October 2007

Ten Hot Management Agreement Issues in Japan

This article is based upon presentations that the authors gave at the recent Jones Lang LaSalle Hotels' 8th Hotel Investment Forum in Tokyo and in part examines to what extent the issues and trends Graeme Dickson's discussion in the August edition are reflected in developments in hotel management in Japan.

In our view the ten hot issues are:

1. **Sign Them Up:** International operators are also increasingly active in Japan.

2. **Leases OK:** Operators are more willing to agree to lease in Japan.

3. **The Big Question:** Why more leases in Japan?

4. **Legal Perspective:** There are pluses and minuses for management agreements v leases.

5. **The Operator's Perspective:** Sale, insolvency, agency, licensing and brand control factors.

6. **The Owner's Perspective:** Legal characterization of management agreement, agency and management control are important factors.

7. **Cross-border Agreements:** Tend to follow the wider trends in Asia but with some differences, issues.

8. **Let's Bind Financiers;** But what if they do not want to be bound?

9. **Agency In:** It is difficult to move away from agency relationships in Japan.

10. **Let's Co-Brand:** In cross-border deals, the owner may want to use a local brand alongside the operator's brand.

We discuss these issues in greater detail below.

1. International operators are increasingly active in Japan

Similar to the rest of Asia, international operators have been actively involved in new hotel projects in Japan in recent years, particularly in the luxury / upscale market.

This is basically the product of the opportunities that have been thrown up by the recovery in the Japanese economy generally and the tourism and hospitality markets in particular, an expanding pipeline of quality development projects, and restructuring of the domestic hotel market.

Judging by some of the remarks made at the conference, there is still quite a large appetite for further management agreement opportunities.

2. Operators are more willing to agree to lease in Japan

In Asia, it seems that international operators prefer and are usually able to negotiate management contract deals with owners rather than leases.

In Japan, however, it seems that international operators have been more prepared to accept lease arrangements, at least historically.

However, there are signs that the tide is turning and that Japan will over time follow the trend elsewhere in Asia.

3. Why more leases in Japan – the legal view

No doubt there are commercial reasons why operators have been more willing to accept leases in Japan. However, there are also important legal factors to consider. Yes, leases mean taking on operating risk but they do offer certain advantages over management agreements, even from an operator's perspective.

Where the owner or developer is pushing for a fixed-term lease, it is worth considering the advantages and disadvantages from both perspectives and the weight that ought to be attached to each. A few points from both perspectives follow.

4. Legal perspective

See above.

5. Operator's perspective

- **Sale:** An operator with a management agreement is at greater risk of termination on sale of the hotel compared to one with a fixed-term lease. A fixed-term lease may be registered and, even if not, actual occupancy serves as perfection of a fixed-term lease.

- **Bankruptcy:** An operator with a management agreement is more exposed to bankruptcy compared to one with a fixed-term lease if the property owner becomes insolvent.

- **Agency:** Complex problems may arise from an agent-principal relationship (liability of owner and operator) in the case of a management agreement.

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- **Licensing:** Complex problems may arise in relation to the license of brand to the owner under a management agreement.
- **Development:** In a new build situation, a fixed-term lease potentially provides greater protection during the construction phase.
- **Brand Control:** Under a management agreement, stronger control on the part of owner in terms of how the hotel is operated and control on the part of operator in terms of how the property owner may use the brand is necessary, given that the acts of principal and agent are legally inseparable from those of third parties.

6. Owner's perspective

- **Characterization of Management Agreement as Ordinary Lease:** The risk is probably remote but it's possible that a management agreement may be characterized as a lease (but not a fixed-term lease), or even if not characterized as such, that it may be subject to a right to decrease rent (management fee) and to "continuous agreement theory" in relation to termination or expiration, i.e. payment of compensation.
- **Agency:** The same complexities apply to the owner.
- **Brand Control:** The same considerations apply to the owner.

7. International management agreements in Japan

Generally speaking, the management contracts that international operators negotiate with Japanese owners reflect the general trends in Asia. Operators of course will want to use their template terms where possible.

However, there are a few areas that present issues in Japan as detailed below.

8. Non-disturbance agreements – Japanese lenders are typically reluctant to sign up

Under a typical non-disturbance clause, the operators will want to oblige the owner or developer to obtain a non-disturbance agreement from the relevant lender or lenders in order to back up the owner's commitment to ensure that the management contract will remain in effect for the agreed term.

In Japan, owners and developers are usually reluctant to accept an absolute obligation along these lines basically because lenders are not familiar with the practice yet and are usually not willing to enter into such commitments.

This is perhaps one reason why operators are willing to consider the lease alternative in Japan – as noted above, fixed-term leases provide operators with a certainty of tenure analogous to that sought through non-disturbance clauses.

9. Management agreements – the agency relationship in Japan

We also see some operators wanting to move away from agency relationships in their management contracts by way of an express statement to the effect that the contract does not create such relationships and a waiver of rights based on such relationships.

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These clauses present difficulties in Japan because under Japanese law management agreements are usually characterized as delegation agreements (*inin keiyaku*), and such agreements include an agency relationship, especially where the operator has discretion to operate the hotel on the owner's behalf.

In any event, owners are usually reluctant to let the operator walk way from the duties that these arrangements entail, namely the duty of loyalty (*chujitsu gimu*) and duty of care of a good manager (*zenkan chui gimu*) – as distinct from fiduciary duties recognized in common law jurisdictions.

10. More co-branding to come?

Experience in Asia demonstrates that international operators are increasingly keen to leverage brand value. In Japan, we also see owners keen to leverage their brands. The new IHG ANA joint venture is a prominent example. The co-branding arrangements in that case clearly arise from the parties' desire to leverage their respective international and domestic brand values as part of the joint venture.

However, we also see owner interest in co-branding outside of the joint venture context and it is possible that we will see more co-branding arrangements in the future.

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