

# Termination of a Hotel Management Agreement

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March 2012

Given the time, effort and financial investment generally spent by a hotel owner in its operator selection process, and the additional time then spent by the owner and the selected operator in negotiation of the hotel management and ancillary agreements, it is fair to say that both parties intend for their relationship to endure for the length of the management term, with mutual benefit resulting from the hotel operation.

Given the time, effort and financial investment generally spent by a hotel owner in its operator selection process, and the additional time then spent by the owner and the selected operator in negotiation of the hotel management and ancillary agreements, it is fair to say that both parties intend for their relationship to endure for the length of the management term, with mutual benefit resulting from the hotel operation.

On the most part, this is the outcome. However, there are occasions where, for a variety of reasons, the relationship does not last and termination of the management agreement may be required.

This article looks at the most common provisions that might be found in a hotel management agreement, which would allow its termination, by either the hotel owner or the operator, in both contentious and non-contentious circumstances.

## (A) Termination by the hotel owner

Events that might bring about termination by a hotel owner include:

- Failure of the operator to achieve a pre-defined level of performance
- Termination at will
- Operator material breach of the management agreement
- Operator fraud/misappropriation of monies
- Operator sale/withdrawal of the brand
- Condemnation or damage to the property

## (B) Termination by the hotel operator

Events that might bring about termination by a hotel operator include:

- Owner's material breach of the management agreement
- Owner's failure to provide sufficient working capital
- Transfer of ownership of the hotel
- Owner bankruptcy, Mortgage default/foreclosure
- Condemnation or damage to the property

### **(i) Operator failure of performance test**

Inclusion in the management agreement of a well-structured performance test provides valuable security to an owner in respect of protecting it against operator incompetency, by measuring an operator's value through the performance of the hotel. Ideally, the owner will have a right of termination where the performance test is not satisfied by the operator, whether or not subject to

the operator's right to cure the failure.

Performance is best measured against profitability of the hotel, and the mechanics of how performance is to be tested are usually subject to lengthy discussions between the parties when negotiating the management agreement. The test should protect the operator from external circumstances beyond its control that could adversely affect a hotel's performance and should not generally become effective until after two to four years from the hotel opening date.

Where a performance test exists, an operator will usually insist on a right to cure through payment of the deficit between the actual performance of the hotel and the performance required by the performance test. Payment of the cure would prevent an owner from terminating the management agreement, although an owner should be careful to cap the amount of times that an operator can cure its failure, so as not to negate his protection.

### **(ii) Termination at will**

Again, this is an important provision for an owner, and its inclusion will provide an owner with maximum flexibility to support and accommodate its future plans in respect of its business or assets, or to remove an incompetent/undesireable operator.

Such a clause would allow the owner to terminate the management agreement (ideally) at any time, upon written notice, without the need to rely on any breach or particular reason. It is rare for such a protection to be available to an owner, and where agreed to by an operator, would usually be subject to the owner paying a pre-agreed compensation amount.

Such flexibility is hard to come by as operators place great value on the stability and security of their management agreements, and the negative impact to brand value that can arise from their termination. Where agreed in principle, the level of compensation amounts that would be due, will be the subject of much debate, before it is mutually acceptable to both parties.

### **(iii) Material breach of the management agreement**

Material breach by either party, of one or more of its obligations under the management agreement usually enables the non-defaulting party to terminate through issue of a termination notice.

Most management agreements will contain a period of time during which the defaulting party can cure the breach. Additionally, there may be an obligation on the parties to participate in a consultation process by both party's executive management, during which discussions must take place in order to seek and implement a remedy of the situation.

In the event that these corrective measures fail, then the non-defaulting party will be required to submit a further notice confirming termination of the agreement. Activation of the dispute resolution process, as provided for in the management agreement, may then ensue, where the recipient of the termination notice disputes the other party's ability to lawfully terminate the agreement.

### **(iv) Condemnation or damage to the property**

Where the property is severely damaged or destroyed, preventing or disrupting operation by the operator, it is usual to see a provision whereby either party may terminate the agreement. The question that arises, in the absence of total destruction, is whether the level of damage is sufficient enough to trigger a termination right, or alternatively, an obligation on the owner to repair such damage.

This provision often varies from one management agreement to another, with the control either being placed with the owner, (subject to payment of compensation to the operator where the owner

does not repair/rebuild and the management agreement is terminated), or alternatively, with the operator (who may require the owner to repair/rebuild where it believes that the hotel is not inoperative and should be restored).

#### **(v) Fraud/misappropriation of monies**

It should be remembered that the hotel's monies, at all times, belong to the owner. However, almost all management agreements provide for the operator to control the hotel's bank accounts, through designation of authorized signatories, to enable the operator's proper management of the hotel in respect of payment of operating expenses and operator fees etc. Notwithstanding this, it is not uncommon for an owner's approval to be provided in respect of certain expenditure items over a pre-agreed amount.

