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## Calculating Damage Awards in Hotel Management Contract Terminations

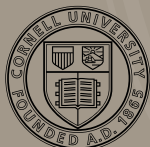
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# Calculating Damage Awards in Hotel Management Agreement Terminations

by Jan A. deRoos and Scott D. Berman

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## EXECUTIVE SUMMARY

**W**hen a hotel management agreement is terminated without the consent of the manager, the law clearly allows the manager to recover damages (from the owner) as a result of the termination. In most cases, the owners and managers resolve their issues without litigation. For the substantial number that cannot agree and thus must be adjudicated, the courts have supported solid estimates of forgone fees for determining damage awards, based on careful, defensible calculations of the hotel's performance during the prospective contractual period. The methodology outlined in this paper provides a way to establish with reasonable certainty the damages that occur from the involuntary termination of a hotel management agreement. While many hotel management agreements contain a liquidated damages clause that establishes the termination fee when the parties agree to terminate the contract, these liquidated damages clauses are not applicable in a situation where the hotel management agreement is terminated even though the manager has not breached the contract. This report provides a numerical example demonstrating that the actual damage amount is at least twice and potentially five times the amount of a typical termination fee. An analysis of recent court cases shows that the courts accept the methodology proposed here, although they may debate the assumptions that underlie the calculations (such as the anticipated inflation rate). What courts will not accept are unsupported estimates and certain expense claims not expressly found in the contract language.



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## ABOUT THE AUTHORS



**Jan deRoos**, Ph.D., is the HVS Professor of Hotel Finance and Real Estate and an associate professor at the Cornell University School of Hotel Administration. On the faculty of the Hotel School since 1988, he has devoted his career to hospitality real estate; with a focus on the valuation, financing, development, and operation of lodging, timeshare, and restaurant assets. He is founding director of the Center for Real Estate Finance and founded the undergraduate Minor in Real Estate at Cornell University. He teaches courses in the SHA undergraduate and graduate degree programs, teaches extensively in the Executive Education programs, and has developed an on-line professional Certificate in Hotel Real Estate Investments and Asset Management. His most recent work includes publications in the *Journal of Real Estate Research*, the fourth edition of *The Negotiation and Administration of Hotel Management Contracts*, co-authored with James Eyster, the third edition of the Hotel Valuation Software, co-authored with Stephen Rushmore, and chapters in the most recent editions of *Hotel Asset Management: Principles and Practices* and *Hotel Investments: Issues and Perspectives*, both published by the American and Hotel Lodging

Association.

**Scott D. Berman** has over 30 years experience, the last 22 years with PwC, where he is currently the industry leader for the hospitality and leisure sector, providing real estate advisory services on a multitude of leisure time and tourism related projects including, but not limited to hotels and resorts of all types, timeshare and vacation ownership, recreational facilities such as spas and marinas, cruise ships, casinos, theme parks and other public assembly facilities. He has extensive experience in dealing with complex business issues as a financial consultant, expert witness, and arbitrator. Mr. Berman has been a qualified as a lodging industry subject matter expert on dozens of cases at both the Federal and State levels and has testified before several international tribunals.

Mr. Berman is also a frequent speaker at major industry conferences including those of the Urban Land Institute, ALIS & The American Hotel & Lodging Association, AICPA, New York University Investment, and has spoken at the Dean's Distinguished Lecture Series at the Cornell University School of Hotel Administration. Mr. Berman is an active member of the Urban Land Institute Hotel Development Council (HDC) and its former Chair; a member of the Advisory Board of the Cornell University Center for Hospitality Research and the Center for Real Estate and Finance; Chairman of the Industry Relations Committee for the Greater Miami and the Beaches Hotel Association; and a member of the International Society of Hospitality Consultants. He is a former member of the Board of Directors of the American Resort Development Association. He has appeared on CNN and CNBC as a leisure industry expert and is frequently quoted on hospitality issues in *The Wall Street Journal*, *USA Today*, *The New York Times*, *Forbes*, and a variety of industry publications.



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# Calculating Damage Awards in Hotel Management Agreement Terminations

by Jan A. deRoos and Scott D. Berman

The “great recession” that followed the financial panic of 2008 produced strains in the relationships between hotel owners and management firms that continue to play out—often with hotel operators finding that their management agreement may be terminated against their will and outside the provisions of the contract.<sup>1</sup> The majority of these cases involve one of two “involuntary termination” scenarios:

- A dispute between the hotel owner and operator in which the owner is attempting to terminate the management agreement, or
- A hotel bankruptcy proceeding in which creditors or a bankruptcy judge seek to terminate the management agreement as part of the bankruptcy proceeding.<sup>2</sup>

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<sup>1</sup> In instances where the operator co-invests with the owner, the relationship is more complicated. Case law treats these instances as agency coupled with an interest, which makes it much harder to terminate the hotel management contract (HMA).

<sup>2</sup> Four recent HMA termination actions are found in the opening paragraph of “United States: Hotel Management Agreement Termination Disputes: Is there Shelter from the Storm”, Allison McCarthy, Holland & Knight, October 18, 2013 ([www.hklaw.com/publications/Hotel-Management-Agreement-Termination-Disputes-Is-There-Shelter-from-the-Storm-10-15-2013/](http://www.hklaw.com/publications/Hotel-Management-Agreement-Termination-Disputes-Is-There-Shelter-from-the-Storm-10-15-2013/)). Quoting from the article:

In the wake of *Fairmont v. Turnberry* and *M Waikiki LLC v. Marriott Hotel Services* in 2012, the hospitality industry was abuzz about the dramatic ousters of the hotel operators by the hotel owners. The sensational events attracted even non-lawyers to read about these cases. A debate raged about whether a hotel owner should have the power to terminate a hotel management agreement at will, without notice or cause, and the effect this power would have on the hospitality industry, where the revenue streams from hotel management agreements are a key component in the valuation of brand management companies. As the hospitality industry reconsidered its business model in response to these cases, the setting continued to change as a result of the recent holdings in *Marriott International v. Eden Roc and RC/PB, Inc. v. The Ritz Carlton Hotel Company*.

