

# 5 Tips on How to Avoid Hotel Management Disputes



The hospitality industry is an economic sector that is in a constant state of flux. To stay competitive both the hotel owner and operator must be willing to respond to changes in the market before change is forced upon them. Hotel operators, for example, have had to adjust to the rapid expansion of online reservation platforms and alternative accommodation service providers, changing requirements of travellers and guests (particularly millennials), and general industry disruptors. The competitive nature of the industry, coupled with ever moving trends and products can provide fertile ground for disputes to develop.

Whilst the initial design and development of a hotel will likely be subject to a Technical Services Agreement ('TSA'), a hotel owner's relationship with the operator is closest during operation of the hotel, which is governed by a hotel management agreement ('HMA'). The HMA typically has a duration of 10 – 20 years, thus, ensuring that the HMA is clear and workable in setting out the respective rights and obligations of the hotel owner and the operator is critical to the financial success of the hotel business, the operator's remuneration, and return of the hotel owner's investment.

While an international hotel operating company will have, after years of experience, a sophisticated understanding of the provisions of its standard HMA and, more importantly, the likely consequences of these provisions at both commercial and operational levels, the knowledge of a hotel owner may be more limited. As a result, there can be a gap of understanding between an operator and an owner on the various industry conventions and specific terms and provisions that underpin HMAs. For example, it may be necessary to explain to an owner that, while the operator will be responsible for organising routine maintenance and has a right to procure other capital projects needed for the hotel to remain in keeping with the brand requirements, the latter will typically be paid for by the owner. Thus, authorisation considerations are required to balance the parties' interests.

This article considers some of the issues that may arise and of which both parties need to be aware so as to ensure a fair and fruitful relationship.

## The Operator's fees and costs

In a standard HMA, the operator, through the hotel staff, is tasked with handling the financial operation of the hotel. This includes ensuring that the operator itself is properly remunerated in accordance with the

fee structure agreed in the HMA. The operator's fees are typically paid directly from the operating account by the hotel's General Manager, who is legally an employee of the owner, but appointed and directed by the operator.

There are many different ways in which the operator can be remunerate, however a typical arrangement in an HMA is that the operator's fees will be calculated as follows:

- A base fee, calculated as a percentage of revenue of the hotel business, to ensure the operator gets paid a certain amount each month regardless of resulting profit ;
- An incentive fee, earned by the operator when the gross operating profit achieves an agreed threshold (or thresholds, which are generally banded). There exists as an incentive for the operator to manage the hotel as effectively, efficiently, and successfully as possible, and because such fees will only be due once a threshold is met, this provides some protection in respect of the owner's recovery on its investment.

The gross operating profit is calculated by deducting operating costs (not owner's capital investment) from gross revenue. The HMA should enable the owner to limit the operator's ability to incur certain types of costs that may result in increased revenues, and therefore a higher base fee, but which may not lead to increased profits.

An Operator will usually also be entitled to additional fees for provision, at a corporate level, of marketing and group/centralised services, together with other services, such as inclusion of the hotel in the operator's guest loyalty programme. There may also be a separate trademark licence fee (if not included in the base fee) payable for the hotel's use of the operator's brand. There are many variations to fee structures from one operator to another.

Therefore, complex formulas for fees and costs may be applied in the HMA that, without sufficient transparency in terms of calculation method (and adoption of a specified accounting method, reporting and audit) may lead to dispute. It is critical, therefore, for an owner to be fully comfortable in respect of fees and costs that will be applied under the HMA, and the operator must ensure that these are accurately calculated.

### **Owner's funding obligations**

There are usually three key funding obligations on an owner under the HMA: (a) provision of working capital; (b) furniture, fittings and equipment ('FF&E') reserve; and (c) capital expenditure.

It is important that the HMA clearly addresses these obligations on the owner whilst providing comfort and protection to the owner that these funds will not be unreasonably demanded or spent.

Provision of working capital should be capped to cover forecasted cashflow requirements for a capped period of time, to ensure that the owner is not financing the operation of the hotel where cashflow management is lax.

An owner will need to pay funds into a separate reserve fund to cover the costs of replacing existing or purchasing new FF&E. As the FF&E will inevitably impact the standard of a property, and likely impact the operator's brand reputation, as well as the hotel's performance and value, the FF&E will generally need to be maintained at the hotel in accordance with the operator's brand standards. In a competitive market, it is important to maintain the overall image and positioning of the hotel; however, there must be a balance between the cost impact on the owner of the same, particularly if performance of the hotel is struggling. Clearly documenting the parties' respective rights and obligations in the HMA will go a long way to limiting tensions that may arise from perceived misuse of the funds in the reserve, and inclusion of the anticipated annual FF&E spend in the annual budget for the owner's approval is key.

As with the FF&E fund, an owner will be required to pay for work and fitting-out at the hotel that are not ordinarily treated as an operating expense of the hotel (and therefore, not funded from hotel revenue). Again, there will be an obligation on an owner to comply with an operator's brand standards, to the extent these impact on capital cost items; however, the actual cost of same should be subject to the owner's approval as part of the annual budget process.

### **Term of the HMA**

The term of the HMA needs to be clearly specified, along with the renewal provisions. If the hotel is a success, renewal will usually be in both parties' interest. Typically, an operator will require a long initial term, and renewal periods exercisable by the operator to assure its rights of management of the property and to enhance the value of the operator company itself. However, an owner will often require a no-fault break clause to allow it to exit the HMA and not be committed long-term to a commercial venture that may be failing. The conflicting position of the parties on these items is common, and a no-fault break clause will often only be considered with payment of compensation to the operator for loss of future fee revenues.

A compromise is the inclusion of a performance test, which aims to measure the value of the operator through the performance of the hotel and provide a right to the owner to terminate the HMA in the event that sufficient performance is not achieved. The provisions of the performance test can be complex, however, and subject to various carve-outs and exclusions, and most usually will comprise both a financial and market competitor test. Analysis and agreement on the performance test at the outset is therefore crucial to ensure that its inclusion does actually provide some protection to an owner, as a feasible and workable termination right.

### **Choice of dispute resolution forum and law**

Whilst commercial disputes are bound to arise from time to time, given the complex nature of the relationship between an owner and an operator, what should never happen is a dispute about how such disputes are resolved. The following must be considered when deciding on the choice of law and method of dispute resolution:

- The parties should choose a recognised alternative dispute resolution mechanism, such as arbitration, especially in regions where a country's national courts are unlikely to have the experience to readily get to grips with HMA disputes.
- The parties should choose a governing law that is sophisticated and well developed. This may not be the law of the jurisdiction in which the hotel is operated.

### **Define material breach**

The governing law may provide the parties with rights to terminate in the event of a default by the other party, but it may not always be clear when these rights can be used. The parties should therefore agree clear provisions in the HMA that set out specific circumstances where one or either party can terminate the HMA, including inclusion of a definition or list of what a 'material' breach(es) may be.

### **Conclusion**

Whilst the above is by no means exhaustive, these are all issues that should be taken into account when negotiating an HMA, as this will bind the parties to each other for a long period of time, with the financial

risk of the business ultimately resting with the hotel owner.

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