Hotel Management Agreements: Ten Topics for 2015 and Beyond
Navigating Agency Law, Duration, Exclusivity, Termination, Finance Provisions and More

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1pm Eastern  |  12pm Central  |  11am Mountain  |  10am Pacific

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I. TERM LENGTH: OBSERVATIONS AND TRENDS
Competing interests: Hotel Owners vs Management Companies

- *Generally*, hotel owners prefer shorter term management contracts, which provide owners with flexibility and incentivizes the management company to maximize returns to owner in hopes owner will renew the term.

- *Generally*, hotel operators/management companies prefer longer term management agreements that are not terminable by the owner for a term of years, as the value of the HMA is directly tied to the predictability of the annual fee income and length of term.
Length of Term: Brand Management Companies vs. Independent Management Companies

- **Brand Management Companies.** In this structure, the company that owns the hotel brand (Marriott, Hilton, Hyatt, Fairmont, Starwood, etc) will enter into a management contract with the owner of the hotel to operate the hotel on behalf of the owner.

  - Typical initial term of 25 to 30 years, with renewal terms *at manager’s option* of 5 to 10 years each, sometimes stretching the total potential term to 55 or 60 years.
  
  - Typically does not include a termination upon sale or termination upon payment of a management fee; rather any sale of the hotel must include assumption of HMA.
  
  - Hotel brands are adopting an “asset light” strategy, whereby they sell their own hotels to third party owners, and taking back long-term management contracts. This model provides greater margins to the hotel brand, but ties up the owner’s asset for decades.
  
  - Brand management companies have a higher cost structure than independents, so usually only see this structure on full service, luxury and resort assets.
Length of Term: Brand Management Companies vs. Independent Management Companies

- **Independent Management Companies.** In this structure, the hotel operates under a brand (if any) through a franchise agreement between the owner of the hotel and the brand (Marriott, Hilton, Hyatt, Fairmont, Starwood, etc), and the hotel itself is operated on behalf of owner by a third party independent management company.

- Typical initial term of 5 to 10 years, occasionally with a 5 year renewal term.
- HMA is often terminable upon sale of the hotel to a third party, or upon payment of a termination fee that generally ranges between 1 to 5 years worth of management fees.
- Under this structure, the hotel owner must pay franchise fees to the brand as well as management fees to the independent management company, but independent management companies have lower cost structure (such as employee expenses).
- Structure is mostly used with limited service, select service and extended stay brands.
- Examples of some of the larger independent management companies include Interstate Hotels & Resorts, Crescent Hotels, Sage Hospitality and Davidson Hotel Company.
Length of Term: Brand Management Companies vs. Independent Management Companies

- **Current Trends.**
  - The long term brand HMA is alive and well, with owners accepting the burden of the term length because lenders continue to accept, even favor, long term branded management contracts during this current cycle.
  - Recent case law granting owners power to terminate management contracts (but with damages payable to the management company) has resulted in owners having more leverage in negotiating length of term, but terms lasting decades are still common.

- Factors affecting Brand’s sensitivity to length of term include:
  - whether the Brand developed the asset itself
  - opportunities to quickly flag a replacement hotel in that market if the HMA is terminated
  - Hotel Brands have recently trumpeted new HMA’s providing for 100 year terms (but these are only found with respect to iconic assets in iconic locations sold to sovereign wealth-type investors).
  - Many “new” brands created by brand companies (Curio, Andaz, Edition, etc) provide for a right to terminate the HMA if parent company fails to reach a minimum level of growth of the new brand within the first ten years of the HMA.
  - Factors that owners should negotiate in connection with length of term: “areas of protection”, key money, threshold guarantees and performance termination provisions.
FEES:
BALANCING INCENTIVES

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REVENUE BASED -

- Base Fee – Typical: 3% of Gross Revenue
- Marketing Fee – Typical – 1% of Gross Revenue
- Negotiable? Maybe a ramp up in early years of a new hotel
- For an existing hotel, Owner may seek a fee that is a higher percentage, but only a percentage of Gross Revenue in excess of previously achieved levels; this will be resisted by the big brands
INCENTIVE FEE – Rewards not just volume (Gross Revenue) but operating efficiency.

