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## Ashurst's Hotel Check-in

EDITION 2









# Key issues for Hotel Management Agreement negotiations

A hotel management agreement is much more than a “services contract” – it underpins the success or failure of a hotel. A good hotel management agreement enhances the value of a hotel and provides a solid foundation for a strong and effective long term relationship between the owner and the operator. A poor hotel management agreement will do the opposite – devalue the hotel and give rise to owner/operator conflicts for a very public asset.

Here is a 5 minute read on the key issues for a successful hotel management agreement negotiation.

## 1. Term

Hotel management agreements are long term documents – usually between 15 to 25 years in the Australian market, depending upon the operator and specific hotel asset.

## 2. Fees

The fee mix usually includes a base fee (a percentage of revenue) and an incentive fee (a percentage of Gross Operating Profit (**GOP**) as a minimum. Then there is any combination of a centralised services fee, reservation fee, marketing fee), licence fee and (where there is construction or significant refurbishment) a technical services fee.



While the overall fee mix is ultimately a commercial matter, it is critical to work through the detail on the calculation of these fees to ensure the parties understand what is included/excluded in gross revenue, what deductions are taken into account in gross operating profit, what centralised services fees are mandatory/ optional and each party's liability is for taxes.

### **3. Key Money**

Significant or strategic hotel assets or a new brand may create an opportunity to secure a key money contribution from the operator who is wanting to secure the site or hotel for its brand. Key money contributions are usually payable on opening of the hotel, and operators will typically seek a proportionate repayment of any key money on early termination.

### **4. Performance Test**

A performance test is a way for the owner to protect itself where it has an underperforming operator – and as such the performance test clause is one of the most heavily negotiated provisions.

Testing is normally across a consecutive two year period, although an initial ramp up period is recognised and excluded. In the Australian market testing is typically against achievement of a specified percentage of budgeted GOP or a specified percentage of the REVPAR of a defined competitive set – and in some cases a combination of the two. The thresholds, how and who measures this, when such rights can be exercised and if there are any cure rights are hotly debated.

### **5. Termination on sale**

A valuable right for the owner is the ability to terminate on sale. The reason for this is that it provides more optionality and which widens the market for potential purchasers. Such a right, if secured, will often only kick in after a few years of operation, and should clearly set out the termination fees payable and how handover and de-branding are to occur.

### **6. Budget**

An effective and workable regime for annual budget preparation and approval is critical to the long term success of the owner/operator relationship. The timing needs to align with both the owner's and operator internal requirements, and the owner's approval rights over the budget must not be unduly restricted. Once the budget is approved, the operator must have obligations to work within the approved budget, subject to appropriate latitude to adapt to changing market conditions and circumstances. The right balance is key.

## 7. Employee provisions

In the Australian market, while the hotel owner is usually the employer the operator will typically have autonomy over employee selection, employment terms and policies and how employees are managed. An owner can seek to have input for some key hires, such as the general manager and financial controller.

Increasingly, operators are seeking approval for employee clustering arrangements and the flexibility to “move” employees to work at other hotel assets. These arrangements can give rise to significant legal risks to the owner who, as the employer, retains legal responsibility and liability for these employees but without any control over such other work environments. If an owner is prepared to agree to such arrangements legal protections are necessary to safeguard the owner from claims.

## 8. Brand Standards

Brand standards are the lifeblood for any hotel operator who relies on them to ensure consistency of guest experience. Brand standards are not static, and adapt and change to meet market expectations.

The challenge for an owner is how to balance this with the costs associated with having to meet ever changing brand standards. Negotiating a moratorium on brand standard changes for the first few years of the hotel operation or following a significant refurbishment is a key financial protection for owners and there are other measures that can be agreed provided safety and operation concerns can be addressed.

## 9. Area of Protection

Ideally, an owner will seek to secure a restriction on the operator from managing or licensing a hotel of the same brand within a defined area surrounding the hotel – ie, the area of protection. It is rare for the area of protection to extend to other brands within the operator’s portfolio. The duration and the specifics of the area of protection arrangement need to be reviewed and agreed.

## 10. FF&E Reserve – can it be notional?

It is important to operators that there is money set aside for the upgrade/replacement of fixtures, furniture and equipment (“the FF&E Reserve”) so that the hotel is up to brand standards. Some owners who are able to demonstrate financial substance are able to negotiate a ‘notional’ FF&E reserve to free up this cash when it is not being used.

## 11. Default and suspension

It is critical to ensure that the default and termination regime in a hotel management agreement provides a reasonable opportunity for an owner to remedy a default before any termination or other serious consequences follow – these provisions will be examined closely by any incoming financier.

Some hotel management agreements may give rise to suspension regimes as this could involve suspension of reservation systems and/or use of the brand, these provisions need careful consideration and must provide a workable way forward for all parties.

## 12. Force majeure

Finally, the pandemic has highlighted the importance of the force majeure clause. A good force majeure clause will appropriately define a force majeure event, require consultation and cooperation between the parties and will not give rise to undue or premature termination rights.

