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Hotel Management Contracts—Past and Present

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Conceived as a relatively simple arrangement that allowed international expansion by hotel chain operators without the risk of real estate ownership, the management contract has become an intricate and nearly essential element of the contemporary hotel industry. While trends in management contracts have shifted with the relative bargaining power of owners and operators, the key to a successful contract is aligning the interests of all parties. Owners seek some reasonable guarantee of cash flow, while operators need assurance that they will be able to benefit from their continued operation of a property. In place of a single document, management contracts now include numerous concurrent agreements that address such matters as real property rights; intellectual property rights; hotels as financial assets; hotels as operating businesses; and the needs of owners, operators, and lenders.

Keywords: management contracts; operator and owner bargaining power; management contract provisions

Hotel management contracts have become a fixture in the hotel industry for most full-service, upscale, luxury, resort, and convention properties. The American Hotel & Lodging Association (AH&LA; 2009) estimates that there are eight hundred management companies managing 12,000 properties worldwide. More than one-third of that number, 4,370 hotels, were managed by the nine largest hotel companies in 2006 (Eyster and deRoos 2009). This article provides a historical overview of hotel management contracts and serves as a benchmark for management contract practice in 2009. A subsequent article will examine future trends.

The earliest definitive analysis of hotel management contracts appeared in a series of *Cornell Quarterly* articles written in 1977 by Professor James Eyster of Cornell's School of Hotel Administration (For example, see Eyster 1977). By this time, management contracts had achieved a notable presence in the industry.

Management contracts were developed starting in the 1950s, when the large hotel operators, particularly

Hilton, InterContinental, Sheraton, and Hyatt, expanded internationally. By separating ownership from the operation of the asset, both parties were better off. The property owner, employing the services of a professional operator and the brand for a fee, could generate significant value and cash flows without having to invest in the expertise of the hotel business. The operator, by agreeing to manage the property on behalf of the property owner, could generate significant fee income, expand the reach of its brand, and earn profits without having to invest in the property needed to support the operation. The provisions of these early contracts, which were relatively straightforward, are now characterized as being favorable to the operator, given their lengthy duration and limited rights by the owner to terminate the contract.

The relationship of owner and operator began to change in the 1980s, when international interests invested heavily in the U.S. hotel industry. During this period, hotel management contracts were in widespread worldwide use, and there was a significant body of literature and legal expertise on the topic, including the seminal Eyster book of 1988. The crash of the commercial real estate bubble in 1990 exposed the lodging market to significant distress. The resulting hotel bankruptcies provoked two long-lasting developments in management contracts. First, when management contracts were tested in the courts, the results were generally favorable to owners (for an excellent summary, see Renard and Motley 2003). Second, due to financial distress issues and a perceived misalignment between owners and operators, the hotel asset management discipline arose to provide professional services to hotel owners. Contracts signed in this era are generally characterized as favorable to the owner, with significant rights of termination and a clearly established set of duties for operators.

Contracts grew much more complicated in the 1980s and 1990s. What were once straightforward clauses were transformed to tiered provisions and multiple contracts as a result of owners' and operators' growing experience with the positive and troublesome aspects of contracts. Examples include

- incentive fee structures based on achieving certain levels of cash flow or certain levels of profitability as measured by (for example) gross operating profit (GOP) margins;
- performance termination clauses;
- owner's rights to approve operating; furniture, fixture, and equipment (FF&E) replacement; and capital expenditure budgets;
- owner's right to have input on personnel decisions;
- owner's right to terminate—at will, upon sale, and upon foreclosure;
- restrictions on blanket indemnification of the operator;
- operator's rights to enforce brand standards; and
- operator's expansion of rights to collect sums for centrally provided services such as loyalty programs, accounting, training, marketing, and reservations.

On the strength of another real estate bubble, the period from 2000 through 2009 has been characterized by an explosion of hotel management contracts, especially by the branded operators. The demand for management services outstripped the supply in many markets, primarily driven by the success of the brands in meeting the owners' objectives and the fact that operators were able to engage in auction-like behavior. Given the limitations of real estate markets, the best brands have had the ability to select which of several prospective projects they would manage in a given market. This ability, combined with the

expansion of the lending market and competition among lenders for good hotel loans, provided a window of opportunity for hotel operators to obtain contracts on particularly favorable terms from 2000 through 2008.

