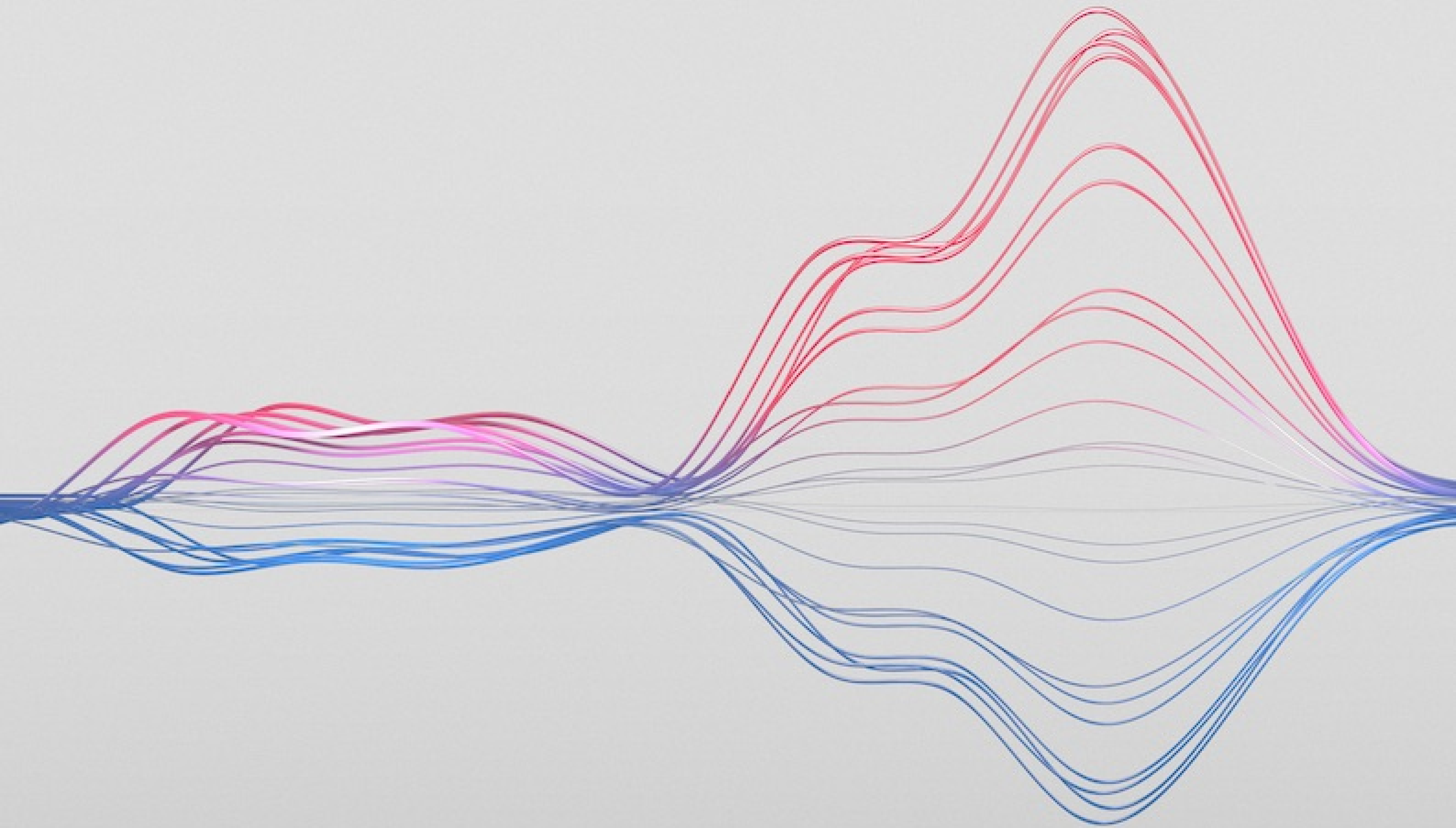
UNITED STATES

Hotel Management Agreements



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DOWNLOADED: 09 MAY 2024

Introduction

One cannot discuss the evolution of hotel management agreements (HMAs) without first talking about the separation of hotel ownership and hotel operations; a transformation of the major chains' business models, more commonly known as an "asset light" strategy. Today the form taken by hotel operators in HMAs is an important factor in the effective working of the market in hotel investment. DLA Piper's Hospitality and Leisure Sector Group has negotiated HMAs for a myriad of different clients across the H&L landscape (owners, investors, operators (both branded and white label) and lenders) in all of the world's key jurisdictions.

Many consider hotel management agreements to be borne out of a modified lease for the Hong Kong Hilton back in 1963, and the main terms included in it underpin most HMAs to this day. All major chains today have, to one degree or another, expanded nationally and internationally through a combination of franchise and management, and all have their own "form" or template agreements. In summary, over the last few years, we have found that trends that started as a result of the financial crisis of the last decade have continued to develop. In many markets the advent of recession made operators more risk averse. Traditionally HMAs were a means to limit operators' exposure to fixed rental payments when revenues were dropping. In less developed markets, even with a degree of economic recovery, operators have continued to use HMAs in this way. In more developed markets, such as Spain and the United Kingdom, we have seen increased complexity in agreements, a symptom of owners becoming more knowledgeable and seeking more control and input on the operation of their hotel, although owners continue to take the lion's share of commercial risk in developments.

Another important factor, as with any real estate investment, is the attitude of those who are providing the money, be it equity or debt. Leases were the traditional mainstay of hotel developments and indeed Germany remains a country where hotel deals are commonly based around leases. However, as investors have started to see the increased returns from ownership, the boom in arrangements like ground leases and other market changes is essential to have an understanding of investors and be able to work with them in a scenario of increasingly complex legal arrangements.

