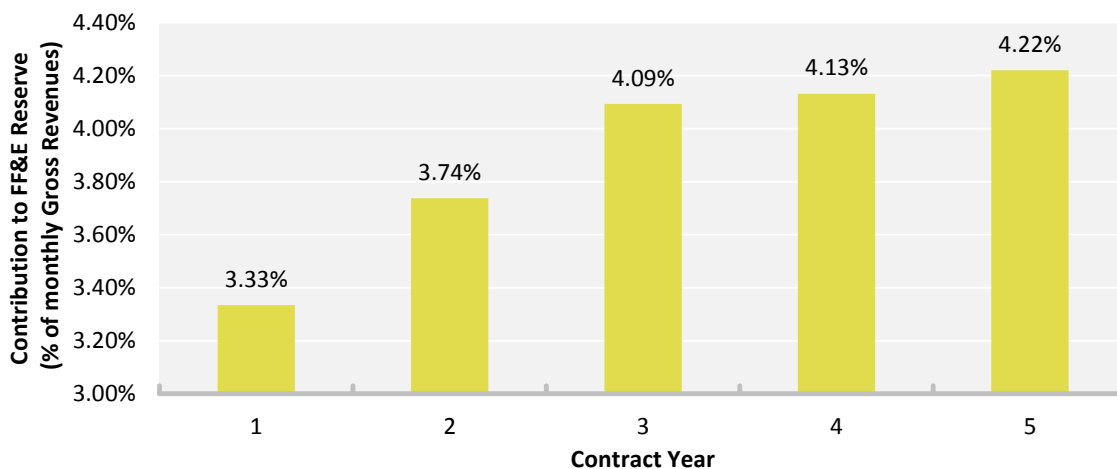
## Reserve for Replacement

The reserve for replacement, also referred to as the FF&E reserve or FF&E escrow fund, provides funds to be used for major renovations and FF&E expenditures. The amount contributed to the fund is typically 4% - 5% of gross revenues per month; there do not appear to be any historical or segment-based differences within management agreements. In many cases, the amount to be reserved may be dictated by the lenders financing the hotel. This section explains the cyclical nature for spending of funds, the increase in required funds as a property ages, and owner and manager perspectives on reserve funding.

**Cyclical nature of spending:** Capital expenditures are typically made in lump-sums during hotel renovations. In general, soft goods for a typical full-service hotel must be replaced every 6-8 years, and case goods must be replaced every 12-13 years. To save up for future expenditures that will be needed to adhere to brand standards, the manager deposits a percentage of gross revenues (or a dollar amount per room) into a dedicated interest-bearing bank account each month. These revenues typically roll over from year-to-year until they are spent on periodic renovation projects. To help owners plan for capital expenditure requirements, management companies are typically required to provide a 1-year capital expenditure forecast and plan for the next 3-5 years when submitting each year's budget. Small repairs and maintenance that are needed throughout the year are not paid for using reserve funds – they are typically an expense within the "Property Operations & Maintenance" expense line item.

**Age of property affects amount of funds required:** To account for higher spending requirements as a hotel grows older, the percentage of gross revenues contributed to a reserve for replacement fund often increases during the first few years of the hotel’s operation until it reaches an amount of 4-5%. If the amount of money in the reserve fund is not enough to pay for necessary expenditures, an owner may be required by the lender to increase the percentage of gross revenues deposited into the reserve fund each year leading up to the planned renovation. Alternatively, an owner may need to contribute a lump sum of equity that will cover the cost of the expenditures so that the hotel can continue to adhere to brand standards.

**FIGURE 6: THE AVERAGE PERCENTAGE OF REVENUES CONTRIBUTED TO THE FF&E RESERVE OFTEN INCREASES DURING EACH OF THE FIRST 5 YEARS**



Source: HVS Research

**Owner and manager perspectives:** In general, owners want to minimize spending and managers want to maximize spending from the reserve for replacement account.

The owner wants to minimize spending for two main reasons. Firstly, because owners are responsible for providing funds to cover any expenditure that exceed reserve fund balances, they want to control spending so that they do not need to contribute excessive funds or make a cash call on investors. Secondly, to the extent that the reserve fund is not spent by the time an owner sells the hotel, the fund could be distributed as profits to the owner and equity partners, thereby improving their investment returns. Thus, managers are usually required to seek approval before spending any reserve funds beyond what is provided for in the annual approved Capital Budget.