No longer. At this writing, both owners and operators are faced with unprecedented dreadful performance, possibly for an extended period, causing enormous stress between the parties. Management contracts will certainly be tested again, with the likely consequence of changes in recent practice. Litigation is expected to spike significantly over the next two years. Disagreements between owners and operators may escalate, as has occurred at the Four Seasons Aviara, where the parties have resorted to changing locks, engaged in personal confrontations, and filed competing lawsuits (see Segal 2009).

In this article, I analyze the state of hotel management contracts in 2009, drawing heavily on a review of contracts written during the past ten years, my work with practitioners in the course of teaching and consulting, and a review of recent writings on the topic (see Eyster and deRoos 2009; Wales and Ferroni 2008; McDaniel 2008). My intent is to provide a benchmark for management contracts as the industry moves into the next decade and to offer a context for the negotiation of new contracts, as well as the administration of existing contracts.

Contract Fundamentals

In negotiating a management contract, owners and operators keep an eye on five fundamental issues. While some are more important to one party than the other, they form the essence of all contracts. On these five points, I have observed a greater level of balance between the owner and operator than at any point in history. These five fundamentals form the outline for this article, as follows:

- the legal framework;
- investment by the operator in the relationship;
- term, renewal, and termination rights;
- fees and system reimbursable charges; and
- reporting and controls.

The Legal Framework

The legal framework defines the parties, their relationships, and their rights. Far from being a single document, a management contract involves negotiations that can include up to eight concurrent agreements (i.e., preopening management agreement, postopening management agreement, brand license, royalty or franchise agreement, marketing agreement, technology agreement, employment agreement, and technical services agreement).

Separation of the Management Contract from the Contract for Brand Services

Separation of the postopening management agreement into two contracts (management contract and brand license agreement) is an innovation that favors the operator. This practice has grown steadily in recent years. In a typical negotiation of the two contracts, little fee payments are associated with the management contract itself, typically a base-only fee of less than 1 percent of revenues. The brand license agreement, by contrast, provides for base royalty fees of approximately 2 percent and an incentive royalty fee that mirrors contemporary incentive fee practice in a more traditional contract where the management and brand are bundled. The effect is to shift the source of fees from the management contract to the brand license agreement. For international operators, this structure produces lower taxes for the operator due to differential treatment of management fees and license fees. In most

cases, the two agreements are cross-defaulted, but this is not necessarily true in all cases. Owners should be careful not to expose themselves to a situation in which they have the right to terminate the management contract but are obligated to take brand services (and pay the corresponding fees) under the brand license agreement.

The Parties to the Contract

In a contemporary management contract, each party often incorporates a special-purpose company; the operating entity is a single-asset subsidiary of the operator, while the owning entity is a "bankruptcy remote" special-purpose entity controlled by the owner. The intent of creating these entities is to limit liability and to provide lenders with a clear foreclosure path should the owner default on the hotel loan. It is clear that the liability management aspects of the special-purpose companies work as intended.

However, in the current environment, I observe that the lender's desire to prevent owners from using bankruptcy and instead force hotels into foreclosure may not be in the best interests of any party. I say this because the foreclosure process is handled in the state courts and its outcomes are uncertain, depending on the judge and the appointed receiver. On the other hand, hotels that have gone through a bankruptcy typically use the federal court system, which is well equipped to handle a hotel failure in relatively predictable fashion. It is clear that the bankruptcy process favors borrowers as long as the hotel loan is nonrecourse to the borrower; in addition, the bankruptcy process provides a lender (the new owner) with significant power to terminate or modify the management contract. The foreclosure process, by contrast, is so unpredictable that it would be unfair to characterize it as favorable to the operator, but in general, it is more likely that the operator's contract would survive a foreclosure process than a bankruptcy process.