Typical: 10% of Gross Operating Profit – i.e., Gross Revenue MINUS Operating Expenses – i.e., just those expenses that are within the control of the Manager and therefore include routine departmental expenses, but do not include the traditional “below-the-line” items:

- FF&E Reserve (negotiable)
- Capital Expenditures
- Property Insurance
- Property Taxes
- Debt Service
- Depreciation
- Distributions/Dividends
- Owner’s Income Taxes
Alternatively, the incentive fee may be a percentage of Income Before Fixed Charges* or Income Before Fixed Charges MINUS the FF&E Reserve or Net Operating Income† or even Net Income.‡

*Income Before Fixed Charges = Gross Operating Profit MINUS Base Fee.

† Net Operating Income = Gross Operating Profit MINUS Base Fee, Insurance Premiums, Property Taxes and Ground Rent.

SOME VARIATIONS ON INCENTIVE FEE FORMULAE:

• Earned as a percentage of Gross Operating profit but only paid to the extent of Net Operating Income in excess of Owner’s Priority which is typically a percentage of project cost increased by subsequent capital expenditures; Earned but not paid fees accumulate and may or may not bear interest and are paid to the extent of excess NOI after current Incentive Fees are paid.

• Or a higher percentage – say 25% - of Net Operating Income (all expenses before the replacement reserves, debt service, depreciation and income taxes).

• Or for an existing hotel, a higher percentage but only of Gross Operating Profit in excess of a previously achieved level.

• There are many variations that are the ‘stuff’ of hard negotiation.
OTHER CHARGES/FEES:

Central Service Charges – e.g., reservation charges (typically $X per reservation), reward programs (typically a percentage of Room Revenue generated by the reward-program member who is a guest at the hotel), employee training charges, brand marketing charges and more - be sure to limit these to the extent possible to cost recovery and make them apply in the same manner as they apply to all other hotels in the chain.

Voluntary (Optional) Programs – such as optional purchasing programs, technical services for improvements, quality audits and more.

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CREDIT ENHANCEMENTS: Assistance from the Manager to Fund the Project to Build or Acquire the Hotel

Some examples –

• Equity Participation
• Subordinated/Mezzanine Loan
• Key Money
• Fee Subordination (e.g., Incentive Fee with an Owner’s Priority)
• Debt Service Guaranty
• Contribution of Technical (and Other) Services
III. OPERATING STANDARDS: KNOWING THE MARKET AND MAKING MEANINGFUL CHOICES

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OPERATING STANDARDS
refer to the (sometimes) objective minimum operational standards to which:

(i) the Management Company is required to meet or face termination or obligation to indemnify Owner, and/or

(ii) the Management Company will operate to (such as level of staffing, amenities and quality of FF&E), even if Owner would prefer a lower or different standard.

- Compliance with Operating Standards are always an Owner expense (w/ exception for matters for which Manager indemnifies Owner), so question is whether Owner is requiring Manager to manage to a certain standard, or if Manager can require Owner to pay for Manager to operate to a certain standard.

- Operating Standards will vary based on whether the hotel is non-branded, branded with an independent management company, or branded and operated by a brand management company.
OPERATING STANDARDS COMMON TO ALL HMAs (whether non-branded, branded with independent management or brand-managed)

- “in accordance with all applicable laws” (Management Company will often try to limit obligation to “commercially reasonable efforts”, but so long as Management Company has a reasonable cure right, a more common limitation would be “so long as Owner provides sufficient funds to do so”).

- “in accordance with all permitted encumbrances affecting the Hotel” – it is important that the Management Company review all title exceptions affecting the hotel such as ground leases, CC&Rs and restrictive covenants and acknowledge receipt and approval of the same in the HMA.

