STEIN'S LAW

Getting Rid of That Great Hotel Manager

Whenever a developer creates a hotel and a lender finances one, management and branding usually define the product, providing a crucial ingredient for success. Hotel managers know that. So when they negotiate hotel management agreements, they seek as long a term as possible with as little exposure as possible to the risk of termination.

Many lenders who finance these projects would like to have the right to get rid of the manager if they ever need to foreclose and take over the hotel. In many cases, however, especially for higher-end hotels, the lender grudgingly agrees to accept and live with whatever termination rights the management agreement gives the owner. So even if the lender were to foreclose on the hotel, the new owner of the hotel through foreclosure would have no greater ability to remove the manager than the hotel's previous owner would have.

As a result, when the lender looks ahead to the possibility of taking back its collateral and then figuring out a graceful exit through a sale of the property, the lender must often accept the risk that the management contract will travel with the hotel. Many lenders often assume that this will reduce bids because likely purchasers will often want to reposition the hotel and install a new manager. Rightly or wrongly, the lender and possible bidders may believe the manager and its brand were part of the reason the hotel went into foreclosure in the first place.

Against that backdrop, two questions arise: what termination rights will a typical hotel management agreement give a hotel owner—and hence, in many cases, the lender after foreclosure? And how useful might those termination rights be?

Joshua Stein

Assuming the hotel manager doesn't violate the contract, steal money or do something else egregious, many management contracts force the owner or its lender to thread a needle in order to terminate the contract before its scheduled expiration date. More accurately, the owner or lender must thread four needles and those needles have very small eyes. So, who is it that prepares those needles for threading? At least half the time, it's the manager.

For a hotel owner to have the right to prematurely terminate a manager, many management agreements require that the manager flunk two financial tests, two years in a row. Two times two is four.

The more straightforward of the two tests requires that the manager achieve some measure of profitability or performance equal to a high percentage—often as high as 95 percent—of the average achieved by a group of competitive hotels, known as the "competitive set." In other words, the manager doesn't have to beat the market, but has to come near the average market performance.

The second test, far less objective, requires that the manager also come near the financial performance projected in the hotel's annual budget. But the manager prepares that budget. The hotel owner may have a nominal right to approve it, but if the owner and manager disagree, then an arbitrator sets the budget. For that reason, it doesn't give the owner a lot of comfort.

Regardless of the budget, the manager can protect him- or herself from having two bad years in a row, just by timing the hotel's expenses so as to alternate between profitable and unprofitable years.

Even if the manager somehow flunks the termination tests, the manager can tear up the test results if the hotel's financial problems arose from force majeure, major construction or renovations, or a number of other causes.

Although all of this may sound very carefully calibrated and fair and reasonable, it leaves the owner and lender with a management contract that is nearly impossible to terminate, ultimately serving the manager's goal. Even in the best (or worst) case, termination requires a multi-year campaign that starts with carefully policing the manager's budget and then trying to apply the various tests in a straightforward and objective way. This all happens against the backdrop of a management contract that lets the manager control just about everything about the hotel and its finances.

In today's world, hotel managers often have the upper hand in these negotiations. When the market changes, owners and lenders should recognize that the elaborate termination procedures in many management agreements just don't help very much and may justify some aggressive revisitation.

Joshua Stein is the sole principal of Joshua Stein PLLC. The views expressed here are his own. He can be reached at joshua@joshuastein.com.