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Last modified 09 February 2021

General

Are Hotel Management Agreements (HMAs) common in the jurisdiction?

Yes. HMAs are used across the US, typically for upper scale and luxury tier hotels operated under a major hotel brand. As franchised brands have increased across the US in recent years, third-party managers operating under a brand franchise have increased. We have also seen an increase in conversion of managed to franchised hotels as owners seek to have more control over operations and reduce operating costs. Third-party management agreements and brand management agreements are very different in both form and terms. The focus of this guide is brand-managed HMAs.

If not HMAs, what are the alternatives / what is commonly used?

The alternative is to have a lease. Widely used in Europe, the lease structure has been slow to debut in the US, and is used primarily with foreign investors and in the franchise context. Upscale and luxury hotels which are managed are rarely subject to leases and most always managed under a branded HMA. A lease agreement is consummated through a sale-leaseback, where the hotel owner sells an asset to a new owner, which leases the property back to the seller, who self-manages, as an operator itself, or more typically, through a third-party operator. Most branded hotel operators in the US prefer to remain asset-light and will not take on the financial risk of owning a real estate asset, as their primary expertise is management, not ownership with its attendant risks.

Is it common or usual for the HMA to be governed by (i) local laws; (ii) the laws of one of the parties' country of incorporation; or (iii) an alternative jurisdiction?

Hotel managers operating in the US will typically push for Maryland law as the applicable law in the HMA due to the benefits of Maryland law, as applied to hotel operators. Conversely, hotel owners usually prefer the laws of the local jurisdiction, or more owner-favorable or neutral jurisdictions such as New York. New York is a typical compromise jurisdictions in the HMA with respect to above-property service disputes for foreign hotel companies operating in the US, to the extent applicable law is bifurcated.

Are there any significant or unusual points to note in respect of tax on HMA payments in the jurisdiction?

No. The US does not charge VAT, so tax withholdings and corresponding "gross up" of management fees is not an issue in HMAs for US-based hotel operators, as it can be in foreign jurisdictions.

Term and termination

Is there a standard contract period of an HMA?