Both of these scenarios became much more common in the economic downturn, with owners who face financial pressure being much more likely to exercise their options to terminate. In June 2014, we conducted a Bing search on the terms “hotel management (contract or agreement) termination,” which returned 484,000 hits on the web and 25,800 results in news articles related to the phenomenon. The news articles are heavily concentrated in the periods following the two most recent economic downturns, the period from 2001 through 2003 and again from 2009 to 2012, but they are found around the world. For instance, an Indian hotel publication wrote: “... the key reasons for the termination of operator agreements are poor operator owner relationship, and most of the time it’s emotional disconnect. Both parties may have merit in their side of argument but fail to find alignment.”<sup>3</sup>

The use of management contracts for hotels grew substantially after the 1930s, replacing an earlier model in which owners would lease their properties to management firms. As investor risk aversion and regulation decreased, owners significantly reduced their practice of leasing hotels, preferring to use a management contract in lieu of the lease.<sup>4</sup> Through the use of management agreements, operating companies historically took the role of agent and were paid a negotiated management fee (typically comprising base and incentive fees). In this arrangement, owners bear more risk than in a fixed lease arrangement with an operator.<sup>5</sup>

For the purposes of this discussion, a key aspect of management contracts is their longevity. Some contracts have terms of up to 100 years for the best managers. Even contracts that fall short of a century can be quite lengthy. In *The Negotiation and Administration of Hotel Management Contracts*, Eyster and deRoos find that the average contract term for a branded operator is 36 years (a 16-year initial term and two ten-year renewals that can be extended unilaterally at the operator’s option), and the averages are 14 years

for independent operators managing full-service hotels and 19 years for independent operators managing select-service hotels.<sup>6</sup>

If all goes well, the lengthy terms create stability for both parties. However, the long terms also raise the question of how to compensate the manager if the owner finds it necessary to terminate the contract. Many contracts have explicit language regarding manager compensation should the contract be terminated per the terms of the contract—usually for cause, with termination fees of up to four times the most recent annual fee.<sup>7</sup> Few contracts grant the owners the right to terminate contracts without cause, however. A majority of contracts do grant the owner the right to terminate contracts upon sale of the hotel, and lenders often have the right to terminate the contract upon foreclosure.

Involuntary termination scenarios universally fall outside of any contract, and calculating termination fees in these cases calls for a different methodology than found in contract termination clauses. In general, operators feel that they should be made whole financially, and when long terms remain on a contract, the operator’s loss of fees is significantly larger than the for-cause termination fees found in contracts. We must emphasize that most owners and management firms are able to settle their differences without judicial intervention. However, given the number of disputes that end up in court, the analysis presented here is valuable for the industry.

Further, based on recent court decisions, it is clear that there is little in the lodging literature to guide those seeking to prepare an estimate of damages, despite a clear legal standard used by courts to deal with damage recovery in contract breaches.<sup>8</sup> Building on recent court decisions and other termination events, this article with its related spreadsheet tool seeks to close the gap in the literature by providing a reasonable methodology for preparing an estimate of damages in the case of an involuntary termination. Our proposed methodology, called the present value method, is distinct from the multiple method used to calculate termination fees in many contracts. As part of this analysis, we offer a numerical example that will allow users to employ the present value method that we describe. We hope the methodology will become widely used and cited within the industry, and we are making the Excel-based tool available on request to author de Roos (jad10@cornell.edu).

<sup>3</sup> “Hotel Change-Overs: The nouveau trend,” Hospitality Biz India.com, April 14, 2014.

<sup>4</sup> See: George O. Podd and John D. Lesure, *Planning and Operating Motels and Motor Hotels* (New York: Ahrens, 1964): “In the 1930s and later, several professional management organizations specialized in the operation of hotel properties on a fee basis. Recently we have noted similar contracts negotiated in the motor hotel field” (p. 199).

<sup>5</sup> The authors acknowledge the considerable literature and controversy regarding the owner’s agent in hotel management agreements. For example, see: Eyster and deRoos, *The Negotiation and Administration of Hotel Management Contracts*, 4th edition, (New York: Pearson Custom Publishing, 2009); K. McDaniel, “Current issues in the negotiation of hotel management agreements,” in *Modern Real Estate Transactions*, ed. M.T. Carroll (Philadelphia: American Law Institute/American Bar Association, 2005), pp. 597-646; and J.S. Renard and K. Motley, “The agency challenge: How Woolley, Woodley, and other cases rearranged the hotel-management landscape,” *Cornell Hotel and Restaurant Administration Quarterly*, Vol. 44, No. 3 (2003), pp. 58-76.

<sup>6</sup> Eyster and deRoos, p. 59.

<sup>7</sup> *Ibid.*, p. 77.

<sup>8</sup> While each state in the U.S. has slightly different legal standards, in general the courts allow recovery in the amount necessary to place the manager in the same position it would have occupied had the breach not occurred. This is generally interpreted as the net profits, not gross revenues. In the case of HMAs there is disagreement over precisely what revenues are forgone, and which expenses need to be deducted in order to arrive at an estimate of net profits.

## Recent Hotel Management Agreement Termination Disputes

As we said, the wave of involuntary operator dismissals was in the main a fallout of the global recession caused by the financial panic of 2008. At many hotels, demand collapsed along with revenues, strangling the cash flows to owners and causing financial distress. Faced with financial straits, hotel owners took a variety of actions, including termination or threatened termination of the operating firms' hotel management agreement (HMA). Below is an annotated list of recent examples of hotels with pending or completed HMA terminations. For each of these, it is clear that the manager had an interest in preparing a claim representing the losses due to the termination.