Two additional legal matters relate to the contract; first, the owner and operator must consider the matter of whether the owner, the operator, or some third party is the employer. The second relates to the name of the holder of permits, licenses, and other rights to do business as hotel. For permits, licenses, and other authorizations, it is in the owner's best interests to stipulate that the operator is responsible for obtaining and maintaining these on behalf of the owner.

With regard to employees, until recently, neither the owner nor the operator has wished to carry the employees on its payroll (see Eyster and deRoos 2009). Each has been reluctant to assume the continuing business obligations for keeping payroll and pension records and for negotiating and adhering to labor agreements. Also, neither has wanted to be liable for potential tort actions or discrimination claims (for a discussion of discrimination issues, see Sherwyn 2010 [this issue]). Recently, though, several operators have expressed a preference for employing all property-level staff, because that gives the operator specific competitive and strategic advantages. The most significant of these is the ability of the operator to transfer personnel to another property in the case of a contract termination, depriving the owner of the ability to simply terminate a contract under the assumption that the hotel will continue to operate with the existing staff. In addition, operators can provide employees with long-term career paths, strengthening the operator and providing employees with career options not available within a given property. An innovation found in recent contracts is employee leasing or professional employment organizations (PEOs), in which the owner or operator leases employees from a third-party company, which sometimes is affiliated with the owner or operator. These companies handle

the management of human resources, employee benefits, payroll, and workers' compensation.

The Status of the Agency Relationship in Management Contracts

The third major component of the legal framework is that of agency, a topic that has attracted considerable attention (Renard and Motley 2003).[1] The relationship between the owner and operator is one of principal and agent. If the contract and the actions of the parties have in fact the substance of a principal-agent relationship, the courts have affirmed this relationship—even in the presence of contract language specifically stating that the relationship is not one of agency. The agency relationship is decidedly in favor of owners, because it provides a mechanism for owners to terminate contracts that do not otherwise provide for termination. The principal in an agency relationship can terminate a contract if the agent breaches its fiduciary duty to the principal, irrespective of the contract language.

While this matter remains a matter for courts to assess, many owners insist on a principal-agent relationship. On the other hand, some operators insist on language establishing an independent contractor relationship and specifically disclaiming agency. Again, only time will tell whether this language survives a court test. The State of Maryland has addressed the matter with Commercial Law §23-102, which removes the remedy of at-will termination of agency unless that is explicit in the agreement. Instead of the common law understanding regarding agency, Title 23 states that the "four corners" of the contract govern its enforcement, in recognition of the meeting of the minds of the parties to the contract.

Dispute-Settlement Mechanisms

Dispute-settlement mechanisms are an important component of the legal framework—the most common being arbitration or use of experts. Absent any language to the contrary, the parties have full access to the courts at any time in matters under dispute. Operators usually insist on language that creates formal dispute settlement mechanisms that have the effect of preserving the status quo while the dispute is under consideration, are uncertain in outcome, and place decisions outside of the contract parties (Wales and Ferroni 2008; McDaniel 2008).[2] As an example of current practice in the United States, contract provisions are found along a continuum. At one end of the continuum, contracts use arbitration for some, but not all, contract disputes. Arbitration or the use of experts would apply typically to disputes over the budget, budget definitions, performance termination, and capital expenditures. At the other end of the continuum are the few contracts in which the use of experts or arbitration is the sole remedy of the parties in all disputes.

Real Property Rights and Personal Property Rights

The last major component of the legal framework is the matter of property rights. As a rule, the owner owns the real estate. Thus, contracts have long been written with the understanding that all real property

1. It should be noted that the agency matter is the most contentious issue between owners and operators, as evidenced by the spirited discussion at the May 2009 Management Contracts Roundtable at Cornell's Hotel School.
2. McDaniel (2008) presents tables showing that arbitration or the use of experts is found in 81 percent of North American contracts, 72 percent of contracts in EMEA (Europe, Middle East, Africa), and 72 percent of contracts in the Asia-Pacific region.

and physical personal property remained with the owner. In addition, since the operator was doing business on behalf of the owner, all records, data, and other matters relating to the hotel business were the property of the owner. The courts have made it clear that the work performed by the operator does not create an interest in the hotel and that the contract does not create any partnership, joint venture, or tenant rights. This position favors owners in termination disputes by clearly identifying property rights of the parties.