Managers, on the other hand, want to maximize spending to ensure that their properties are in peak physical condition and appear more attractive than competing hotels in the area. Newly renovated properties attract customers and provide a competitive edge, thereby helping maximize top-line revenues and increasing the manager’s base fee.

## Working Capital

Working capital is the cash-on-hand that hotels require for payroll, utilities, operating supplies and other materials. In general, the higher a property is on the chain scale ratings, the more working capital is required per room. Typically, the owner is responsible for depositing a specified amount of working capital into the hotel's operating account each month if the hotel does not generate sufficient cash flow to generate the minimum working capital needed for operations. A failure to do so could result in a loan default or a management agreement violation for the owner. Amounts in excess of the working capital requirements and reserves may be distributed to the owner either as specifically provided for in the management agreement or upon request.

**FIGURE 7: WORKING CAPITAL REQUIREMENTS ARE HIGHER FOR HIGHER-QUALITY HOTELS**

	Average Working Capital Per Room
Luxury	\$1,282
Upper Upscale	\$1,040
Upscale	\$616
Upper Midscale	\$492
Midscale	\$496
Independent	\$1,757
<b>Average</b>	<b>\$834</b>

Source: HVS Research

## Termination Clauses

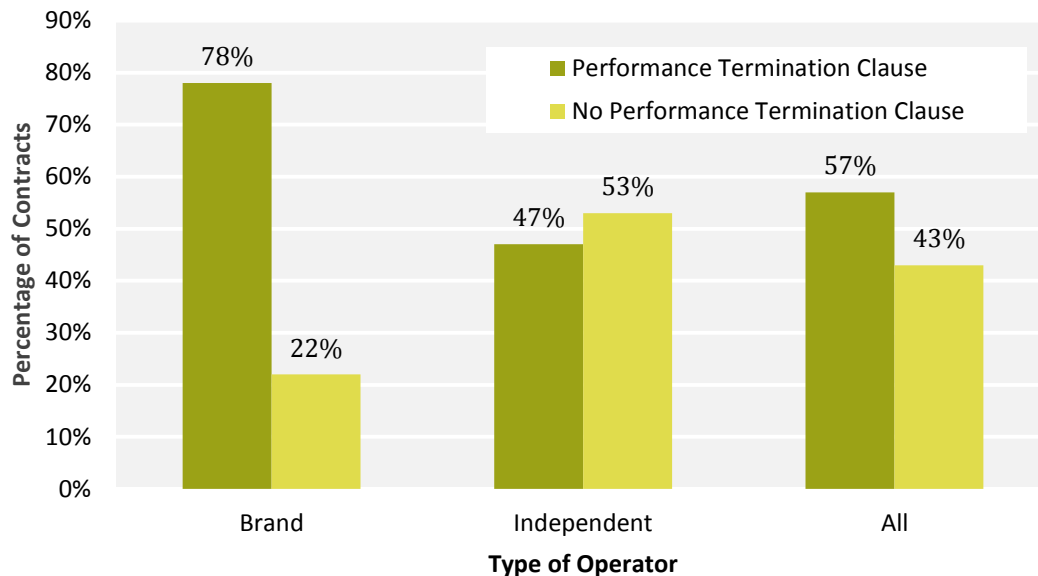
The mid-term termination clause is a critical point of negotiation in hotel management contracts, as both the owner and the operator want the right to terminate the agreement if one of the parties fails to adhere to its responsibilities. The owner's termination rights are subject to negotiations between the two parties, but brand operators tend to be stricter than independent operators in protecting themselves against termination by the owner because they have an additional interest in protecting the brand's interests. Management contracts may also be terminated upon mutual agreement of the owner and operator. This section outlines various owner termination provisions.

**Performance termination:** The performance termination clause allows the owner to terminate the agreement mid-term if the management company turns out to be incompetent or does not do a satisfactory job of managing the hotel. Most performance termination clauses go into effect 2-3 years after the opening of the hotel or the inception of the contract in order to allow the hotel to reach stabilized operating levels, and the performance failure usually has to persist for a specific period of time. Management companies are often given the right to cure the performance failure and avoid termination by making up for the amount of a shortfall in cash or by waiving their base fee for the amount of the shortfall.