- The Paris Hilton Hotel became L'Hotel du Collectionneur Arc de Triomphe in August 2012. Details are not available, but we are certain that Hilton prepared a damages claim as a result of this HMA termination. However, a French commercial court found in favor of owner SIHPM in ending the HMA.
- The Eden Roc Renaissance Miami Beach was renamed the Eden Roc Hotel, Miami Beach in July 2013. Litigation to terminate the HMA has resulted in a change of management, and Renaissance has litigation pending for damages resulting from the termination.
- The Shelbourne Dublin, A Renaissance Hotel also was involved in a termination. Litigation to terminate the HMA was initiated in 2008 and resolved in 2010.
- Edition Waikiki is now the Modern Waikiki, as of September 2011. According to court documents, Marriott claimed damages from HMA termination of \$72.0 million, and was awarded \$20.7 million, a decision which is under appeal. The \$20.7 million figure translates to \$58,600 per key or about 18 times the estimated 2013 management fee.
- Four Seasons Aviara is now the Park Hyatt Aviara. The Four Seasons management was removed from the hotel in 2009, and compensation issues were settled via arbitration in 2011, including an order from the arbitrator for the owner to compensate the manager for the termination of the HMA, according to published sources.
- Fairmont Turnberry is now the Turnberry Isle, an Autograph Collection Hotel, as of August 2011. In October 2011, U. S. District Judge Graham issued an order allowing a change of manager, but acknowledged the manager's right to a damages award. In this order, the damages alleged as a result of the HMA termination are estimated

### EXHIBIT 1

#### Damages attributable to a hotel management contract termination

- Lost base and incentive management fees at the terminated hotel,
- Lost contributions to system reimbursable expenses at the terminated hotel,
- Loss of working capital, loan, or other investment in the terminated hotel,
- Loss of valuable employees,
- Loss of investments in the hotel, such as key money, loans, or working capital,
- Damages that result from ceasing business operations at the terminated hotel,
- Damage to the operator's reputation in the market containing the terminated hotel,
- Damage to the operator's reputation across the system, and
- The direct costs necessary to re-enter the market containing the terminated hotel.

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to be approximately \$30.0 million, which translates to \$76,500 per key.<sup>9</sup>

- The former Hyatt Regency in Dearborn, Michigan, is the subject of an HMA termination. On January 22, 2014, owner Royal Realities served a 30-day notice to terminate the management agreement of Atmosphere Hospitality. The matter is currently under litigation.
- The St. Regis Hotel & Residences, Fort Lauderdale, became a Ritz-Carlton, and after lengthy litigation, the Sheraton Operating Company was ordered to reimburse owner Castillo Grand for certain damages resulting from what a court determined was improper contract termination, after a dispute regarding non-payment of a fee.

#### Establishing a HMA Termination Claim via the Present Value Method

In these examples of HMA terminations, the manager seeks to be made whole. But the managers in these cases have used various unspecified methods for quantifying the damages. In this paper, we propose a methodology to estimate the economic loss to the manager as a result of the contract termination by directly estimating the dam-

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<sup>9</sup> The court record gives no calibration on the resort's revenues or the annual management fee. We estimate that the \$30 million figure is between 15 and 20 times the annual management fee.

### Methodology for estimating damages in a management contract termination

- (1) **Establish the Period Covering the Loss**—The starting point for all damage estimates is the period covering the loss, which is the remaining term of the contract, plus the term expected from any renewal options in the contract or a reasonably expected renewal.
- (2) **Estimate Property Level Performance**—Lost management fee revenues and other contributions are a function of the expected performance of the terminated hotel; thus hotel revenues and expenses must be estimated over the period covering the loss.
- (3) **Estimate Gross Lost Fee Revenue**—Three categories of revenue loss are estimated using the estimates of property performance over the period covering the loss:
  - o **Base fees**—generally based on hotel revenues,
  - o **Incentive fees**—generally based on hotel profitability, and
  - o **Other contributions by the owner**—these include marketing fees, reservation fees, shared accounting services, shared marketing costs, shared regional management, training costs, and similar items enumerated in the management contract.
- (4) **Estimate Avoided Costs**—The gross lost revenue estimates need to be adjusted for any costs so that only the net lost fees are used in the economic loss calculation. The appropriate adjustment is to consider the actual marginal costs avoided, not average costs avoided.
- (5) **Determine Present Value of the Net Fee Losses**—The lost fees (adjusted for avoided costs) are discounted using an appropriate discount rate to establish a present value at the time of the termination.
- (6) **Estimate of Other Damages**
  - o **Investments in the Hotel**—The damages may include the recovery of investments in the terminated hotel. These include working capital, key money or loans to the owner or the property, adjustments necessary to reconcile accounts receivable and accounts payable, provisions for future claims from former guests, or other direct investments.
  - o **Human Capital Damages**—Damages can include the costs related to the lost costs of recruitment, training, and professional development, and the cost of severance packages for the existing staff, as well as the costs to recruit, train, and develop new employees for reentry into the market.
  - o **Reputation Damages**—Reputation damages result from the loss of reputation among guests, both at the unit level and system wide. Perhaps even more germane, reputation damages should be considered with the community of hotel owners, the community of hotel lenders, and the community of hotel operators.
  - o **Damages Due to Reentry**—Damages due to the cost of reentry into the market include the costs to identify a suitable property, negotiate a contract, and staff, train employees, and prepare the property for operation.
- (7) **Total the Damages**—The sums from 5 and 6 are added to produce a total estimate of damages.

ages. This section presents guidelines for an orderly, efficient approach to producing a damages estimate, consistent with established case law for contract damages. We start with an exhaustive list of broad categories of damages, as shown in Exhibit 1, on the previous page. These include not only the loss of expected fees and other revenues at the terminated property, but also damages to reputation, human capital, and the costs of reentry.