A new practice gives branded operators considerable rights to withhold operating information from the owner. In particular, guest history and marketing data, as well as systems used to operate the hotel, are, in essence, owned by the operator. In a minority of cases, the operator has secured rights to control cash flows in the event of the owner's default on capital obligations. While federal bankruptcy law would take precedence over this language in a bankruptcy procedure, the language could stand in a foreclosure procedure.

Investment by the Operator in the Relationship

Operators are often asked to invest in the relationship as evidence of their commitment to a project, and operators often invest strategically to create an interest in the deal, to gain favorable provisions, or to limit the owner's ability to terminate the contract.

Operators may invest with one or more of five financial tools. I list them below in the order of preference most often cited by owners.

- *Key money*. Generally framed as an up-front rebate of fees in the amount of less than 5 percent of the capital structure, this arrangement often has "claw-back" mechanisms for repayment if contract does not run the entire initial term.
- *Second mortgage loan*. Not often used due to first-mortgage restrictions, this approach was found in a few contracts in the 1970s and 1980s. It has since fallen into disfavor.
- *Mezzanine loan*. This investment is treated as any other piece of the capital stack. Amounts are most often between 5 and 10 percent of the capital structure. Generally structured with a cash sweep and a look-back return calculation.
- *Cash flow guarantees*. Not a cash investment in the property, these guarantees generally are structured to provide the owner with cash flow of between 80 and 100 percent of the budgeted cash flow for a specific number of years (generally less than five). The guarantee is calculated on an annual basis, with an overall cap on the guarantee in an amount that is less than 5 percent of the capital structure. These also often have a claw-back mechanism to recover sums paid if cash flow exceeds certain thresholds.
- *Equity investment*. Many owners consider this approach unacceptable. The equity investment by the operator has the effect of creating a partnership relationship between the owner and operator and certainly would alter any principal-agent relationship. Consequently, the use of equity investment by the operator has fallen into disfavor.

When the operator makes a meaningful investment in the relationship, the owner is expected to recognize the investment by agreeing to certain terms that favor the operator. Depending on the parties' objectives, those terms may take the form of fees that are a bit higher than market, a long initial term and renewal term(s), weak termination rights, limited access to the courts, or designating Maryland as the governing jurisdiction for the contract.

Exhibit 1:
Initial Terms and Renewals

	Initial Term (Median Years)	Number of Renewals (Median)	Length of Renewals (Median Years)
Brand operators			
Full-service	16	2	10
Independent operators			
Full-service (no equity)	6	2	4
Select service	9	2	5
Caretaker operators[a]			
Full-service	1	1	1

Source: Adapted from Eyster and deRoos (2009, Exhibit III-3).
a. Caretaker operators are usually independent operators. Frequently, initial contract terms state that the contract continues indefinitely until notice of cancellation is given either with or without cause by either owner or operator. If the contract is terminated before the end of the initial term, the owner is usually obligated to pay management fees for the remainder of the current term; thus, initial terms are quite short.

Term, Renewal, and Termination Rights

Once the nature of the operator's investment is clear, the parties can substantively negotiate the contract term, renewal, and termination rights. Any discussion of fees must wait until the operator has some notion of provisions relating to term and termination. Exhibit 1 presents statistics for term and renewal (Eyster and deRoos 2009).

As has been true for many years, the term and renewals for branded operators is substantially longer than those for independent operators. Similarly, independent operators have weaker termination rights than do branded operators, as shown in Exhibit 2.