Contracts for brand operators more consistently include a performance termination provision than those for independent operators. Brand operators have longer initial terms, and a performance termination clause promises a certain level of return on investment in exchange for the owner's longer obligation to remain with the same operator. Additionally, owners who commit to a brand operator are committing to both the management company and its flag. If a given brand does not turn out to be a good fit for a property, owners with brand operators cannot simply keep the operator and switch to a different franchise agreement. The reverse situation, in which the owner has the option to keep the brand through a franchise agreement while canceling the management agreement with the brand operator (in order to switch to an independent operator), may make negotiating a termination clause with a brand operator easier.

Performance termination standards are subject to normal operating conditions; the owner usually will not be able to terminate the agreement if the hotel does not meet a standard due to force majeure, a major renovation, or a default by the owner, for example.

FIGURE 8: MOST BRAND MANAGEMENT AGREEMENTS HAVE PERFORMANCE TERMINATION CLAUSES



Source: HVS Research

The following are examples of common performance termination standards:

- **Hotel ADR vs. Competitive Set ADR:** The owner has the right to terminate the agreement if the hotel fails to achieve a specific minimum ADR index compared to its competitive set. In such cases, changes to the competitive set need to be by mutual agreement and the ADR goal may be adjusted.<sup>5</sup>
- **Hotel RevPAR vs. Competitive Set RevPAR:** The owner has the right to terminate the agreement if the hotel fails to achieve a specific minimum RevPAR index compared with its hotel’s competitive set. Depending on how the competitive set is defined, this minimum is commonly 90% - 115%. In such cases, changes to the competitive set need to be by mutual agreement and the RevPAR goal may be adjusted throughout the contract term as changes to the competitive set occur.
- **Minimum Owner’s Return:** The owner has the right to terminate the agreement if the owner’s return is less than, say, 80% - 90% of the owner’s priority. A review of management contracts in the HVS database show most owner’s priority thresholds currently range from about 8.00% - 13.25% of the owner’s total cash investment in the hotel.
- **Gross Operating Profit:** The owner has the right to terminate the agreement if the hotel’s gross operating profit is less than, say, 80% - 95% of the of the hotel’s budgeted or forecasted operating profit for the operating year.

<sup>5</sup> A clause that specifies how changes to the competitive set are determined should be included in the management contract regardless of whether or not it is located in a performance termination clause.

- **Cash Flow Shortfall:** The owner has the right to terminate the agreement if the operating cash flow of the hotel, minus the owner's priority, is a negative amount.
- **A combination of the above:** In some cases, a management company must fail to meet a set of criteria in order for the owner to terminate the agreement. If all such conditions are not met, the manager is safe from termination by owner. In such cases, the words "or" and "and" become important subjects of negotiation.

**Termination without cause:** Some contracts allow the owner to terminate the agreement without cause upon as little as 30 days' notice to the operator, though this provision is much more common in contracts for independent operators. The termination fees in such cases typically range from 6 - 36 months of the average aggregate or base management fees earned during the year preceding termination.

**Termination upon sale of the hotel:** The owner may have the right to terminate the agreement upon sale of the hotel. For many brand-managed properties, the manager gets the right of first offer to purchase the hotel before the owner can sell it to a third-party buyer. Third-party purchasers are sometimes required to assume the obligations of the owner upon sale of the hotel, in which case the management company continues to operate the hotel. This may limit the pool of potential buyers and could negatively influence value. Or it could cause the original owner to be liable for paying default penalties to the original operator. In such cases, if the purchaser does not assume the agreement, the sale results in a default by the owner and default fees or termination fees may apply. Termination fees upon sale of the hotel are typically 24 - 36 months' worth of the average monthly base and incentive management fee for the preceding year.

**Termination upon condemnation or casualty:** Either party can usually terminate the agreement without penalty if one of the following occurs: damage to the hotel exceeds 20 - 40% of the hotel's replacement cost; if the damage will take 12 months or longer to repair; if a certain percentage of guestrooms become unusable due to damage or other reasons; or if the damage occurs in the last few years of the contract. When negotiating this clause, owners should insure that they are not bound to rebuild the hotel in circumstances where their return would not meet or exceed the required investment.

**Other causes for termination:** Other causes for termination include material breach of the contract, operator misconduct, bankruptcy, condemnation, and default.

## Insurance

The owner is responsible for the cost of insurance but may require the manager to procure coverage on the owner's behalf in order to take advantage of master policies or purchasing power some operators have. Insurance requirements are fairly consistent, though the amounts and exact components of insurance can vary somewhat from property to property. The table below describes typical coverage requirements that an operator would expect an owner to purchase. Insurance levels can be significantly affected by branding, franchise agreements, and loan contracts.