- “in accordance with all operating requirements set forth in Owner’s loan documents” – it is advisable for Owner to negotiate loan documents that acknowledge that the operating standards set forth in the HMA and the SNDA with the Management Company meet the loan operating requirements, otherwise Management Company becomes overly involved in Owner’s loan documents.

- “in accordance with the Annual Budget approved by Owner” – Management Companies will usually require some reasonable flexibility in operating to the budget over the course of the year, and Brand Management Companies will place certain budget items outside the approval of Owner.
HMA Operating Standards in a Non-Branded Hotel

In addition to the standards common to all categories of HMAs, an HMA for a non-branded hotel will usually provide as follows:

- No “brand” requirements for the operator to defend.

- HMA will otherwise set forth a general obligation of Management to manage the Hotel pursuant to a certain standard in comparison to other hotels in the applicable market, such as “Manager shall operate the Hotel consistent with that of a [full-service][select service][etc] hotel within the [city or region] market area”; in the alternative, the HMA could specify a competitive set within the market area to set the operating benchmark.

- Note that with the requirement to “operate in accordance with the Annual Budget as approved by Owner”, all other operating standards generally default to Owner’s approval and direction.
HMA Operating Standards in a Branded Hotel with Independent Management

In addition to the standards common to all categories of HMAs, an HMA for a branded hotel with independent management will usually provide as follows:

- Management Company will be charged with operating “in accordance with all terms and provisions of the Franchise Agreement” between Owner and Franchisor. The HMA will usually provide that a default under the Franchise Agreement, or the hotel falling below certain guest satisfaction scores, caused by Manager will result in a right to terminate the management agreement, with a caveat that such failure was not caused by Owner’s failure to provide sufficient funds to comply.

- Franchisor will usually require, in addition to the Franchise Agreement, a three-party Management Company Acknowledgement Agreement between Owner, Franchisor and Management Company giving Franchisor direct privity with the Management Company to require Management Company to operate the hotel in accordance with the Franchise Agreement, and in some cases granting Franchisor the right to terminate the Management Company and approve the replacement.
HMA Operating Standards in a Brand Managed Hotel

In addition to the standards common to all categories of HMAs, an HMA for a brand-managed hotel will have the following provisions:

- Since an HMA with a brand management company will (usually) mean no Franchise Agreement is present, HMA will require the Hotel to meet “Brand Standards”, as such standards evolve over time. This is the only type of HMA where the Management Company can compel Owner to make specific capital expenditures directed by Management Company.

- HMA will require Management Company to operate “in accordance with the Annual Budget approved by Owner”, but will limit Owner’s approval rights such that Owner may not object to any expenditure required for “Brand Standards”, “Management Company’s life safety requirements, etc”.

- As these types of HMAs provide Owner with the least amount of input and control over the asset while placing the largest burdens on owner for required expenditures, Owners can protect themselves by requiring (i) changes in Brand Standards to apply only if such changes apply to all hotels in the Brand system (including hotels owned by the brand), (ii) Manager’s incentive fee and performance termination calculations to be impacted by Owner’s capital expenditures in the Hotel, even capital expenditures mandated by Management Company and (iii) certain relief to implement brand FF&E changes over a period of years to obtain use of current fixtures with remaining useful life.

- Critical that Management Company review and approve all title encumbrances and confirm that Management Company will comply – while Brand Standards may change over time, certain recorded operating covenants do not, and Owner must avoid being obligated to comply with recorded covenants while being powerless to require Management Company to comply.
IV. TERMINATION TRENDS: DON’T BELIEVE THE HYPE

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WHAT HYPE?