Since most brand operator contracts do not provide for termination without cause, performance-related termination is generally seen to be in the owner's favor. The original intent was to give the owner rights to terminate the contract during the initial or renewal term should the operator perform poorly. Interestingly, a contemporary performance termination clause operates primarily as a cash flow guarantee and not a termination device. A typical performance termination clause operates as follows:

- Poor performance is defined as a failure to achieve some fraction of the budgeted GOP, generally between 80 and 100 percent.
- The poor performance must continue for more than one year. Many different forms of time measurement are in place, including a rolling twelve-month period, two of three consecutive years, and two (or even three) consecutive years.
- If there is a terminable event, the operator is given the opportunity to cure the performance failure and avoid termination by giving (or lending) the owner the difference between the actual GOP and the benchmark. There may be a claw-back provision on the cures in the event that future performance exceeds the benchmark or the contract is terminated prematurely.
- In addition, there is a force majeure clause that makes any terminable event subject to a market test. In general, as

Exhibit 2:
Owner Termination

	All Properties Except Caretaker[a]	
	Brand	*Independent*
Without cause		
Frequency in contracts		
At any time	0%	42%
After predetermined period[b]	15%	2%
Required notice period (days)	90-365	30
Termination fee multiple[c]	3-5	1-5
On-sale		
No operator option to purchase	35%	67%
Operator option to purchase[d]	56%	22%
Operator option to continue with new operator	72%	38%
Termination fee multiple[c]	2-5	0.5-2.5
On-foreclosure		
Frequency in contracts	80%	80%
Termination fee multiple[c]	0-2	0-1

Source: Adapted from Eyster and deRoos (2009, Exhibit III-7).
a. Caretaker operators: when an owner terminates a contract before the end of the initial term, most contracts require the owner to pay the caretaker operator management fees for the remainder of the contract term.
b. Usually from between one to three years.
c. Multiple of most recent twelve-months' basic plus incentive management fee. Multiple decreases as remaining period of contract term decreases.
d. Combination of right of first offer, right of first refusal.

long as the hotel is achieving its long-term market share of room revenues, no termination is possible.

Operators often have unlimited cure rights and can unilaterally decide whether to cure or be terminated. In addition, the use of a performance termination clause provides a mechanism for operators to keep owners from exerting too much control over budgeting and operations. Since the operator is at all times responsible for the budget via the performance clause, the operator should make its best possible effort to produce an accurate, defensible budget and then achieve that budget. Owners are reluctant to allow operators to avoid performance termination liability by taking control of the budget away from the operator.

No discussion of termination rights would be complete without noting the role of subordination, nondisturbance, and attornment agreements (SNDA), or tri-party agreements, which limit the lender's rights and which represent a sea change in contract status. Over the past ten years, operators have been increasingly successful at binding the lender to the operator by using SNDA language from commercial real estate. Using this agreement, the operator seeks the status of an important tenant, whose rights survive a foreclosure procedure. The acceptance of these agreements in foreclosure and ability of the management contract to survive a foreclosure is a fundamental change in management contracts and will be more vigorously negotiated in the future. While there is a possibility

that the management contract is voided by a receiver in a foreclosure, any receiver who does so must believe that it represents the entire business of the borrower, with the operator but a part of the overall business that is being foreclosed upon.

Fees and System Reimbursable Charges

Simple in concept, fees and system reimbursable charges can be complex in implementation. The idea of combining a base fee and an incentive fee was meant to align the interests of owner and operator. Operator fees could be based on both revenues and profits. Historically, the base and incentive fees were of roughly equal magnitude for a hotel in a good economy with a solid management team. In general, base fees are a straightforward percentage of gross revenues. Some contracts define gross revenues tightly so as to exclude revenues that are not the result of the operator's efforts (e.g., a parking concession). A few operators have accepted contracts that have no base fee but must be assured that the incentive fees provide for a reasonable fee stream over the term of the contract.

Incentive fee structures involve greater complexity and have a wide variety of forms in practice. At their root, incentive fees are the fundamental financial risk-shifting device in the contract. With incentive fees, the operator bears some risk for poor results and has an incentive to maximize the profit measure that serves as the incentive fee basis, typically GOP, generally calculated as gross revenues less operating expenses. However, the operating expenses do not include property taxes, insurance, reserves to replace FF&E, or any capital charges such as debt service, ground lease payments, or an owner's preferred return. Thus, GOP is larger than the cash flow to the owner. Over time, owners sought various means to establish the incentive fee on cash flow after a return on capital and to subordinate the incentive fee to this return, a change meant to further align the owner's and operator's interests.

