The Evolution of **Short-Term Management Contracts** in the Lodging Industry

The words "short term" and "management contract" used to be oil and water in the lodging industry: They just didn't mix. But receding investment horizons prompted by compressed business cycles, coupled with the proliferation of distressed properties following the 2008 recession, appear to have established a permanent market for flexible contracts designed for terms as short as three years. These shorter-term arrangements can be for either independent hotels or for branded hotels operating under franchise agreements.

The effect has been to polarize the management spectrum, with big-name hotel companies including Hilton Worldwide, Marriott International, Hyatt Hotels and Resorts, Starwood Hotels and Resorts Worldwide and InterContinental Hotels Group, among others, specializing in long-term management contracts while several hundred third-party national and regional management companies focus on shorter-term agreements, often for hotels licensed under the various flags of the big brands.

A recent analysis of more than 500 management contracts by HVS Global Hospitality Services brings the dichotomy into full relief: Initial terms for brand management companies range from 10 to 30 years compared with three to 10 years for third-party managers. The average length of contracts signed by brand management companies in the luxury, upper upscale, upscale and upper midscale segments exceeds contracts signed by third-party managers by more than 30 percent. This dichotomy may be the result of pursuing differing financial goals while performing the same essential functions in operating hotels.

"Third-party management companies have gained favor during the last five to seven years because there is flexibility," said William Sipple, executive managing director of HVS Capital Corp. in Denver. "They can align themselves better with management, and many have aligned themselves with capital so they bring a lot to the table."

Kevin Mallory, senior managing director and Americas practice

The 210-room Hotel Indigo San Diego-Gaslamp Quarter hotel is managed by IHG under a long-term management agreement. The hotel, which opened in 2009, was the first LEED-certified hotel in San Diego.

The 521-room Holiday Inn Chicago-Mart Plaza hotel is managed by Hostmark Hospitality Group, a leading hotel management firm based in Schaumburg, Ill. Following a $20 million redesign in 2009, the property received LEED Gold certification for existing buildings, operations and maintenance from the U.S. Green Building Council. Leadership in Energy and Environmental Design certification is the nationally accepted benchmark for design, construction and operation of high-performance environmentally responsible "green" buildings.

leader for CBRE Hotels in Chicago, noted that while "matching management terms and the owner's investment horizon always has been a challenge," third-party managers who do not represent brands can be more flexible than the management companies of the big chains.

Whether managing a branded or independent property, some third-party managers tie the term of their agreements to the likely investment "hold periods" of their hotel-owning clients.

JACK BE NIMBLE, JACK BE QUICK

Third-party managers also benefit from the perception that they can react more quickly to threats and opportunities and, in the process, achieve lower expense ratios and thus generate higher profit margins. "Their willingness to be more nimble and engage in more risky behavior is the wheelhouse of the independent manager," said Jan deRoos, associate professor and HVS professor of hotel finance and real estate at the Cornell University School of Hotel Administration, Ithaca, N.Y.

Daniel G.M. Marre, a partner in the Perkins Coie law firm who is based in Chicago and specializes in real estate development and hotel transactions, conjures a naval battle when comparing big management companies ("aircraft carriers") with third-party managers ("light destroyers.") "An aircraft carrier takes miles to change direction whereas a smaller, light destroyer is built to be nimble," he said.

Brand management companies are tied inextricably to their institutional systems, which slows them down, he said. "That's true of Marriott, Hyatt, Starwood, everyone," Marre said. Third-party managers, conversely, tend to be more responsive and willing to work with owners, he said. "Because they don't come with the baggage of the brand and the system, they are much more nimble. It's much easier to get them to work with you and change direction because they don't have the investment in the brand."

"If you go to a third-party management company and say that you have too many people in housekeeping or too many people at the front desk, they can move much more quickly because there's no brand to be concerned about," he said. Brand management companies, however, often have to consider the effect on the brand and the effect on the other owners. The request then may be subject to review by multiple corporate departments, including marketing and human resources.

The 293-room Embassy Suites Irvine-Orange County Airport in Irvine, Calif. is managed by Hostmark Hospitality Group.

DISTRESSED PROPERTIES FUEL SHORT-TERM CONTRACTS

Short-term management agreements tied to distressed assets have become a niche for some third-party managers. Several companies promote specialized programs for special servicers and balance sheet lenders managing underperforming hotel loans. These third-party management companies often work to position assets for short-term sales as well as for long-term returns. They also often perform the role of court-appointed receiver and operator for foreclosed properties.

