

The 10 most contentious issues between owners and operators when negotiating a Hotel Management Agreement

At the most recent Hotel Investment Conference Asia Pacific held in Hong Kong from the 16th to the 18th October, 2013 we conducted a Master Class focussed on the abovementioned topic.

In advance of the conference we reached out to over 60 senior industry lawyers and commercial executives with extensive experience in relation to the negotiation and implementation of hotel management agreements and the role they play in the life cycle of a hotel. We asked each of these executives to provide us with at least one burning issue. We received many responses and, from all the suggestions, distilled the list down to what we considered to be the top 10.

During the Master Class each of these issues was examined and discussed by a panel of experts comprising both lawyers and commercial executives before an audience of over 210 industry participants. What became apparent was that there were not answers to all the issues. The 10 issues were:

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The issue	Background	Commentary
<p>Dispute settlement Is there an efficient, inexpensive and preferred way to resolve disputes available?</p>	<p>Unless the hotel management agreement specifically provides for an alternative, any dispute would need to be settled in court which is normally protracted, enormously time consuming, very expensive, disruptive and damaging to the relationship between the parties.</p>	<ul style="list-style-type: none"> - Think about and document the process based on the particular circumstances of the parties involved - Consider making the process a combination of internal and external steps. - Internal steps include <ul style="list-style-type: none"> ▪ regular consultative committee meetings ▪ facility to escalate to senior executives who potentially would lose "face" if unable to resolve - External mechanisms include - Expert determination for specific issues (such as a budget impasse) - Arbitration for more egregious disputes - To minimise time and expense document the process in specific detail, ensure the steps are clear and that they result in a solution to the dispute - Consider the choice of jurisdiction and governing law or place of arbitration and choose carefully

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The issue	Background	Commentary
<p>Tax liability on Operator fees</p> <p>Is it fair for the owner to pick up this liability?</p> <p>Is there an efficient, inexpensive and preferred way to resolve disputes available?</p>	<p>Operator base and incentive fees are normally taxed by assessment</p> <p>Licence, royalty and similar fees are normally taxed by withholding</p> <p>Other operator payments (e.g. marketing contribution) are normally not taxed</p>	<ul style="list-style-type: none"> - Operators usual preference is to pass the tax liability for fees and payments to the Owner to deal with because: <ul style="list-style-type: none"> ▪ simple ▪ eliminates uncertainty and unevenness that any tax system introduces and ▪ produces better return due to: <ul style="list-style-type: none"> ▪ no tax liability ▪ no tax compliance costs ▪ no exposure to tax audits and penalties - Owners would prefer operators to pay tax on their fees and payments because: <ul style="list-style-type: none"> ▪ seems intuitively fair ▪ less costly and administratively time consuming - Why don't operators simply increase fees to take into account the after tax position they are seeking to achieve - presumably market forces prevent this happening

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The issue	Background	Commentary
<p>Transparency</p> <p>Can this be achieved in relation to operator fees and charges?</p>	<p>There is a prevalent view amongst owners that operators should be capable of doing a better job in identifying fees and charges in information provided to the owner</p>	<p>Reasons why operators seemingly cannot be more transparent:</p> <ul style="list-style-type: none"> - Administratively difficult to police. - More expensive. - May remove perceived differentiation in service delivery. - Probably don't want to as would make comparison between operators easier and be a competitive disadvantage.

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The issue	Background	Commentary
<p>Undisclosed benefits</p> <p>Is it fair to expect operators to disclose all pecuniary benefits that arise by virtue of their position?</p>	<p>In the course of an operator's duties on behalf of an owner there are a number of instances where arguably the operator has received a benefit (e.g discounts on purchases of hotel supplies) and who should participate in the benefit?</p>	<p>Operators try to do this but it is difficult particularly for the large global players</p> <p>Those operators who act as agent (as opposed to the less onerous independent contractor relationship) for the owner have a strict duty to disclose all benefits which have arisen as a consequence of their agency relationship</p>