Initial terms for branded hotel operators range from 20 to 30 years, with extension terms (at the election of the operator) adding up to an additional 20-50 years, depending on the brand tier. Non-branded management terms are shorter, and range from 10-20 years, with no extension terms.

Is the term usually fixed? Are early exit or similar options included (contractual or implied)?

Terms are typically fixed, with extension options at the discretion of the operator. HMAs typically do not provide for early exit other than termination due to breach or failure of the performance test. Sometimes owners are able to negotiate the ability to terminate on sale after a specified holding period (eg ten years), upon payment of a negotiated termination penalty, which is typically calculated based on lost management fees for the remainder of the term. In such instances, the operator is often granted a right of first refusal to purchase on sale, allowing the operator to prevent termination of the HMA by purchasing the hotel. Outside of the contractual terms of the HMA, case law in select US jurisdictions has evolved in the past ten years to allow the owner to terminate the HMA in a non-default scenario in violation of the HMA terms, based on agency principles, although such termination will not insulate the owner from resulting damages. As noted above, Maryland, where many hotel companies are headquartered, by statute requires adherence to the terms of the HMA, disallowing termination based on agency principles. Hence, most hotel companies require Maryland law as choice of law in the HMA.

Is it usual to include fees / liquidated damages for early termination?

When an owner is able to negotiate the right to terminate on sale, owners typically must pay the operator a termination penalty (ie liquidated damages) of an amount equal to a multiple of prior years' management fees, for which the multiple can span the remaining initial term of the HMA.

What is the usual position in respect of renewal?

In addition to the initial terms, HMAs typically include renewal terms at the expiration of the initial term, which are automatic unless the operator provides notice not to renew. Renewal terms for branded operators can, collectively, range from 20-50 years. Renewal terms are generally not available to non-branded operators. Branded operators will seek to secure multiple automatic renewal terms and owners will seek to make renewal terms subject to a performance metric such as meeting certain gross operating profit thresholds for a test year period immediately before the end of the then current term.

Fees

Is there a standard fee structure for HMAs (eg base + incentive)?

The standard fee structure includes a base fee calculated on gross revenues and an incentive fee based on profits. Base fees range from 2-3% for non-branded third-party management to 2.5-4% for branded management. Base fees tend to have a negative correlation to the initial term (i.e., the shorter the term the higher the base fee and vice versa). Incentive fees vary, but are typically based on some percentage of GOP, AGOP or NOI, and are often subordinated to an owner's priority return on investment.

What other fees and charges are there (such as royalties, accounting, marketing, license fees, etc.)?

Additional operator fees may include above-property centralized services and system fees such as reservation, marketing, accounting and loyalty program fees, as well as property-level technical services and pre-opening fees. Technical services and pre-opening services are typically handled under one or more separate agreements.

Are owners typically required to set aside funds for fixtures and fittings?

Virtually all HMAs require FF&E reserves, for which percentages typically vary from 2-4%, with an occasional 5% for ultra-luxury brands. With new or refurbished hotels, the FF&E may start low and ramp up. During challenging economic times, hotel brands often work with their owners to minimize the FF&E reserves or allow access to such reserves to offset operating deficits for limited periods of time, although this is typically discretionary and not memorialized in the HMA.

Performance and operations

What is the usual standard imposed on an operator in respect of the operation of the hotel?

Contractual performance standards vary among operators, type of hotels, etc., but are typically fairly general, such as "acting as a reasonable and prudent operator," "with a view toward maximizing long-term profitability and value of the hotel," "operation and management as a world class luxury hotel," etc.

What performance measures are commonly used in the jurisdiction?

Although performance measures can vary, depending on the brand, typical performance measures are established through a two-prong performance test, which is some form of (i) a percentage of budgeted GOP of adjusted GOP, and (ii) a percentage of RevPAR of a defined competitive set of hotels. Percentages of GOP and RevPAR vary, depending on the age of the hotel, the market and other factors, but typically range from 80-95%. If both performance tests are failed during an established performance test period, the owner has the right to terminate the HMA. Operators often negotiate cure rights in order to avoid termination, and the tests are excused for things like *force majeure* events.