Third-party managers are appointed as receivers "because the lenders don't necessarily want to take title or be in the chain of title with the distressed assets," Sipple said. "They bring a receiver in to manage the process and eventually dispose of the property. Lenders also expect third-party managers to secure the asset and turn it around. Lenders may invest some time and capital into turning the asset around and maximizing the recovery value."

THE BENEFITS OF SELLING UNENCUMBERED PROPERTIES

It is historical lore in the hotel industry that the fewer the number of non-terminable commitments, including franchise and management agreements, that encumber a property at the time of sale, the larger the potential universe of buyers, and therefore, the higher the potential sale price.

Some investors approach short-term contracts as a strategy for facilitating the eventual sale of their property. Case in point, deRoos said "flippers," or short-term investors, may attempt to negotiate unilateral termination rights. "It's all about how do we unwind this on sale," he said. While some smaller companies may agree, larger third-party firms will insist on a minimum three-year engagement followed by the right to terminate, subject to a fee, he said.

Mallory said it is important for investors to consider their exit strategy when structuring a management agreement to maximize their options when they choose to sell. "When you acquire a property and undertake an investment thesis, you really need to understand what your options will be on the last day," he said.

"Many of the properties purchased today are owned by investors who have shorter-term horizons and are maybe looking at a turnaround of a property," said Mallory. "In many cases, selling a property unencumbered by a brand and/or management unlocks greater value in the property. Conversely, if you are selling a property that is encumbered by a management agreement, the owner-operator segment of potential buyers won't be able to consider it."

The Benefits and Costs of Long-Term Brand Management Agreements

The major hotel chains that offer management contracts justify their mandatory, long-term commitments based on the combined value of their brand and management expertise. They cite evidence that the full value of a management relationship only can be realized over a long-term contract that enables the brand's name recognition, distribution systems and marketing efforts to attract a steady flow of customers.

Investors who buy or build luxury, upper-upscale and upscale hotels and resorts expect their properties to enjoy a long economic life. This longer-term perspective naturally aligns their values with those big-brand managers. "Brand operators are usually well-established and have strong reputations, so owners are more willing to make a long-term commitment to them (sometimes for decades)," according to a recent HVS Global Hospitality Services report entitled *Historical Trends, Hotel Management Contracts.*

Practical considerations also can tip the scales in favor of the big brands. Some banks mandate brand management contracts as a condition of financing. Some brands make branded management a prerequisite for granting a coveted brand in a major metropolitan area. According to

The 176-room Lake Eve Resort, an all-suite luxury hotel in Orlando, Fla., is operated by Hostmark Hospitality Group. Acquired in 2012 by a joint venture including Hostmark, The Arden Group and Eightfold Real Estate Capital, the property is undergoing a $24 million upgrade of guest rooms, lobby, exterior lighting, signage and pool area, which will feature a new children's water park.

William Sipple, executive managing director of HVS Capital Corp. in Denver, the big brands will opt for a management contract over a franchise agreement in any major market that affects their brand equity.

Also, large hotels are more likely to receive additional benefits from the brands' national group sales forces than franchised hotels under the same brand.

FINANCIAL IMPERATIVES DRIVE LONG-TERM CONTRACTS

Brand companies focus on long-term agreements because they provide the best fit for their overall business model, said Daniel G.M. Marre, a partner in the Perkins Coie law firm in Chicago. "The brands want cash flow, longevity and to build market share in a particular location," he said. "There are two ways to do that: One is through a management agreement, the other is to execute a license—or franchise—agreement.

"Marriott is a perfect example. Their shareholders want to see the value of the company grow, and the way Marriott does that is by generating cash flow by signing very long-term agreements." Those long-term contracts have provisions that allow owners to sell, but they are written to guarantee that the brand manager is retained.

Jan deRoos, associate professor and HVS professor of hotel finance and real estate at the Cornell University School of Hotel Administration in Ithaca, N.Y., observes that shorter management contracts would hurt a brand company's public valuation. "The branded manager's value is a function of three things: The number of contracts, average fee per contract and average length of term," he said. "The number of contracts is the growth trajectory for your firm. Big brand managers want every management contract they sign to add to their earnings per share."

THE DEBATE OVER MANAGEMENT COMPANY CONTROL

The benefits of retaining a brand manager can come at a stiff price, as detailed by attorneys Jim Butler and Robert Braun of the JMBM Global Hospitality Group in their *HMA Handbook - Hotel Management Agreements for Owners, Developers, Investors & Lenders.* "Virtually none of the branded hotel management agreements are terminable at an owner's option – unless you negotiated for that point," they said, adding that the brand manager consequently "will have almost exclusive control over your hotel for many decades unless you can negotiate an amicable buy-out or termination of the contract."