A summary of base and incentive fees is presented in Exhibit 3, which describes the two most common types of incentive fees. A fee based on GOP is common in Asia and most of Europe and the Middle East. When this incentive fee structure is used, the incentive fee percentage is often tiered, based on the achieved GOP margin of the property in any given year.[3] An incentive fee subordinate to and based on cash flow after a return on assets, called an owner's priority return, is commonly employed in North America.[4]

Note that while base fees are higher for select-service hotels operated by branded operators, they are lower for independent operators. This is due to the fact that the select-service hotels are rarely independent hotels, and the brand itself is usually bundled with the management contract. For a hotel operated by an independent company, the owner often pays franchise fees in addition to the management fees.

Always a matter of some contention, system reimbursable charges have become the most controversial area of fees to emerge over the past ten years. These charges are for services provided by third-party

3. As an example, the incentive fee could be structured as follows: a gross operating profit (GOP) percentage of less than 35 percent would earn an incentive fee of 6.0 percent, a GOP percentage between 35 and 40 percent would earn an incentive fee of 7 percent, and a superior performance of a GOP percentage exceeding 40 percent would trigger an incentive fee of 8 percent.
4. A typical contract would call for the incentive fee to be 10 to 30 percent of cash flow available after an owner's priority return of 10 percent assets.

Exhibit 3:
Base and Incentive Management Fee Structures

	Basic Fee (Percentage of Gross Revenues)			Incentive Fee	
	Low	*Median*	*High*	*Fee Base*	*Ranges (Percentage of Fee Base)*
Brand operators					
Full-service	2.0	3.25	3.5	GOP	6-10
				Owner's priority return	10-30
Select-service	3.0	5.0	7.0	GOP	8-12
				Owner's priority return	10-30
Independent operators					
Full-service	1.5	4.0	6.0	GOP	5-10
				Owner's priority return	10-20
Select-service	2.5	2.75	3.0	GOP	8-12
				Owner's priority return	10-30
Caretaker operators					
All hotels	3.0	4.0	6.0	GOP	5-8
				Improved GOP	10-25

Source: Adapted from Eyster and deRoos (2009, Exhibit III-4).
Note: GOP = gross operating profit as defined in the Uniform System of Accounts for the Lodging Industry. Owner's priority return = cash flow after owner's priority (the owner's priority is a return on total property investment, generally in the range of 8 to 12 percent).

affiliates of the operator or by the operator itself for centralized services, including fees for international marketing, group marketing, regional sales and revenue management teams, frequent traveler programs, the operation of reservation systems, purchasing fees, training fees, fees for providing hardware and software, centralized accounting services, and travel expenses of corporate personnel.

Operators feel that properly structured and administered centralized services increase the efficiency, pricing power, and effectiveness of their delivery of management and brand services. They argue that their service to owners would be less effective at greater cost if the services were provided locally. Operators also argue that consistent implementation of a global brand network demands regional and central services that are beyond the reach of individual hotels. Owners recognize the value created by centralized services but have concerns in three areas: whether the charges are fair (that is, the services are provided at their true marginal cost), the ability of the operator to impose new and expensive mandates over the term of the contract for programs not anticipated during contract negotiations, and whether the effectiveness of centralized services applies equally from hotel to hotel.

Owners have heretofore granted broad rights to operators to define and impose system reimbursable charges, typically amounting to 2.5 to 5.0 percent of total revenues. However, these charges continue to grow to the point that they are equal in magnitude to management fees in some cases. Moreover, they are difficult to total at any particular property as these fees are associated with almost every aspect of hotel operations and purchasing. Two paths regarding system reimbursable charges are emerging in contracts today. The first approach is advantageous for operators and continues the existing trend toward broad rights to define and allocate system charges to hotels. Some operators have inaugurated a different approach, in response to owners' concerns, that involves a single charge that serves as the payment for all operator provided services over the term of the contract. In these cases, the system reimbursable fee is most commonly a fixed percentage of revenues, with some additional fees associated with the traditional fee per transaction for reservations.