WAIIKI EDITION [Marriott Lifestyle Brand]
- As of August 28, 2011, is now “The Modern Honolulu”

FAIRMONT TURNBERRY ISLE HOTEL & RESORT
- As of August 28, 2011, is now “The Turnberry Isle Hotel & Resort”

EDEN ROC RENAISSANCE MIAMI BEACH
- As of July 11, 2013, is now “The Eden Roc Miami Beach”

In each instance, the hotel owner was able to use common law agency and/or personal service contract principles to terminate their long-term management contract with the brand (discussed in more detail in another section). Many observers of the industry speculated that these developments would cause an upheaval in Hotel Owner and Brand Management Company relations.
WHAT ACTUALLY HAPPENED?

Answer – not much.

Why?

- Factors in common among the headline brand ousters: (i) large resorts, (ii) new construction or substantial renovation resulting in very high debt service payments, (iii) opened or re-opened during depressed resort lodging market, and (iv) owner perception that brand manager was operating to protect the brand rather than maximize revenue and profits. Only a small portion of the lodging market share these criteria.

- Common law termination is expensive – Owner still owes damages to management company for loss of fees, so the benefits of common law termination have only seemed to outweigh the costs under the specific circumstances outlined above.

- “It’s the [lodging] economy, stupid”. In the years following the high-profile ousters, the lodging market has roared back with year over year increases in occupancy and average daily rate, particularly in “Top 25 Markets”.

-
- Hotel transactions have been booming since the recession, both in volume and low capitalization rates (low cap rates = higher purchase prices). Many of these transactions involved hotels subject to existing non-terminable, multi-decade brand HMAs, which has not slowed down the market in any observable way. Further, brand companies are in a rush to move any hotels they own off their books by selling to third party owners while taking back long-term management agreements as a condition of sale. The volume of such transactions has been hitting new records of late.

- Related to the economy and transactions market, financing is readily available for hotels, particularly high-end brand-managed hotels in so-called “Top 25 Markets”. Owners have not found themselves handicapped by having long-term, non-terminable brand HMAs in place.
Bold Prediction: we will not see a restructuring of the form Brand HMA until after the dust settles following the next recession.

SO WHAT MIGHT CHANGE?

- Option to terminate upon sale, in exchange for (i) termination fee and/or (ii) purchase option in favor of Brand Management Company.

- Option to terminate HMA and replace with a franchise agreement with same brand.
  
  - Under this structure, Owner would be permitted to replace the Brand management company with a lower-cost independent management company, and the brand keeps the flag on the hotel (for franchise fees instead of management fees). Also, look for current trends to continue of more full-service and upscale brands being operated under franchise agreements instead of management agreements.

- Brand minimum profit guarantees in exchange for multi-decade HMA term – particularly to see Owner through the critical first few years after opening.
Rethinking of Performance Termination

Currently Brand management companies must fail two tests before facing termination, a profit threshold test and a REVPAR test. The REVPAR test is a comparison of the hotel’s revenue performance against a “competitive set” of similar hotels in the market. Under the traditional test, to face termination, the Management Company must not only fail to perform, but perform poorly in relation to other hotels. Many have criticized the traditional test as having resulted in very few terminations during the recent severe recession. Brands would argue that the traditional test performed exactly as designed, since performance declined due to macroeconomic factors outside of the management companies’ control.

One innovation may be to institute a “Performance Relief” concept, whereby management fees and certain other management related expenses are automatically reduced during a sustained period of REVPAR declines below a certain threshold, so that Owners’ and brand management companies’ interests are aligned even during a recession.

Look for brand management companies to insist upon Maryland law as the state law governing the contract. Warning to Owners: strongly recommend that Maryland law not apply, at least not generally. Brands have already shown they can have the law in Maryland changed in their favor, imagine how the laws may shift in the Brand’s favor over a 50-year term.
AGENCY LAW:

OLD SCHOOL HELP, AGE-OLD DRAFTING ISSUES

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Recent decisions have re-enforced the “agency” common law overlay whereby hotel management agreements have been held to be “agency appointments” with the hotel owner as “agent” and the management company as “principal”. In NY and NJ, HMAs are now also “service contracts”...both resulting in Owner having the “power” (not the “right”) to terminate. The agency overlay also gives rise to a fiduciary duty imposed upon the management company.
So, what to do? Nothing if you are Owner; enjoy this added protection provided by operation of law. Try to negate these if you are Manager. Applying Maryland law may negate the “agency” overlay, but likely not the “service contract” overlay. Great stuff here for us lawyers!!!
DRAFTING AWAY THE COMMON LAW OVERLAY:

This Agreement shall be interpreted in accordance with general principles of contract interpretation without regard to the common law principles of agency (except as expressly provided for in this Agreement), and shall establish and create the only duties and obligations enforceable against the Parties. It is the intent and desire of the Parties that any liability between them shall be based solely on principles of contract law and the express provisions of this Agreement. To the extent any duties, fiduciary or otherwise, that exist or may be implied for any reason whatsoever, including those resulting from the relationship between the Parties, and including all duties of loyalty, care, full disclosure, or any other duty deemed to exist under the common law principles of agency or otherwise (collectively, the "Implied Fiduciary Duties"), are inconsistent with, or would have the effect of modifying, limiting or restricting, the express provisions of this Agreement, the terms of this Agreement prevail.

For purposes of assessing Manager's duties and obligations under this Agreement, the Parties acknowledge that the terms and provisions of this Agreement and the duties and obligations set out in this Agreement are intended to satisfy any fiduciary duties which may exist between the Parties.


VI. Lender Perspectives on Hotel Management Agreements

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1. Lender Perspectives on Hotel Management Agreements

- Impact of the HMA on the Lender’s security package
- Using the HMA Assignment and Subordination Process as Support to Lender’s diligence
- The HMA and Borrower structure
The HMA: “All funds received by operator in the course of operating the hotel shall be deposited in the Approved Account at the Approved Bank. Such funds shall not be subject to a lockbox or similar provision in favor of any lender.”

The Loan Agreement: “Borrower shall establish and maintain a cash management account into which income from the Property payable to Borrower or Operating Lessee will be deposited (the “Cash Management Account”), which account shall be owned by Borrower but remain under the sole and exclusive control of Lender.”

The Closing Opinion: “The execution and delivery of the Loan Documents do not, and the performance by the Company of its obligations thereunder will not breach or result in a default under any other agreement...”
Subordination and Assignment of Management Agreement to Continue to Follow the Money

• "As of the date hereof, the only Capital Plan items that remain to be completed are regrouting of tiles in the second floor spa bathrooms."

• "The estimated cost of completing the Capital Plan items is $117,000."

• "The balance in the reserve account (as defined in the Management Agreement) is $947,000."

• "The Management Agreement has not been modified or amended."

• Obtain consent of Manager to assignment to Lender.

• Obtain notice and cure rights for Lender under the HMA.

• Obtain right for lender to review books and records on equal footing with hotel owner.

• Address risk of termination of TRS Lease by having manager acknowledge that owner can be counterparty to HMA. (More on this below.)

• Identify the manager operating accounts, learn their balances, obtain grant of security interest in said accounts.

• Subordinate the management agreement.
Knowing the Borrower’s Structure

- HMA and Borrower’s structure—50% of the Time That Will Require Lender Confront REIT Mechanics
REIT Complexity Emerged As REITs Became Less Like Mutual Funds and Sought Active Management

- Hotel REITs may not operate hotels directly because room fees are considered bad income for REIT income tests.

- Income tests are critical to preserving REIT qualification. (Hotel income is generally too intermingled with services to qualify as "rents from real property").