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The issue	Background	Commentary
<p>Management fee priority Why in Asia is the concept of "Owners' Priority Return" so unusual?</p>	<p>We understand that in the United States it is common for an amount designated "Owner's priority return" to be entitled to be deducted from Gross Revenue in priority to the management fees</p>	<p>There was no clear explanation provided. One view was to the effect that this was a requirement of the owner's financiers and driven by the fact that in the US it is possible because the LVR (i.e loan to value) % is significantly higher than what is achievable in Asia (in Asia usually around 55%)</p>

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The issue	Background	Commentary
<p>Financial projections What constitutes reasonable reliance?</p>	<p>Typically the operator's financial projections are critical for a hotel project to obtain finance (particularly a new build) yet operators generally will not take any legal responsibility for such projections</p>	<p>If the operator with its wealth of experience is not prepared to incur legal liability for projections then who or what is being relied upon to support the viability of a hotel development or conversion?</p> <p>If an operator did provide such support then should it be separately remunerated for the risk and liability it would incur?</p>

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The issue	Background	Commentary
<p>Construction delays Should owners compensate operators and if so what is a fair basis for such compensation?</p>	<p>Usually contractual provisions impose a liquidated or liquidated liability on an owner if the hotel is not constructed and opened within a specific time frame</p>	<p>Operators argue that:</p> <ul style="list-style-type: none"> — there is usually an opportunity cost associated with their commitment to a hotel project which has a construction component (especially if there is any restriction on competition) and therefore compensation is appropriate; — the prospect of compensation is also an inducement for the owner to complete the construction work on time; and — irrespective of the contractual arrangements, operators usually only seek compensation if the owner has allowed the delay to occur rather than being delayed due to factors beyond its control <p>Owners argue that:</p> <ul style="list-style-type: none"> — it seems odd that a service provider should be entitled to compensation in such circumstances; — if the operator should be compensated by the owner if the project is delayed then why shouldn't the operator compensate the owner if the project is finalised ahead of schedule? — if construction work is delayed then there is always going to be a significant cost

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The issue	Background	Commentary
<p>Area of protection (AOP) How should this be approached in gateway cities and other "high traffic" areas so that it is fair to owners and operators?</p>	<p>It is usual for an operator to be prevented from operating a similarly branded hotel within a specific radius of the subject hotel</p> <p>Particularly in mature destinations (such as gateway cities) operators seek to minimise or eliminate completely this restriction</p>	<p>There seems to be no clear view that an area of protection is beneficial to an owner in all circumstances. Each circumstance should be examined on its merits</p> <p>What test can be applied to determine the nature and extent of an AOP in any given circumstance?</p> <p>What is the value to the operator should such a restriction be waived and what should the owner receive in return - difficult to assess?</p> <p>If the restriction is brand related, should there be some meaningful restriction imposed on an operator to prevent it from just inventing a new brand to overcome the impact of the restriction?</p>

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The issue	Background	Commentary
<p>Without cause termination rights What's reasonable and what's fair compensation for such rights?</p>	<p>The only certain mechanism available to an owner to prematurely terminate an operator is such a provision</p> <p>Operators usually are strongly resistant even if termination fees equate to the net present value of fees for balance of term</p>	<p>Why should an owner not have the right to terminate an operator prematurely in return for a reasonable termination fee and why do owners enter contracts with operators without such a right?</p> <p>How do you determine what constitutes a fair and reasonable methodology to calculate a termination fee and should it differ in different circumstances (i.e. should it be less if it is performance based?)</p> <p>Should the operator also have this right and should the fee be calculated in the same way?</p>

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The issue	Background	Commentary
<p>Performance-based termination rights What's reasonable and to what extent should such rights be influenced by force majeure and operator cure rights?</p>	<p>It is generally accepted that the form of provision usually accepted by an operator is practically unworkable due to the myriad "if, but and maybe" qualifications such provisions usually contain.</p>	<p>The current crop of performance based termination provisions all seem to suffer from the following shortcomings:</p> <ul style="list-style-type: none"> — A breach must occur over a multi year period rather than just a single year — Force majeure (i.e. factors beyond the operator's control) invalidate a test year rather than just being taken into account to lower the performance hurdle — Operator cure rights suspend the operation of the provision even though the cure payment may only represent a small component of the owner's loss due to the performance deficiency and in some instances are repayable to the operator at a later time

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