<b>Comprehensive General Liability</b>	Provides coverage for claims against bodily injury, death, or property damage occurring on, in, or in conjunction with the operation of the hotel. Typical coverage requirements call for a policy limit of no less than \$1,000,000 per occurrence and \$2,000,000 general aggregate. <sup>6</sup>
<b>Property Insurance</b>	Provides coverage against damage to the hotel's property, including boiler and machinery coverage. Property insurance often covers 90% - 100% of the replacement cost of the hotel and its contents.
<b>Flood Insurance</b>	Flood insurance may be desired if there is a special flood hazard in the property's area, as determined by the National Flood Insurance Program.
<b>Earthquake Insurance</b>	Earthquake insurance may be desired if the property is located in an earthquake-prone zone, as determined by the U.S. Geological Survey.
<b>Business Interruption</b>	Business interruption insurance covering loss of profits and continuing operating expenses for at least 12 months is common.
<b>Employer's Liability</b>	Employer's liability coverage in an amount of no less than \$1,000,000 per occurrence is typically required.
<b>Worker's Compensation</b>	Statutory worker's compensation insurance is required.
<b>Automobile Liability</b>	Automobile liability coverage for vehicles operating in conjunction with the hotel - whether they are hotel-owned, non-owned, and/or uninsured - is generally required. Typical coverage requirements call for a policy limit of no less than \$1,000,000 per occurrence.
<b>Crime Insurance</b>	Crime insurance coverage is often required for employee dishonesty, loss inside and outside of premises, depositors' forgery, and computer crime. Safety deposit box liability insurance protecting guests' valuables is also required.
<b>Terrorism Insurance</b>	For post-9/11 contracts, terrorism coverage is sometimes required, as available, under the Terrorism Risk Insurance Act (extended in 2007 under Terrorism Risk Insurance Program Reauthorization Act) or under commercially reasonable terms.
<b>Employment Practices Liability Insurance</b>	EPLI protects against claims brought against the business, officers, employees, and managers for discrimination, harassment, wrongful termination/discipline, breach of employment contract, and negligent hiring or compensation.

<sup>6</sup> This requirement applies to management agreements for independent operators, but some brands are now moving to requirements of \$20 million in liability coverage that would apply to their brand-managed hotels in addition to their franchises with independent operators. In the case of an independent operator with a brand flag, the brand's requirement for \$20 million in liability coverage stated in the franchise agreement between the owner and the brand would override the \$1 million/\$2 million requirement listed above.

## Dispute Settlement

Most contracts call for alternatives to dispute settlement in the form of mediation or binding arbitration. When compared to litigation, arbitration has many advantages: it is quicker; it is less expensive; and its proceedings are decided by neutral participants who usually have extensive experience in the hotel industry. The decision of the arbitrator(s) is final and binding upon both parties. However, it is not guaranteed that the arbitrator is knowledgeable, so agreeing to this provision is a risk that the dispute process might take just as long, cost just as much, and not have an equitable outcome.

## Budgets and Financial Reporting

A management contract should outline responsibilities of the owner and operator pertaining to budgeting and financial reporting. More recent contracts are increasingly requiring that hotel operators provide owners with highly detailed information regarding the hotel's performance.

At a minimum, the management company should submit an annual budget, usually 30-90 days prior to the start of the fiscal year, and the owner normally has the right to approve the budget. If the two parties cannot come to an agreement on a specific line item, the budgeted amount for that line item usually becomes last year's approved amount increased by the increase in the Consumer Price Index for that year while the two parties negotiate. In some cases, disputes regarding the budget may be submitted to arbitration, but this is an extreme and unusual step. Once a budget is approved, owners generally restrict the operator from exceeding the budgeted amount for a given line item or category of items by 10% - 15% or the aggregate budget by 5% without prior approval. Operators can deviate from the budget in the case of increased occupancies or revenues, and where line items are *de minimis*, the percentage limits of deviation may not be enforced.