- Solution: Hotel Ownerco leases Hotel to another entity who pays rent to the Owner under an Operating Lease. The Tenant is the Taxable REIT Subsidiary or TRS. A TRS can engage in business activities that could present income qualification issues for the REIT. The TRS is a CCorp and its income is subject to corporate level tax.
Hotel Owner REITs Market Caps on December 30, 2013-- and on March 13, 2015

- Felcor (FCH) 983M – 1.35B
- Ryman (RHP) 2B – 3.19B
- Sotherly (SOHO) 59M– 82.25M
- Chatham (CLDT) 540M– 1.11B
- Diamondrock (DRH) 2.27B– 2.91B
- Host (HST) 14.58B– 15.81B
- Strategic (BEE) 1.93B– 3.39B
- LaSalle (LHO) 2.99B – 4.46B
- Pebblebrook (PEB) 1.98–3.36B
- Hospitality Properties Trust (HPT) 4B –4.75B
- Summit (INN) 770M – 1.18B
- Hersha (HT) 1.13B– 1.41B
- Ashford (AHT) 672M– 1B
- Sunstone (SHO) 2.46B– 3.44B
- Chesapeake (CHSP) 1.23B– 1.83B

Ballard Spahr LLP
What Hilton's IPO Tells Us About Brands/Managers

• Trend for these mega managers is to exit hotel ownership and stake themselves to long term, steady fee streams offered by management agreements. "Asset light" has pros and cons. IPO underscores trend.

• According to its S-1, Hilton owns or leases 157 hotels, while it manages or franchises 3,843 hotels.

• As of March 2013, Marriott International owned 6, leased 38, managed 1,021, and franchised 2,571 hotels.

• "We intend to grow our higher margin, fee-based businesses. We expect to increase the contribution of our management and franchise segment, which already accounts for more than half of our aggregate segment Adjusted EBITDA."
UPREIT Borrower’s TRS Is The Counterparty to the HMA

Hamlet & Ophelia

Units in OP

Operating Partnership

REIT

GP

100%

Ownerco/Borrower

100%

Leaseco/TRS

Lease

Hotel Management Agreement

Hotel Manager
VII. Privacy Issues under Hotel Management Agreements

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Privacy Issues under HMAs

- *Los Angeles v. Patel*
- “Federal” privacy law confusion and the FTC
- Books and Records
Managers Acknowledge the Privacy Risk

• "We may be exposed to risks and costs associated with protecting the integrity and security of our guests' personal information. i.e., collecting, handling, storing, transmitting personally identifiable guest information.” (from Hilton’s S-1)

• The protection of personal as well as proprietary information is critical to us. We are subject to numerous laws, regulations and contractual obligations designed to protect personal information...Compliance with applicable privacy regulations may increase our operating costs and/or adversely impact our ability to market our products, properties and services to our guests.” (from Starwood’s 2014 Annual Report, pp. 16).
Hotel Records

- *Los Angeles v. Patel*
- SCOTUS oral argument was March 3, 2015.
- Los Angeles ordinance requires motel/hotel operators to allow the police to examine hotel guest registers, without seeking a warrant.
- Do hotel owners have a fourth amendment right in the hotel register such that police officers would need pre-compliance judicial review?
Federal Privacy Law Applicable to HMAs?

- Sotomayor’s line of questioning and the sense— even among the justices— that there is an abundance of applicable federal privacy laws.

- Federal privacy laws are sector-specific and activity-specific.


- Activity-specific: Fair Credit Reporting Act; Children’s Online Privacy Protections Act; Electronic Communications Privacy Act.
FTC Enforcement Actions

• **FTC v. Wyndham**

• 15 U.S.C. 45(a) prohibits unfair or deceptive acts or practices in or affecting commerce.

• Currently on appeal to the Third Circuit. Oral Argument on March 1, 2015 on the issue of the meaning of “unfair trade practices”. Could negligent administration of a hotel system’s wi-fi systems constitute an unfair trade practice?

• Three breaches of Wyndham’s corporate data files in two years, resulting in the electronic theft of the credit card data of hundreds of thousands of the hotel chain’s customers.