In the days when the consumer distribution channels were dominated by reservations call centers, the brands could also claim an advantage in taking hotel rooms to market. Technology has largely leveled the playing field, however, as developments in readily available property management systems and private-label reservations systems as well as the emergence of online travel retailers enable the third-party managers to compete effectively for consumers.

Kevin Mallory, senior managing director and Americas practice leader for CBRE Hotels, explained that chain management companies prohibit early contract terminations in order to protect their brand integrity. "These companies have spent a tremendous amount of capital building up their brands," he said. "They don't want to go into a property one day and be out the next." Premature terminations not only dilute the value of the management company's brand, but they prevent those companies from recouping their marketing and opportunity costs," he said.

Butler and Braun also caution that most long-term agreements give the brand manager "almost exclusive control over all aspects of a hotel property and operation" including personnel, rates, policies, sales and marketing, renovations, capital expenditures as well as collecting revenues and depositing them into accounts controlled exclusively by the operator. Hands-off investors may not consider those issues to be a problem, unless the relationship sours.

The higher the quality of the property, the more restrictive the provisions in favor of the manager are likely to be, said Sipple. "It's much more complicated to take over a higher-end property; you have differences in management ability that are necessary and the differences are more pronounced at the higher quality level than they are at the lower level in terms of asset quality."

Any attempt to terminate a long-term agreement early will prove costly. "When a brand has a management agreement for a high-profile property, the brand acts as if it owns that property," Marre said. "If you try to terminate them, they'll go into court and say, "Your Honor, these were our anticipated fees. But we also spent a lot of time and money building our brand, building up goodwill and keeping the competition out of this location. And that, Your Honor, is worth an additional X million dollars."

Investors must decide whether the benefit of big brands' institutional power and professional management experience outweigh the loss of control and restrictions on selling. "A long-term management contract can be a two-edged sword," Marre said. "It can really enhance the value of a property, and it can really detract from the value of a property because it's encumbered by this agreement. It really depends on the buyer's view of what they want to do and where they are in the economic cycle."

Negotiating the Ideal Short-Term Contract

There's nothing like a clean sheet of paper to spur creative thought.
We asked industry experts what considerations should go into the ideal short-term contract.

Jan deRoos, associate professor and HVS professor of hotel finance and real estate at the Cornell University School of Hotel Administration, Ithaca, N.Y.:

"I would insist on a fairly tight performance termination clause. The manager really has to get on board. If they don't perform, I want to be able to cut this thing early. Maybe the manager is unwilling to give unilateral termination rights. If they won't give me that, then I want performance termination."

Kevin Mallory, senior managing director and America's practice leader for CBRE Hotels, Chicago:

"Matching up the investment strategy with all the parties that are involved in the transaction is absolutely paramount. There really has to be a good, strong balance in management agreements, incenting managers to protect the long-term viability of the business while meeting the top financial objectives of the business."

Daniel G.M. Marre, a partner in the Perkins Coie law firm, Chicago:

"I'm going to try to negotiate an agreement that allocates as much value as I possibly can to the owner. You do that by giving the owner certain rights and powers under the management agreement that a buyer might value highly, for instance, a relatively low base management fee. The incentive fee is another way to create value for an owner. The manager gets paid based on net operating income, so that's an incentive to really save money."

William Sipple, executive managing director of HVS Capital Corp., Denver:

"The basic idea is to maximize cash flows during your holding period while creating the most favorable exit scenario. That's how you're going to maximize value. You have to get an efficient operator that is going to create the highest net operating incomes from which the property will be valued and, at the same time, minimize the amount of encumbrances on a sale of the property – to open up the marketing of the property to the greatest number of people so that you can create a market for the sale."

What Marriott v Eden Roc Means for Terminating Management Agreements

By Jim Butler
PARTNER, JEFFER MANGELS BUTLER & MITCHELL LLP (JMBM) AND CHAIRMAN, GLOBAL HOSPITALITY GROUP

Hotel owners: How the appellate decision in Marriott International v Eden Roc can affect your hotel investment (and why you should understand the law behind the court's decision)

A New York Appellate Division court in March made it possible for the owners of the Eden Roc Renaissance hotel in Miami Beach to oust Marriott as its operator despite the long-term hotel management contract between the two, which would have lasted another 43 years.

Owner-Operator Disputes Over Hotel Management Agreements

The relationship between a hotel owner and hotel operator is complex. While the owner bears the financial risk of the hotel's success or failure and its gain or loss in value, the operator has the exclusive right to manage the owner's business and is paid "off the top" whether the hotel is profitable or not. The contract between the owner and operator – the hotel management agreement – typically transfers control of the hotel's assets to the operator.