Reporting and Controls

Two important topics are generally found in the category of reporting and controls: territorial protection and the broad topic of financial reporting and budgets. Regarding territorial protection, owners feel that they should have the right to a reasonable trade area for their hotels and should not have to compete with the operator or the operator's brands for business within the trade area. Operators know that the hotel business is highly competitive and that new entries are inevitable as hotel demand develops within a market. Their position is that they should not be precluded from adding hotels to a market—especially newly developed districts in that market—once a given hotel is successfully established.

In the past, owners were given little territorial protection, but over the years operators have added territorial protection devices in response to owner demands. Over the past ten years, such protections have generally precluded the operator from operating the same brand in a defined geographic area for a term of years, generally the initial contract term or ten years, whichever is less. Almost universally, the operator has the right to open hotels from the operator's brand family without violating the territorial protection (Dev et al. forthcoming). Most contracts shrink the geographic area over time, and some provide tests for adding new, same-brand properties in the market. Some operators have been successful in obtaining contracts that allow new competitors as long as the existing hotel is proven to be unharmed or that compensate the existing hotel even if it is harmed (sometimes referred to as impact provisions). Compensation can take the form of first rights to develop new hotels in the market or cash payments.

Financial reporting and the budgeting process are, in most cases, straightforward matters. Operators have long recognized that the hotel is being managed on behalf of the owner and that the owner needs timely and accurate reports to comply with accounting requirements. Owners that are publicly listed firms or that have fiduciary responsibility to their investors are responsible for producing the audited records of the hotel; this requires the close cooperation of the operator. In cases where the owner is a partnership or private company, the operator often produces the audited records. A recent concern has arisen for operators that are publicly listed firms in the United States. As a result of the Sarbanes-Oxley requirements, these firms no longer wish to have the liability of producing the audited records. In these cases, the owner is asked to take records prepared by the

operator; the owner retains the services of an independent auditor to certify the records. While a bit more complicated, these procedures recognize the reality of contemporary liability-management practices.

Budgets are the most contentious issue between owners and operators. Budgets are the benchmark for bonuses, for incentive fees, and for performance clauses; and they serve as a set of goals to be achieved. Owners have traditionally had the right to approve the annual budgets for operating, FF&E replacement, and capital expenditures. Recent contracts, however, have restricted these rights to the favor of the operator. Examples include changing the owners' right to approve budgets to the right simply to review the budget. This is intended to remove the owner's incentive to use annual budget approval as a negotiating weapon. This change is found in many contracts with performance termination provisions. Other changes include the right to exceed agreed-upon limits to FF&E replacement and capital expenditures when these changes are framed as changes to brand standards. Increasingly, owners focus on the definitions of items that might variously be handled as a maintenance expense, an FF&E replacement, or a capital expenditure. In addition, owners are insisting on contract language and cooperation from operators to create and implement long-term furniture replacement and capital expenditure budgets, due to the large sums involved and uncertainty over whether reserve funds would be sufficient to handle anticipated expenditures. It is becoming common for the contract to acknowledge a three- to five-year planning cycle for these items to facilitate strategic and cash planning.

Summary

Management contracts have become much more substantive and sophisticated over the past fifty years—and particularly in the past two decades. What was once a relatively straightforward agreement for one company to manage a hotel on behalf of another has become a multiple-contract set of agreements that require significant experience to negotiate and understand. Management contract practice has advanced substantially, and contemporary contracts deal with a myriad of issues—notably, real property rights; intellectual property rights; hotels as financial assets; hotels as operating businesses; and the needs of owners, operators, and (increasingly) lenders. Contract provisions must be written to anticipate the needs of a property over a long time horizon—an average of twenty-five years for branded hotels and frequently as long as fifty years or more. As case law has modified the interpretation of management contracts, the parties have revised them to reflect those legal precedents. The many influences, issues, and parties involved make hotel management contracts among the most complex property management contracts in commercial real estate.

Decisions made during the negotiation and administration of a management contract can have large, lasting effects on a hotel, especially since those contract provisions are essentially the defining relationship for any given hotel. The rapid evolution of management contracts and the quick response of the parties to changing market conditions make careful study of contemporary management contracts an important topic for every hotel owner, operator, and lender. The next issue of *Cornell Hospitality Quarterly* will extend the analysis of this article to examine future trends in management contracts.

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