Owners monitor their management companies by requiring them to submit daily, weekly, monthly, and yearly financial reports. Owners are most often requiring rigid and comprehensive weekly activity or highlighted reporting at the departmental level. At the end of the year, the owner may require an audit to be performed by an independent certified public accountant, usually at the owner's sole cost and expense. If the audit reveals that the amount paid to the owner was inaccurate by a significant amount, say, more than 3% - 5% of the amount due, the manager is usually responsible for paying for the cost of the audit. Additional internal audits of high liability areas such as Human Resource and Accounting and procedural audits are required in many management contracts at no cost to the owner.

Examples of other reports that may be required from the operator include the following:

- STR Reports
- Social media reports
- Quality control reports
- Department-specific highlights
- Employee surveys
- Sales booking pace reports
- Accounts receivable aging reports
- Explanations of variances from the budget and from the prior year's results

Upon termination of the contract, all books and financial reports typically remain property of the owner “so as to ensure the orderly continuance of the operation of the hotel” and for tax purposes. The management company is usually given the right to access these books and financial reports at any time for a period of at least five years for inspection, audit, transcription, or examination.

## Area Restrictions

Some management agreements have a non-competition clause that prevents the operator from building or managing properties of the same brand near the hotel. Sometimes alternative versions of such restrictions can apply for new hotels with related brands as well. These restrictions commonly encompass a 3 - 6 mile radius around the property but sometimes cover an entire city, and they may expire after 5 - 7 years. When in place, a map showing the area is usually recommended to be included in the management agreement.

A management company may sometimes build or operate a hotel in a restricted area if an impact study or a feasibility study conducted by an independent consulting firm concludes that a new hotel would not decrease the subject property’s RevPAR significantly.

## Employment

The management contract should specify whether the hotel’s employees are employees of the owner or operator. Each party generally prefers to defer responsibility of employment to the other due to liability issues; the employer is responsible for making payments of withheld taxes and social security to the IRS and faces concerns such as employee theft and discrimination.<sup>7</sup>

The owner generally plays a role in the selection of key management positions in the hotel. These key positions include: the general manager; the director of sales and marketing; and the controller or director of finance. In most cases, the owner has the right to approve the candidate for the general manager, if not for all three positions. The contract sometimes limits the owner’s approval rights, however, stating that the owner may not decline more than three candidates for any given position. Brand operators also tend to be stricter than independent operators in allowing the owner to influence hiring decisions – sometimes brand operators only allow the owner to provide “input” that the operator will take into consideration, but the final hiring decision is left solely to the management company.

## Considerations for Owners

When entering a management contract, owners need to consider their investment and exit strategies, desired level of interaction with the operator, and the degree to which the contract satisfies the owner’s goals and objectives.

Owners should consider their investment and exit strategies when deciding which management companies and contract terms to pursue. Owners looking for a long-term investment may prefer longer initial and renewal terms. For long-term investments, operating standards and termination clauses will be more important in case the operator fails to perform as expected. Owners looking for a short-term investment may prefer shorter initial and renewal terms. In this case, higher performance standards may help drive up the value of the hotel so that the owner can sell it sooner.

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<sup>7</sup> Rushmore, Steve. "Hotel Management Contracts and Related Documents." *Hotel Investments Handbook*. 2002.

Clauses that specify the frequency at which the owner will meet with the operator or hotel staff to review hotel performance are also important. Owners should strive to hold in-person meetings at least once a quarter, as they provide an opportunity to discuss financial results, capital projects, and sales and marketing activities, among other issues.

A well-negotiated management contract that satisfies both the owner and operator will help ensure an effective relationship between the two parties in the long-term. If the objectives of both parties are not effectively negotiated and met, disputes may result.

While this article provides an overview of typical terms found in hotel management contracts, the authors recognize that today's management contracts represent a variety of formats and level of detail. Some are becoming much more sophisticated and include new terms that are not discussed in this article. As such, a detailed review of contract terms is of utmost importance. This article is not intended to serve as guidance nor are discussions within this article intended to serve as recommendations pertaining to any particular hotel management agreement or individual negotiations.



## About HVS

**HVS** is the world's leading consulting and services organization focused on the hotel, restaurant, shared ownership, gaming, and leisure industries. Established in 1980, the company performs more than 2,000 assignments per year for virtually every major industry participant. HVS principals are regarded as the leading professionals in their respective regions of the globe. Through a worldwide network of 30 offices staffed by 400 seasoned industry professionals, HVS provides an unparalleled range of complementary services for the hospitality industry. For further information regarding our expertise and specifics about our services, please visit [www.hvs.com](http://www.hvs.com).

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