*Ballard Spahr LLP*
On February 4, 2015 the FTC’s Division of Consumer & Business Education alerted hotel guests that hackers are using security vulnerabilities in hotel Wi-Fi to steal hotel guests’ passwords and other personally identifiable information. FTC recommends use of personal mobile hotspots in hotels.

October 3, 2014, the FCC announced that Marriott International signed a Consent Decree and agreed to pay a $600,000 civil penalty to resolve the FCC's Wi-Fi blocking investigation.
Typical Management Agreement Books and Records Provisions

• Management Agreements customarily provide that manager receives, holds, and disburses funds, maintains accounts, and handles the collection of accounts receivable.

• Management Agreements *sometimes* provide that Owner owns books and records at the end of the Management Agreement term.

• If “books and records” include guest records draft the Management Agreement with particularity. There will be countervailing arguments as to proprietary information from brand managers.
VIII. Hotel Management Agreement

Indemnity Strategies

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WHERE:

• Operator shall defend, indemnify, protect, and hold Owner harmless from and against any and all claims, demands, damages, judgments, costs, losses, penalties, fines, liens, suits, and expenses and liabilities, including, without limitation, attorneys’ fees and costs and expenses incident thereto, arising in connection with the operation of the Hotel or any component thereof by reason of (i) Operator’s gross negligence, and (ii) any intentional fraud or knowingly willful misconduct on the part of Operator or its Affiliates. The acts (including gross negligence, intentional fraud or knowingly willful misconduct) of Hotel Personnel shall not be imputed to Operator or its Affiliates, or deemed to constitute Operator’s or its Affiliates’ intentional fraud or knowingly willful misconduct, unless such acts or omissions resulted directly from the gross negligence, knowingly willful misconduct or fraudulent acts of the personnel of Operator in supervising such Hotel Personnel. All costs and expenses incurred by Operator under this Section shall be at its own expense.
WHO:

- Operator shall defend, indemnify, protect, and hold Owner and its officers, directors, shareholders, employees, agents and representatives harmless from and against any and all claims, demands, damages, judgments, costs, losses, penalties, fines, liens, suits, and expenses and liabilities, including, without limitation, attorneys’ fees and costs and expenses incident thereto, arising in connection with the operation of the Hotel or any component thereof by reason of (i) Operator’s gross negligence, and (ii) any intentional fraud or knowingly willful misconduct on the part of Operator or its Affiliates. The acts (including gross negligence, intentional fraud or knowingly willful misconduct) of Hotel Personnel shall not be imputed to Operator or its Affiliates, or deemed to constitute Operator’s or its Affiliates’ intentional fraud or knowingly willful misconduct, unless such acts or omissions resulted directly from the gross negligence, knowingly willful misconduct or fraudulent acts of the personnel of Operator in supervising such Hotel Personnel. All costs and expenses incurred by Operator under this Section shall be at its own expense.
COUNSEL:

- Operator shall defend, indemnify, protect, and hold Owner and its officers, directors, shareholders, employees, agents and representatives harmless from and against any and all claims, demands, damages, judgments, costs, losses, penalties, fines, liens, suits, and expenses and liabilities, including, without limitation, attorneys’ fees and costs and expenses incident thereto, arising in connection with the operation of the Hotel or any component thereof by reason of (i) Operator’s gross negligence, and (ii) any intentional fraud or knowingly willful misconduct on the part of Operator or its Affiliates. The acts or omissions (including gross negligence, intentional fraud or knowingly willful misconduct) of Hotel Personnel shall not be imputed to Operator or its Affiliates, or deemed to constitute Operator’s or its Affiliates’ intentional fraud or knowingly willful misconduct, unless such acts or omissions resulted directly from the gross negligence, knowingly willful misconduct or fraudulent acts of the personnel of Operator in supervising such Hotel Personnel. All costs and expenses incurred by Operator under this Section shall be at its own expense. **Operator shall select counsel reasonably acceptable to Owner and counsel to Operator’s insurance carrier shall be deemed satisfactory.**
IX. LITIGATION: WHERE THE HMA CONTROVERSIES SHOW UP

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AGENCY TERMINATION:

- See discussion of Marriott Edition/Fairmont Turnberry/Eden Roc Renaissance cases. Litigation has dwindled with the improving economy, but litigation may resume following next recession which may foment structural changes to Brand HMAs.