### Monetizing the Damages

Because the damage estimate will likely be adjudicated during litigation or arbitration, it is important to establish a realistic perspective on what is possible to recover when one uses the methodology outlined in Exhibit 2. The courts sup-

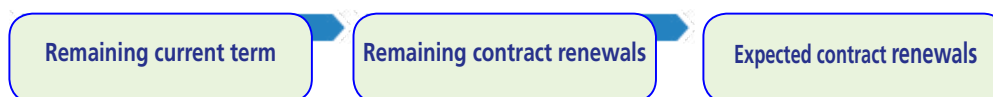
port the use of the present value methodology found in steps one through five. The damages outlined in step six, while real, are much more speculative and much more difficult to support in court. Courts are uniformly hostile to awarding speculative damages or to awarding damages that have little support in their estimate. Only to the extent the damages are monetized are they recoverable, and further, only when the damages are supported by clear and convincing evidence will they be awarded.

### Step 1—Establish the Period Covering the Loss

The period covering the loss is broken into three categories, each with its own probability of occurrence, as we



## Elements for calculating period of management company fee loss



depict in Exhibit 3. The reason for the three time periods is that the probability of a manager's continuing as operator varies at different points in the contractual relationship. For the remaining current term, for instance, the probability that the manager would have continued is 100 percent, since the manager is almost certain to have continued, absent a breach of the contract.<sup>10</sup>

The probability that the manager would have continued in place for the remaining contractual renewals depends on the contract's language. In most cases, however, this probability approaches 100 percent, because many contracts provide that the manager has the unilateral right to renew the contract absent any breach. These clauses are often tempered with language giving the owner the right to terminate if certain performance hurdles have not been achieved, and thus the probability of continuation needs to be tempered by this fact, if such language appears. Otherwise, we estimate that the expected probability of contract renewal is 100 percent.

When considering the category of expected contractual renewals in contracts with bilateral renewal rights, we enter the realm of speculation. To make these estimates as solid as possible, the large global branded operators and hospitality consultancies have excellent historical information on renewal rates and terms which can be used to calibrate the probability of renewal.

Thus, the total period covering the loss can extend for 20 years or more, especially when the contract renewals are considered. The importance of establishing the period covering the loss as the first step is shown next, so that the calculations are based on the time frame over which the property level performance must be forecast.

### Step 2—Estimate Property Level Performance

This portion of the work involves a classic market study and estimate of future financial performance over the time period established in step 1. The analytical framework for this work is well documented, with an established proce-

dural foundation.<sup>11</sup> We start with a forecast of occupancy percentage and average daily rate (ADR), and from these, we can forecast revenues and expenses to establish expected profitability over time. A careful analysis will account for changes in occupancy and ADR over the time period, as well as the impact of changes in occupancy on the fixed and variable expenses of the property. Most established methodologies can reasonably estimate property performance for a five- to ten-year period. Then, for the remainder of the time period in the analysis, we can use equilibrium or stabilized results adjusted for future inflation.

The equilibrium approach is needed because the longer the period, the greater the challenge in estimating the results, particularly when the period covering the loss extends beyond a decade. In general, the most defensible way to forecast long-term performance is to establish a long-term equilibrium occupancy and average rate, and then project future performance by forecasting the annual impact of inflation on each revenue and expense category within the equilibrium. The use of a long-term equilibrium is reasonable; the notion is to establish the occupancy percentage and average daily rate that would exist if the supply and demand for transient lodging accommodation is balanced.

### Step 3—Estimate Gross Lost Fee Revenue

Estimates of lost fee revenue come from the application of the fees scheduled in the HMA to the annual property level performance data that are calculated in step 2, starting with the gross base fee, which is almost universally a simple percentage of total hotel revenues.

The incentive fee is based on a contractual definition of profitability, which in most contracts is adjusted gross operating profit (known as "Income Before Fixed Charges" in the *Uniform System of Accounts for the Lodging Industry*), less any base fee. Some contracts subordinate the incentive fee to cash flow after the "owner's priority."<sup>12</sup> The analysis proceeds by estimating profitability according to the definition in the HMA and then applying the appropriate fee calculation. In this estimate as in the others, it is important that the analyst

<sup>10</sup> The probability of continuing is less than 100 percent if the contract gives the owner the unilateral power to cancel the contract at any time, generally subject to the payment of a termination fee. For the purposes of this paper, this power is moot, as we are modeling the economic losses to the manager due to an actual or alleged breach of the HMA.

<sup>11</sup> See, for example: Hotel Valuation Software at the Cornell University School of Hotel Administration: [www.hotelschool.cornell.edu/research/chr/pubs/tools/hvstool.html](http://www.hotelschool.cornell.edu/research/chr/pubs/tools/hvstool.html)

<sup>12</sup> Cash flow after the owner's priority is a measure of profitability that makes the incentive fee subordinate to a minimum return to the owner.

not take any liberties with the language contained in the HMA when calculating the annual incentive fee losses. As we discuss in greater detail below, courts are not patient with inappropriate estimates.

The other contributions by the owner include contractual items such as marketing fees, reservation fees, shared accounting services, shared marketing costs, shared regional management, and fitting cost. Again, the key to estimating these figures is carefully reading and applying the language in the HMA to the estimated property performance figures. Since conjecture has no place in this estimate, the best practice calls for the projections to be limited to those fees that are specifically outlined in the HMA and can be readily estimated.

The sum of the three figures—lost base fees, lost incentive fees, and lost other contributions—provide the basis for the next step, which is to adjust the fee estimate and calculate the present value of those estimated net losses.