Misappropriation of monies constitutes a material breach of the management agreement and the entire underlying relationship between the parties, warranting immediate termination. However, it is essential to determine whether the misappropriation is down to the operator or an individual employee within the hotel acting on his/her own volition (and who, in most cases, would be the owner's employee).

#### **(vi) Failure to provide working capital**

Generally, an operator has no responsibility to provide working capital for the hotel. All funds required must be provided by the owner (particularly in respect of funds required before the hotel opens) or, additionally post-opening, from revenue generated by the hotel.

In order to properly manage the hotel and meet the hotel's debts (whether in respect of service providers or suppliers, or payroll costs etc), the operator will ensure that it has access to working capital as and when this is required, and there is usually a specific obligation on the owner to provide same where the hotel revenue is likely to be insufficient to meet these requirements.

Failure by the owner to provide such working capital as and when requested by an operator, will, subject to a period of time within which to pay same, most often enable the operator to terminate the agreement.

#### **(vii) Owner bankruptcy, mortgage default/foreclosure**

Generally, the existence of financial difficulties of either party to a hotel management is likely to cause problems. Bankruptcy of either party will usually provide the other with a specific right of termination. An operator will particularly want a right of exit in such a situation, in order to disassociate itself from the hotel (which may be suffering damage to the hotel's reputation), to protect its own brand value and reputation.

Operating a hotel where there is a default by the owner on a loan for which the hotel asset is held as security can be problematic for operators, as the threat of foreclosure is not one that they would necessarily wish to be associated with. The risk of foreclosure is not something that can be controlled by the operator and in most cases, a lender would want the flexibility to either continue with the operator or terminate the management agreement (perhaps to sell an unencumbered asset). This leads to uncertainty as far as the operator is concerned and is generally not acceptable, therefore an operator may require a specific termination right in such circumstances.

#### **(viii) Operator sale/withdrawal of the brand**

Owners appoint a hotel operator to manage the hotel under a specific brand, and the capital investment required by the owner accords to the brand standards and specifications of such brand. Such level of expenditure underpins the owner's general feasibility as to the hotel development

costs and associated business case (ie. in respect of its projected return on investment).

In the event that the brand is sold by the operator to a third party in the future, or the operator decides to withdraw the brand from the market, for strategic or repositioning purposes, the owner will, unless he has the ability to terminate the management agreement, be obliged to comply with the brand standards of the new brand and/or the brand standards of the existing brand which may change as a result of the brand's new ownership. In either circumstance, there is likely to be significant cost to the owner as a result.

An owner would therefore be prudent, if possible during negotiations, to agree that it has the ability to terminate the management agreement in such circumstances. Most operators would strongly argue against this, as the value of the brand in a third party sale scenario is based on the value of the operator's existing management agreements. Any exit provisions in favour of an owner in these circumstances would have a negative impact on the value of the brand to a third party purchaser. Nevertheless, an owner should have comfort that it will not suddenly be required to support a large capital expenditure resulting from the brand sale/rebranding, and a compromise would be for the owner to have a right of termination if such expenditure is above a maximum amount.

### **(ix) Transfer of ownership of the hotel**

In the event that an owner wishes to sell the hotel, ideally it wants the freedom to sell with or without the management agreement, dependent on whether the management agreement encumbers the asset and decreases its value, or is seen as a positive benefit thereby increasing its value and saleability.

Most operators would not permit an owner to terminate the management agreement in such circumstances unless some form of compensation formula had been agreed, to recompense the operator for its future loss of management fees.

From an operator's perspective, it might not wish to continue under contract with the new owner and therefore in most cases, a management agreement will contain a right for the operator's approval to the transfer, (and the identity of the transferee), to be sought before the transaction can take place. In this way, should the identify of the transferee not be acceptable, (ie. because it may be a competitor of the operator, or not financially secure, thereby causing risk to the operator's continued management of the hotel), the operator will reserve a right to terminate the management agreement prior to the transfer, and again require compensation for its future loss of management fees.

### **(x) Conclusion**

As you can see, there are many pre-ordained instances where a hotel management agreement might be terminated by either party, over and above the existence of a breach situation. The above summary provides a very high level overview of the types of termination scenario that may arise, but is by no means exhaustive. The existence of any breach, dispute, assertions of underperformance, or financial difficulty will inevitably put a strain on the owner/operator relationship and the hotel's performance, which ultimately is likely to benefit neither.

Regardless of the cause, the impact that termination of a hotel management agreement can have on the hotel's operation, its reputation, the owner's investment and the operator's brand value, should not be underestimated. Termination will touch the lives of many third parties, including suppliers, service providers, employees and guests. Further, termination which is subsequently disputed, with the result that the parties remain under contract pending the outcome of a lengthy dispute resolution process, can be extremely damaging.

Termination is not, therefore, something that should be implemented lightly.

Dispute management should, wherever appropriate, be given sufficient time, effort and attention in order to properly assess the legal, commercial and financial risks that may arise should such termination be require. This should be done with the assistance and guidance of legal, financial and industry advisors, as appropriate, to ensure that a clear 360° view is obtained prior to any action being taken.

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