GUEST DATA ISSUES:

- See discussion of Privacy Issues and federal agency actions against Marriott and Wyndham. Hotel owners have not yet been targeted on a large scale for data security breaches, but HMA should specify that the hotel Owner does not have an obligation to indemnify the Brand management company for a data breach occurring and brand corporate offices..
NEW CONSTRUCTION CONTROVERSIES:

- Brand HMAs for new hotels are often signed before the hotel is constructed, usually concurrently with the closing of the construction financing, and will contain an addendum or separate agreement governing the procedure for the submission and approval of all construction plans and specs for the hotel by management company. A typical dispute involves a fact pattern where construction completion is severely delayed and over budget, and the hotel owner sues the management company for damages claiming management company failed to promptly review and approve plans and specs, and required revisions after initial approval that caused delays and costly change-orders.

- The design and development phase is a high-risk phase for the hotel owner, and the brand management company is not at risk under the construction loan documents so doesn’t face the same urgency.

- Drafting tips to avoid disputes and delays include (i) specifying time frame for submissions of plans and specifications and approval of such plans and specifications by the management company, (ii) specifying which edition of the brand design guide will control throughout construction, which may take up to two years during which time the design guide will likely be updated, (iii) requiring brand management company to acknowledge that approval is deemed to mean plans meet Brand Standards, and (iv) specifying a detailed dispute resolution process designed to resolve disputes and bottlenecks quickly.
EMPLOYEE LAWSUITS

- Note that in most cases, employees are the management company’s employees, but the owner will usually become involved because either the owner is sued jointly with the management company, or because the management company is asserting that owner is obligated to indemnify management company under the HMA. The HMA should provide some obligation of management company to properly hire, train, supervise and discharge employees in accordance with industry standards and applicable laws so that owner is not always obligated to indemnify management company in the event of employee litigation.

DISPUTE RESOLUTION

- Most HMAs will push dispute resolution to “Industry Expert” or other type of arbitration or mediation before going to court, which is why fewer disputes become publicly known than probably exist. Owners should be careful to confirm that the HMA provides that a mediator or arbitrator will have the power to order discovery in the event a dispute arises. This is important because (i) discovery is not otherwise automatically available in alternative dispute resolutions, and (ii) in most disputes, Owner will be requesting information from the Management Company, rather than vice versa.
BRANDED RESIDENCES: HOW THE HMA CAN IMPACT RESIDENTIAL COLLATERAL VALUE

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RESIDENCES
Types of Residences: timeshares (deeded, undeeded), condo hotel units, fractionals, whole ownership.

The Strategy: a source of financing for the hotels (particularly when condo hotel units are involved) and a major value-uplift to the real estate by association with the branded hotel.

The residences also expand the market for the use (sale) of hotel amenities.

- Will they be branded, marketed and managed by the Manager?
- Will there be a Rental Program? (Note SEC issue and new “safe harbor” (SEC Rule 506(c))
- What Hotel amenities will be available to residence owners?
- What are the branding and management fees?
- Was is the split of rental proceeds with residence owners

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The “HMA” allows the management company to operate the hotel as a distinct element of the real estate package that also includes the residences and common elements they share – perhaps elevators in a downtown mixed-use project or nature trails, the beach and recreational facilities in a resort project.

When condo-hotel units are in the mix, they become part of the “Hotel” (hotel rooms) when they are occupied by persons other than the unit owner; they are let out as hotel rooms; lock-off bedrooms each provide a hotel “key”.

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Fee opportunities for the brand:
1. Hotel management fees (previously discussed);
2. Residence branding fees; and
3. Condo or HOA management fees.