Hotel owners nationwide are keenly aware of both the benefits and impediments of long-term hotel management agreements with branded operators (and nearly all such contracts are long term, often running 40 or 50 years). On the upside, the brand can provide stability, consistent standards, a reservation system, marketing expertise and professional staffing. But the downside can be hard for owners to live with – brands can rigidly incur needless expenses and be unresponsive to market conditions and impervious to the owner's need to run a profitable business and protect its asset.

While the majority of hotel owners and operators work hard to achieve a balance that is a win-win for both parties, it is easy to understand how things can go badly, fast.

The Eden Roc - Marriott Dispute

On March 30, 2012, Key International, owner of the 631-room Eden Roc hotel in Miami Beach, terminated Marriott as the hotel's operator "... following years of mismanagement of the property and a failure to maximize the Eden Roc brand," according to its news release. But Marriott refused to acknowledge the termination or vacate the hotel. In October 2012, Eden Roc attempted to remove Marriott from the hotel's premises, but Marriott refused and obtained a temporary restraining order barring the hotel's owner from trying to oust it as Eden Roc's operator.

The owner appealed the decision, and on March 25, 2013, a New York appeals court issued an order that vacated the lower court's injunction. Key International is now free to terminate Marriott as Eden Roc's operator.

What the Eden Roc Decision Means to Hotel Owners

Now that an appellate court has ruled that a hotel owner can terminate a hotel management agreement with its operator – the second time an appellate court has done so – owners are asking, "Does this mean I can terminate my hotel operator, even if I have a long-term contract with them?"

The short answer is "Yes." Hotel owners can regain control of their hotel property when they see fit. This is good news for hotel owners.

But there are a number of very important caveats that will help frustrated hotel owners determine whether this is the best course of action when they are unhappy with their operators.

The 'Power' vs. the 'Right' to Terminate a Contract

The Marriott International v Eden Roc decision establishes that an aggrieved hotel owner can get rid of an operator despite the terms of a long-term, no-cut hotel management agreement that may run for 50 years or more.

But this is not necessarily a "free" termination (although it could be depending upon all the facts and circumstances). Hotel owners need to understand that there may be serious consequences to pay if they terminate a hotel management contract, in terms of liability and cost.

Eden Roc reaffirms the "power" (i.e. ability) of an owner to terminate a hotel management agreement and to regain control of its property for any reason.

However, if the owner did not have the "right" to terminate the agreement – adequate legal justification such as a material breach by the operator – then the owner would be liable to the operator for damages resulting from terminating the contract. Those damages could be very substantial, and no owner should undertake a termination of a hotel management agreement without expert advice on alternative approaches as well as the potential consequences of the action.

The Hotel Management Contract as a 'Personal Services Contract'

In Marriott International v Eden Roc, a unanimous panel of the Appellate Division, First Department of New York, agreed that the hotel management contract "is a classic example of a personal services contract that may not be enforced by injunction."

At first blush to someone outside the hotel industry, this case might seem unremarkable. It restates and affirms legal principles that have been used throughout the United States for more than a century as to the rules applicable for a mandatory injunction to enforce a personal services contract.

However, the fact that the Eden Roc decision is based solely on the inability to use an injunction to enforce a personal services contract is novel in the hotel industry. To date, all other lawsuits where terminating the hotel management agreement is at issue have also involved the use of "agency" principles.

In Marriott International v Eden Roc, the court did not rely on agency principles at all. In fact, the court stated that it found no agency relationship, but the court still found the owner could terminate the agreement and Marriott could not enforce it by injunction.

By the way, as noted below, we disagree with the court's determination that there was no agency relationship under the management agreement, but that is a different issue for another discussion and another case.

What's All the Fuss About 'Agency?'

After a few high-profile lawsuits over the termination of hotel management contracts (see the Woolley, Pacific Landmark and Skopbank cases with citations at the end of this article), most operators accepted that under the typical hotel management agreement the operator would be the "agent" of the owner, with all the attendant implications of fiduciary duty.

Many sought expanded waivers of certain fiduciary duties, such as the duty not to compete, and the duty not to take undisclosed kickbacks on purchases, but most operators did not fight the basic concept that they were agents, and as such they were subject to the "cardinal rule of agency" restated in Woolley that a principal (the owner) always has the power to terminate his agent (the operator).

However, Marriott and a few other operators took a different track. And with zealous focus, they sought to strip their management contracts of any "agency" overtones or language, while retaining complete control over hotel operations. These contracts apparently confused some of the lower courts into thinking that because they purported to be non-agency contracts, they must be so, and therefore could not be terminated under agency principles.