#### Step 4—Estimate Avoided Costs

The lost-fee estimate from step 3 needs to be adjusted because there may be costs that the manager will avoid due to the fact that the hotel is no longer in the manager's system. Here is another analysis that should carefully estimate only those marginal costs that will be avoided, and not merely apply average costs. Since the entire damages estimate outlined in this article seeks to calculate the marginal economic losses to the manager as a result of the HMA termination, any examination of avoided costs must consider only the marginal costs avoided. This calculation acknowledges the fact that the manager will only avoid those costs that are directly attributable to the loss of the subject property in the manager's system. The result of this calculation is the annual net fee losses to the manager.

The analyst preparing the claim should proceed in a manner that anticipates that this section of the damages claim may be challenged on two counts; first the claim may underestimate avoided costs, and second, the claim may omit avoided costs that should be included. The authors' experience with the preparation of such claims suggests that courts have little patience for inflated cost avoidance claims or the omission of legitimate avoided costs.

#### Step 5—Calculate the Net Present Value of Losses

In this step the annual net fee losses from steps 3 and 4 are discounted to the present using an appropriate discount rate and standard discounted cash flow methodology. It is universally accepted that the base fees and other contributions are discounted at a rate significantly less than incentive fees. The reason is that base fees and other contributions are considered inherently less risky than incentive fees, which are derived profits rather than revenues. The following

principles apply to the choice of a discount rate. First, the discount rate should not be the firm's equity cost of capital nor should it be the firm's cost of debt capital. Neither of these represents the true weighted average cost of capital (WACC) to the firm. By calculating the weighted average cost of capital with appropriate risk adjustments as necessary, we develop a useful benchmark that is the firm's true cost of capital. Appropriate adjustments can be then made from this benchmark. The following specific guidelines explain the application of WACC for discounting base fees, incentive fees, and other owner contributions.

**Base fees.** The WACC is the appropriate discount rate for the base fees, as these flows are the least risky flows to the firm. It could even be argued that for certain assets in gateway markets these flows should be discounted at less than the WACC, as these flows are less risky than average.

**Incentive fees.** The WACC plus a risk premium is appropriate for the incentive fees, as these fees are subject to more risk. In general, this risk premium is between 300 and 600 basis points above the WACC.

**Other contributions.** The WACC is appropriate for the other contributions, as these flows are based on revenues, not profits.

#### Step 6—Estimate Other Damages Related to HMA Termination

Calculation of the other damages is more complex. For investments in the terminated hotel (as outlined in Exhibit 2), the analyst must include only those items that are clearly identifiable. The loss of investment in human capital is clearly included here. The cost of reputation damages or damages to goodwill are difficult to quantify, but we consider them important to include in a damages claim, especially if the HMA termination has received extensive press coverage that negatively reflects on the manager. Finally, the analyst will have to estimate the cost to the management firm of finding another property to reenter the market. This expense will be greater in a market that has high barriers to entry.

Once again, we caution the analyst to include only those costs directly related to the loss of the hotel as a result of the termination, which will be presented as a lump sum for each item. In summary, in preparing the claim, it is important to discount future losses with the proper methodology.

#### Step 7—The Final Damages Estimate

The final damages estimate is the sum of the present value of the net fee losses from step 5 plus the damages calculated in step 6. The analyst should carefully review the total and check all assumptions to make sure the numbers are reasonable. While this final step is just mathematics, it is nevertheless driven by the assumptions made in steps 1

**EXHIBIT 4****Average full service hotel statistics in 2012**

<b>Number of Rooms</b>	296
<b>Occupancy Percentage</b>	71.0%
<b>Average Daily Rate</b>	\$157.47
<b>Total Revenues</b>	\$61,233 per available room
<b>Income Before Fixed Charges</b>	\$19,108 per available room 24.7% of total revenues
<b>Net Operating Income<sup>1</sup></b>	\$15,128 per available room 18.9% of total revenues
<b>Capitalization Rate</b>	8.02%
<b>Valuation (by Capitalizing 2012 NOI)<sup>2</sup></b>	\$188,600 per available room

<sup>1</sup> This is the amount available before debt service or other capital obligations. This figure is net of a deduction for a "Reserve for Replacement" of \$1,191 per available room (1.9% of total revenues).

<sup>2</sup> This valuation is most likely low as a 2012 valuation would properly rely on a 2013 Net Operating Income. However, we believe that the 2012 Net Operating Income reasonably represents a stabilized figure and are comfortable with the figure.

through 6, which are a logical extension of the generally accepted methods used to estimate future hotel performance.

## A Numerical Example

### Using the Present Value Method

To demonstrate the present value method that we have explained in this article, we present the results of an Excel model to estimate the damages for contract termination for a typical chain-affiliated full-service hotel in the United States. Our figures come from the STR HOST Almanac 2013, U.S. Hotel Operating Statistics for the Year 2012.<sup>13</sup> Other parameters come from the data for the fourth quarter of 2012 found in the PwC Real Estate Investor Survey published in the first quarter of 2013. According to the HOST publication and the PwC Real Estate Investor Survey, the average full-service chain-affiliated hotel in the United States had the operating characteristics outlined in Exhibit 4.

The Excel model relies on the widely available Hotel Valuation Software (available elsewhere on this website), combined with a proprietary software model developed for

<sup>13</sup> Quoting from the STR website: "The Hotel Operating Statistics (HOST) program is the most extensive and definitive database on U.S. hotel industry revenues and expenses. The operating statements of more than 6,100 hotels have been entered into this database, giving STR the capability to produce custom reports tailored to a variety of client needs. HOST contains information on hotel revenues and expenses and presents information by department including rooms, food & beverage, marketing, utility costs, property and maintenance, administrative & general as well as selected fixed charges."