Is an operator or owner guarantee common in the jurisdiction?

Guarantees are not a standard HMA requirement. The existence of guarantees depends on the bargaining strength of the parties and the particular hotel and market.

What is the usual position in respect of employees? With whom does the liability for the employees sit?

Most often the operator employs all of the employees; however, the owner has the right to approve certain key management employees such as the general manager, director of finance, director of F&B and director of sales. This notwithstanding, employee liability rests with the owner, other than to the extent caused by the gross negligence or willful misconduct of the manager in hiring or overseeing employees.

Is it usual to have a non-compete clause, eg that no other property with that brand can open within a certain radius?

Yes. Non-compete clauses are common and may include a radius restriction which varies, depending on the market and brand. Radius restrictions are typically specific to a particular brand as opposed to a brand segment.

Who is responsible for insurance?

All hotel insurance (property, liability and operational) is obtained by the owner, or the operator on its behalf, at the cost of the owner. Some brands offer optional insurance programs for owners to cover the insurance needs of the hotel.

Does the HMA give rights in real estate in the jurisdiction?

If properly drafted, and to the extent the HMA or a memorandum thereof is recorded, the HMA can be considered a covenant running with the land, resulting in the need for subordination of the HMA to any lender encumbering the hotel property, but is not considered a real estate interest.

Does the HMA need to be recorded against the property, if this is possible in the jurisdiction?

This is not required, as most operators like to keep the HMA confidential. However, sometimes a Memorandum of HMA is recorded in the local real estate records.

Where financing is taken, is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?

Yes, and typically the agreement includes subordination, as well as non-disturbance (SNDA). SNDAs are highly negotiated between the lender and the operator, and vary depending on the strength of the lender, the owner and the brand. Key issues tend to revolve around lender exercise of remedies upon loan default, control of accounts under the operating agreement and transfer provisions.

What other agreements usually sit alongside an HMA in the jurisdiction?

Depending on the operator, the following agreements may also be executed. It is common for hotel companies headquartered outside of the US to have the management, license and service components documented in multiple agreements:

- Technical Services and Pre-Opening Agreement
- Trademark License Agreement (if not contained in the HMA)
- Services Agreement (if not contained in the HMA, covering above-property centralized services)
- Sales and Marketing License Agreement (if there are also branded residences)

- Residential Management Agreement (if there are also branded residences)

Transfers and assignments

What are the standard rights / restrictions in respect of transfer / sale of the hotel?

Changes in ownership of the hotel or change of control of the hotel owner are typically subject to prior approval of the operator, with certain carve-outs for affiliate transactions. However, with institutional or strong owners, transfer to third parties which meet certain criteria, such as (i) having adequate financial resources to perform under the HMA, (ii) not being a competitor, and (iii) not being a specially designated national or blocked person, is sometimes allowed.

When a managed hotel is sold (either asset or share deal), is it usual in the jurisdiction that either the Operator's consent is required for the sale, or that the hotel may only be sold if the HMA transfers with the hotel?

Typically, the hotel may be sold subject to the HMA without the consent of the operator as long as the transferee (i) has the financial resources to perform under the HMA, (ii) is not a competitor, and (iii) is not a specially designated national or blocked person.

Do HMAs commonly include a right of first refusal for the operator to purchase the hotel?

No, unless the owner has the right to terminate the HMA on sale.

Is it usual to include provisions which enable the sale of the property with vacant possession ie without the brand?

The ability of the owner to terminate the HMA on sale is a non-standard negotiated right. If negotiated, there is typically a termination penalty that is required, calculated based on lost management fees for the remainder of the term of the HMA. Termination on sale rights also typically do not kick in until after an initial management period (eg ten years), and are often coupled with an ROFO in favor of the operator, to allow the operator to avoid termination by acquiring the hotel itself.

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