The Eden Roc court noted in a one-sentence conclusion that the hotel management agreement did not create an agency relationship. We do not believe that this was a correct conclusion, or that it will withstand the test of time when the question is brought before an appropriate appellate decision, despite all the attempts of Marriott and certain other operators to avoid an agency characterization.

But in denying the agency relationship, the Eden Roc court gave owners a tool that is potentially even more powerful than the agency relationship when it comes to the power to get control of a hotel back from an operator. And it certainly destroyed the value of Marriott's elaborate attempts over many years to avoid this result by seeking to avoid an agency relationship.

What About Breach of Contract and Damages?

It is important to understand that the Eden Roc decision did not deal with the issue of damages for a possible breach of contract. This lawsuit was about a battle for control of the hotel and a determination of whether Marriott had the right to continue operating the hotel against the hotel owner's wishes. The court ruled that Marriott did not.

The issue of damages between Eden Roc and Marriott will be left until a later date.

What About Other Jurisdictions?

The appellate court's ruling firmly establishes that hotel operators have the power to terminate management services agreements with their operators and regain control of their properties.

Although the Eden Roc court is interpreting and applying New York law, the same rule is pervasive throughout the United States. When our hotel lawyers handled the Fairmont v Turnberry case in Miami which also involved terminating a hotel management agreement, our research indicated the same legal result under both New York law (the law governing the Turnberry contract) and Florida law (which a Florida court might refer to in a conflict-of-laws analysis).

An appellate court in California court concluded the same thing in a lawsuit involving Doug Manchester's hotels in San Diego in the *Pacific Landmark Hotel, Ltd. v. Marriott Hotels, Inc.* litigation, another instance in which an appellate court voided Marriott's attempt to continue to control a hotel where the owner acted to terminate it.

In other words, although the outcome of the legal question decided by *Marriott International v Eden Roc* could theoretically vary if governed by different state law, at least in California, New York and Florida, the law is pretty much the same. We think this will hold true throughout most of the United States but hotel owners with contracts governed by the laws of other jurisdictions would be wise to analyze this carefully before terminating a hotel management contract.

In fact, an owner should not take any action in an owner-operator dispute involving a hotel management agreement without advice from experienced counsel at every critical stage of the process, starting at the earliest possible time.

How Will the Eden Roc Decision Change Disputes Between Owners and Operators?

This case provides an important reaffirmation of principles that will be critical for a few owner-operator disputes. If you are in one of those disputes, it may change the entire course of your situation, and for those parties, it will be a watershed event. We are frequently involved in these kinds of events and we never underestimate the impact it may have for those affected.

However, we do not see any wave of terminations being inspired by this decision. Most owner-operator relations are amicable and satisfactory. And even when they are not, the best solution is always a mutually workable result. Most difficulties are resolved at the negotiating table in a good faith exchange of viewpoints and business alternatives.

But when disputes cannot be resolved by discussion, Marriott International v Eden Roc will be an important case in the litigation dynamics between owners and operators.

Will Marriott International v Eden Roc Change How Hotel Contracts Are Written?

This case is the second time Marriott has gotten a bloody nose in trying to avoid the result that equity demands – namely that no operator can force its agency or its personal services on another if that party wishes to terminate.

Lawyers for the brand operators will continue to write contracts that are favorable to the brand and lawyers for hotel owners will negotiate hard to level the playing field and achieve a contract that is fair to the owner. That's what lawyers do. But no amount of contractual acrobatics or gobbledygook will avoid the inevitable result – that owners have the power to terminate the personal services of the operator.

The sooner operators accept this, the sooner operators and owners can get back to the real business of working together to provide great lodging for guests, consistent brand standards that make sense, and efficient operation of hotels that satisfies the legitimate needs of operators and provides a fair return to owners and their capital partners.

Important Legal Decisions on Hotel Owner-Operator Relationship

For our friends who want the legal citations for some of the important legal decisions referred to in this article, here are the details, as well as the common names we use to refer to these cases:

- Woolley v Embassy Suites Inc. ("Woolley"), 278 Cal. Rptr. 719 (Ct. App. 1991)
- Pacific Landmark Hotel Ltd. v Marriott Hotels Inc. ("Pacific Landmark"), 23 Cal. Rptr. 2d 555 (4th Dist. 1993)
- Government Guar. Fund of the Republic of Finland v Hyatt Corp. ("Skopbank"), 95 F.3d 291 (3d Cir. 1996)
- FHR TB, LLC v. TB Isle Resort, LP ("Turnberry" or "Fairmont v Turnberry"), 865 F. Supp. 2d 1172 (S.D. Fla. 2011)

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