**EXHIBIT 5****Assumptions for HMA termination claim example**

<b>Period Covering the Loss</b>	25 years with no extensions
<b>Property Level Performance—2012</b>	From the HOST Report—2012 Results with line item detail per available room
<b>Property Level Performance—2013 and beyond</b>	Hotel Valuation Software
<b>Inflation on Revenues and Expenses</b>	3.0% for all line items in all years
<b>Base Fee<sup>1</sup></b>	3.0% of Total Revenues
<b>Avoided Costs, reducing the claim</b>	20% of Base Fees
<b>Incentive Fee<sup>2</sup></b>	8.0% of Income Before Fixed Charges Minus the Base Fee
<b>Other Contributions</b>	None; it is assumed that any lost revenues are accompanied by an equal reduction in costs.
<b>Weighted Average Cost of Capital (WACC)<sup>3</sup></b>	9.04%
<b>WACC Premium for Base Fee</b>	1.0%
<b>WACC Premium for Avoided Costs</b>	1.0%
<b>WACC Premium for Incentive Fee</b>	6.0%
<b>Other Damages<sup>4</sup></b>	\$0.00

<sup>1</sup> Calibration for the base and incentive fees come from Eyster and deRoos, *The Negotiation and Administration of Hotel Management Contracts*, Exhibit III-6, p. 66.

<sup>2</sup> The proprietary model is able to easily model an incentive fee that is based on income before fixed charges, or an incentive fee based on cash flow after an owner's priority return.

<sup>3</sup> A WACC of 9.04% is the average of the WACC's reported by Bloomberg for Accor (9.0%), Choice (7.9%), Hilton (5.1%), Hyatt (10.3%), InterContinental (9.6%), Marriott (9.7%), Starwood (12.2%) and Wyndham (8.6%) on Tuesday, February 4, 2014.

<sup>4</sup> Other damages in this instance include nothing for key money, loan advances, recovery of working capital, reconciliation of current accounts, future claims, system wide effects, and the cost of reentry. Actual cases would range of up to \$20,000,000 or more in some cases.

this article. Using this model, we prepared a damages claim as described above. As the analysis relies heavily on the analysts' assumptions, we present the major assumptions for this example in Exhibit 5.<sup>14</sup>

The model produces a total management fee calculation of \$994,000 in the first year of operation, along with cost savings of \$109,000, for a net cash damage of \$885,000. Over

<sup>14</sup> The full model is available upon request from co-author deRoos.

## Average chain-affiliated full-service property hotel management fee calculation and valuation

Categories of Claimed Damages	Detail & Backup	Cash	Cash Value	Present	PV		
		Total (\$'000)	Per Key	Value (\$'000)	Per Key		
<b>Basic Fee</b>	Proforma Sheets	\$ 19,878	\$ 67,157	\$ 6,262	\$ 21,154		
	Basic Fee Sheet						
	PV Calcs Sheet						
<b>Cost Savings</b>	Basic Fee Sheet	\$ (3,976)	\$ (13,431)	\$ (1,252)	\$ (4,231)		
	PV Calcs Sheet						
<b>Incentive Fee</b>	Proforma Sheets	\$ 16,357	\$ 55,261	\$ 3,492	\$ 11,796		
	Basic Fee Sheet						
	PV Calcs Sheet						
<b>Other Contributions</b>	Proforma Sheets	\$ -	\$ -	\$ -	\$ -		
	Basic Fee Sheet						
	PV Calcs Sheet						
<b>Other Damages</b>							
Recovery of Key Money	If Applicable		\$ -	\$ -	\$ -	Include items here as appropriate, modify as needed.	
Recovery of Loan Advances	If Applicable		\$ -	\$ -	\$ -		
Recovery of Working Capital	If Applicable		\$ -	\$ -	\$ -		
Reconcile "Payables" and "Receivables"	If Applicable		\$ -	\$ -	\$ -		
Provision for Future Claims							
Luggage	If Applicable		\$ -	\$ -	\$ -		
Guest Accident	If Applicable		\$ -	\$ -	\$ -		
Deposits	If Applicable		\$ -	\$ -	\$ -		
System Wide Affects							
Reputation at Subject Hotel	If Applicable		\$ -	\$ -	\$ -		
Reputation within Consumer Market	If Applicable		\$ -	\$ -	\$ -		
Reputation within Owner/Franchisor Market	If Applicable		\$ -	\$ -	\$ -		
Cost of Market Re-Entry	If Applicable	\$ 1,000	\$ 3,378	\$ 1,000	\$ 3,378		
	<b>Grand Total (\$'000)</b>	\$ 33,260		\$ 9,501			
	<b>Grand Total per Key</b>		\$ 112,364		\$ 32,097		

the 25-year period covering the loss, the present value of the damages is \$9,501,000 or \$32,100 per room, as summarized in Exhibit 6. Given that typical management agreement language provides for a termination fee of up to four times the most recent 12-month management fee, the methodology presented in this article produces a damages estimate that is at least double and potentially up to ten times the amount found in a typical termination clause. For this reason, it is important that managers be aware of the methodology and its use when facing involuntary termination.

### Commentary on Recent Cases Using the Methodology

We offer commentary on the following four recent cases, which illustrate the use of the methodology presented above when an owner has breached the contract. These cases are just a small sample of numerous cases involving contract cancellation. The fourth case is an exceptional situation where the operator was found to have breached the agreement by early termination. The cases are:

*In Re MSR Resort Golf Course, LLC*, No. 11-10372 (SHL) (Bankr. S.D.N.Y. Aug. 10, 2012) and *In Re MSR Resort Golf Course, LLC*, No. 11-10372 (SHL) (Bankr. S.D.N.Y. Aug. 23, 2012).