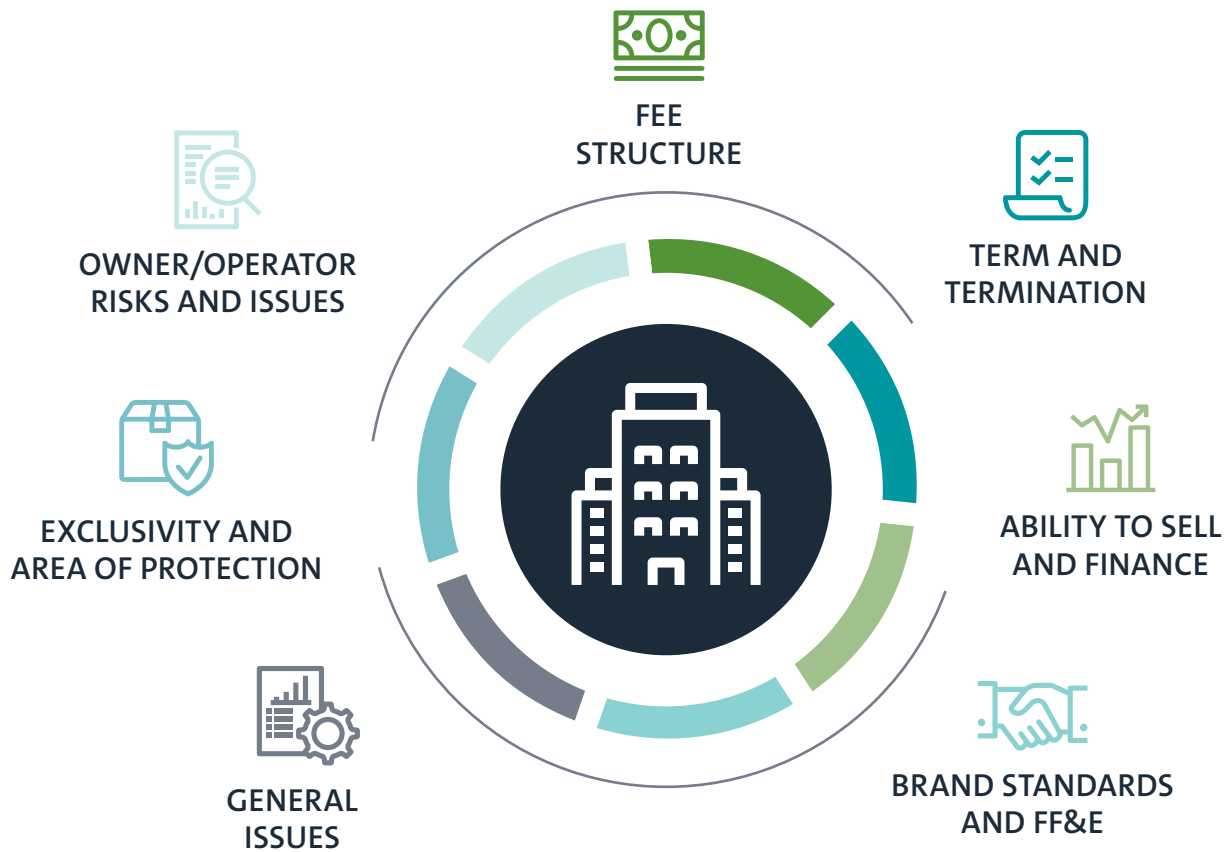
**A hotel management agreement is a unique contracting arrangement specific to hotel assets and requires specialist expertise, as the devil is often in the detail. We cannot overstate the importance to both the owner and the operator of a well negotiated hotel management agreement as it is critical to the long-term success of a hotel.**





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# Key issues for Hotel Management Agreement negotiations



## FEE STRUCTURE

- Base fees
- Incentive fees
- Technical services fees
- Centralised service fees
- Reservation fees

## ABILITY TO SELL AND FINANCE

- Restrictions on sale
- Change of control
- Non disturbance agreements
- LVR restrictions

## GENERAL ISSUES

- Liquor licensing
- Labour and employment
- Commercial contracts
- Indemnities
- Insurance obligations

## EXCLUSIVITY AND AREA OF PROTECTION

- Defining the exclusivity area
- Determining restricted brands

## TERM AND TERMINATION

- Length of term
- Options to renew
- Termination on sale
- Termination fees
- Performance tests

## BRAND STANDARDS AND FF&E

- Design approvals
- Brand standards and associated obligations
- FF&E reserve

## OWNER/OPERATOR RISKS AND ISSUES

- Key money
- Operator/owner controls
- Budget approval process
- Performance standards
- Reporting obligations

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*“At Ashurst, areas of strength include the hospitality sector, where John Stawyskyj and Pauline Tan are considered by one client to be the “best hotel advisers in the market”.”*

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*“Clients identify its “broad range of highly respected experts that are certainly quite agile in providing advice,” adding: “it’s a firm that you go to for significant issues and they do deliver very succinct and concise advice.” Another noting its “excellent service, understanding of our business and legal requirements.”*

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