Proceeding on August 10, 2012, and supplemental bench ruling regarding debtors' motion for an order estimating the damages from rejection of Hilton's management agreements on August 23. The debtors seek an estimate of the damages Hilton would sustain if the debtors reject three management agreements. The management agreements relate to three properties: the Arizona Biltmore Resort & Spa in Phoenix, Arizona; the La Quinta Resort and Club PGA West in La Quinta, California; and the Grand Wailea Resort Hotel & Spa in Maui, Hawaii.

*In Re M. Waikiki, LLC* No. 11-02371, Re: Docket No. 537 (Bankr. D. Haw. May 29, 2012).

Amended findings of fact and conclusions of law on estimation of Marriott claim at the former Edition Hotel in Waikiki, Hawaii

*FHR TB, LLC v. TB Isle Resort, LP*, 865 F. Supp. 2d 1172 (S.D. Fla. 2011).

Motion for injunctive relief to reinstate Fairmont Hotels and Resorts as the manager of the Turnberry Isle Resort in Aventura, Florida. While the motion was denied, the court addressed the matter of the claim for damages as a result of the termination of the management agreement.

*Sheraton Operating Corp. v Castillo Grand*, NY Slip Op 52438(U).

In a series of actions, courts dismissed Sheraton's request for payment of a \$3 million project license fee and \$200,000 in attorney fees, which it had claimed after issuing a termination notice based



on the assertion of violation of certain contract provisions. The court held that the owner was not obligated to pay the fee. Although the court granted some of Sheraton's claims, damages awarded to Castillo exceeded \$30 million, including interest on a construction loan, various pre-opening fees, and loss of property value, among other costs.<sup>15</sup>

At the outset, it is important to note that the first three of these are bankruptcy cases, and the fourth arose during the 2008 financial panic. We must acknowledge that bankruptcy law and procedure are quite different from typical litigation, and the *Castillo Grand* case had numerous contract issues for the court to resolve. However, given that the parties to most termination cases settle their differences via arbitration or other private means, these cases are the only publicly available documents that provide a glimpse into judicial thought on the methodology.

The remainder of this analysis focuses on the three bankruptcy cases, in which the owner dismissed the manager. In all three cases, the court found that the law allows recovery of damages in an amount that would make the manager whole absent the termination of the HMA.<sup>16</sup> Also in all three cases, the hotel manager prepared a damages claim that followed the broad outline of the net present value methodology to establish a claim with reasonable certainty. The methodology presented in this paper was accepted by the courts as a reasonable way to estimate the economic loss suffered by the manager as a result of a management contract termination. That is, the court accepted that the calculation of the present value of the fees forgone as a result of a termination is an appropriate way to estimate the economic loss. In no case did the court duplicate a standard cancellation fee approach by imposing a multiple of the most recent twelve-month management fee as an alternative methodology for estimating a damages claim. However, in each case the various courts took issue with the assumptions and details of how the claims were prepared. The courts seemed to pay particular attention to discount rates and "other fees." An important aspect of every claim is the use of experts to

prepare and corroborate the claims. The courts are uniform in relying heavily on the testimony of experts in accepting claims and are equally dubious of claims prepared solely by the claimant and objections raised by defendants.<sup>17</sup>

With these points in mind, we examine the various comments and objections brought by the court and the opposing parties. These are organized in accord with the Exhibit 2 outline.

**Period covering the loss.** In all cases, the courts accepted that the period covering the loss was the contract term as enumerated in the contract, including both the initial term of the contract and any renewals that were specifically detailed in the contract. In no case did the claimant attempt to include any extensions beyond those specifically contained in the contract, so it is unclear how these would be treated.

**Estimate property level performance and the resulting lost fee revenue.** In every case the claimant prepared a claim based on an application of management fees to a projection of property level performance during the accepted period of loss. In *MHR Resort* there was a controversy related to the future inflation rate on revenues, and the court used the defendant's estimate of 2.5 percent rather than the claimant's estimate of 3.0 percent. In *M Waikiki* the court relied heavily on the claimant's ADR and occupancy projections.<sup>18</sup>

**Estimate avoided costs.** As we indicated above, the courts were consistent in applying a rule that they would consider only the marginal costs avoided as a result of the claim. Quoting from *M Waikiki* the court states: "The debtor argues that Marriott's claim for management fee should be reduced by about 35 to 45 percent for overhead expenses. I disagree with this argument.... The only expense which Marriott could reasonably avoid because of the termination of the management agreement is the travel expense for periodic visits to the hotel by Marriott central office staff. [Claimant's] estimate of this expense at \$100,000 per year is reasonable and un rebutted and I therefore accept it. ... The figure of 35 to 45 percent appears to be the amount of overhead expense which is allocated to a particular management contract for cost accounting purposes. This is the wrong standard. Cost accounting requires the allocation of all cost,

<sup>15</sup> For a perceptive discussion of *Sheraton v. Castillo Grand*, see: I.W. Sandman and R.C. Savrann, "The Lessons of *Sheraton v. Castillo Grand*," [www.sandmansavrann.com/index.php?id=150](http://www.sandmansavrann.com/index.php?id=150). Also see: *See Castillo Grand LLC v. Sheraton Operating Corp.*, 2009 WL 4667104 (SD NY 2009)

<sup>16</sup> In *MHR Resort*, the case involves hotels governed by the laws of Hawaii, California, and Arizona. The court summarized them by saying "These three states generally agreed that, in a breach of contract action, a plaintiff may recover the amount of damages necessary to place it in the same position it would have occupied had the breach not occurred. The usual recovery for the breach of a contract is the contract price or the lost profits therefrom." In *M Waikiki*, the court stated, "In order to place Marriott, the non-breaching party, in the position it would have occupied had the contract been performed, damages must include Marriott's lost profits (unpaid management fees minus expenses avoided or reasonably avoidable)."

<sup>17</sup> As an example, in *MSR Resort*, the court states "The court rejects as self-serving the only other evidence of the actual amount of corporate overhead, which was an estimate prepared by Hilton's treasurer solely for the purposes of this litigation."

<sup>18</sup> In the *M Waikiki* case the debtor objected to the long-term rejection of management fees over period of decades as being too uncertain to support the award of damages. Quoting the court "I disagree and I find that the figure set out in this decision had been cruising reasonable certainty and that there is a stable foundation for a reasonable estimate of Marriott's future damages. In some respects, the longer projection period is more reliable than a shorter. Because the longer period tends to even out inevitable variability from year-to-year."

avoidable or not, among the businesses' revenue streams. Only avoidable costs are deductible when calculating damages." Similarly, in *M Waikiki*, on the matter of corporate overhead (referring to an earlier case involving Hilton) the court states: "Even though the management agreements do not include the corporate overhead fee as part of the management fee, there is no dispute that the fee would have been earned had the debtors not rejected the Hilton management agreements."

**Present value of the fee losses.** The calculation of the present value of the fee losses elicited an extensive commentary by the court, specifically in the use of discount rates being applied.

In *M Waikiki*, the court uses Marriott's stated weighted average cost of capital of 6.5 percent plus a risk premium of 1.0 percent to discount the first seven years of base management fees. The WACC of 6.5 percent plus a premium of 7.0 percent is used to discount the remaining 43 years of base management fees and the incentive management fees. Both of these discount rates were presented to the court by the claimant, and the court accepted them.

In *MSR Resort*, the court takes a different approach. In this case the claimant seeks reimbursement for the base fee but does not seek any reimbursement for an incentive fee. After an extended discussion of the WACCs proposed by each set of experts, the court accepts the WACC of 10.6 percent proposed by the defendant. The court then uses its own estimate of a risk premium for each hotel adding 1.0 percent to the WACC for two of the hotels and 2.0 percent to the WACC for the more risky third hotel.

**Estimate of other damages.** We start with a listing of other damages claims and the court's decision on each, followed by commentary.

In *M Waikiki*, Marriott's claim included the following items:

- working capital loans—*accepted by the court*,
- bonus (severance) payments to employees—*accepted by the court*,
- loyalty program costs—*accepted by the court*,
- disputed advance deposits—*accepted by the court*, and
- guest accident claims—*denied by the court*.

In *FHR TB* the court found that the owner acknowledged that the operator would suffer damages to its brand and reputation in the event of a termination by the owner and further that damages would not be an adequate remedy. However, in balancing the claims, the court denied an injunction to prevent the termination, stating that Fairmont had the right to seek damages as a result of the termination and that an injunction was not necessary to preserve this remedy.

In *MSR Resort*, Hilton's claim includes the following items:

- brand damages—*denied by the court*,
- losses related to the defendants plan to expand the resort—*denied by the court*,
- group services expenses—*partially accepted by the court*, and
- key money—*denied by the court*.

In both *M Waikiki* and *MSR Resort*, the court was clear that the damages could flow only from those items specifically identified in the HMA. It uses this logic to deny the key money claim and the brand damages claim in *MSR Resort*. Interestingly, in *MSR Resort*, the judge cites *M Waikiki* in denying the claim for brand damages; "in that case, the court denied Marriott's request for damages to reputation and goodwill associated with the hotel owners' alleged breach of Marriott's management agreement. The Court's holding was based on the finding that Marriott presented no evidence of any damage to its brand reputation. Hilton argues that this case supports its position because the Hawaiian Court stated that its holding was without prejudice to the ultimate allowance of Marriott's claims. However, this case does nothing more than support the Court's conclusion that Hilton cannot recover such damages without proof."

## Conclusion and Recommendations

When a hotel management agreement is terminated without the consent of the manager (outside of the provisions of the management agreement), the law clearly allows the manager to recover damages as a result of the termination. Recent court actions have made it clear that the parties to such an action have vastly different opinions regarding the amount owed as a result of an involuntary termination.

The methodology outlined in this paper provides a way to establish such termination damages with reasonable certainty. While many hotel management agreements contain a liquidated damages clause that establishes the termination fee when the parties agree to terminate the contract, these liquidated damages clauses are not applicable in a situation where the hotel management agreement is terminated even though the manager has not breached the contract. While termination fees have historically been in the range of 2 to 4 times the most recent annual fees, the methodology outlined in this article seeks to estimate the present value of the damages to the manager as if the contract had not been terminated. These can easily be 10 to 20 times the most recent annual fees, depending on the remaining term of the contract.

The numerical example we provide shows how this methodology would apply to a typical full-service hotel in the United States that is entitled to an annual fee (net of avoided costs) in the amount of \$885,000 per year. If this contract had 25 years remaining, the damages estimate

would start at approximately \$9,500,000, more than 10 times the annual lost fees. This amount does not include any claim for other damages such as recovery of key money, loan advances, or working capital; provisions for future claims from guests and groups; or the system-wide effects of a termination on the subject hotel and on the hotel brand.

While the net present value methodology may not provide certainty with respect to the award of damages, it does provide a systematic and acceptable approach to this contentious topic. While each case is different in that the court may accept or reject certain items being claimed, those who follow the outline will have a good starting point from which to begin the conversation in the courtroom, in arbitration, or in mediation.

The methods advocated in this article are based on the general philosophy supported by the United States Courts. The basis of these calculations is that hotel management contracts have inherent value, and the operators need to be made whole if they are terminated prematurely without cause. While we present an overarching methodology, we close with the acknowledgment that each situation and each contract is unique. Thus, it is important for the analyst to have deep knowledge and experience in the type of hotel and its specific market so that the assumptions that drive the damages calculation have merit. ■

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