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Hiring third party management companies for your hotel: Proceed with caution

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Running a hotel is no walk in the park. In order to be profitable, a hotel operator needs to supervise and train potentially dozens of employees, have an aggressive sales and marketing team, and be as fluent in the art of boosting TripAdvisor rankings as they are knowledgeable about setting room rates to maximize RevPar relative to the competitive set. On top of all that, if the hotel is branded with a franchisor like Marriott or Hilton, there are brand standards to be maintained as well as property improvement plans to be completed every 5 years. And did I mention that someone has to fix broken toilets and leaky faucets?

All of the above being said, there is still no reason why an owner can't winter in Boca (or perhaps run a multibillion dollar REIT or private equity fund in New York), while still owning hotel assets in New England. All one needs to do is hire the right third party management company to operate the hotel for them under a hotel management agreement while engaging in other pursuits! So how does one go about doing that? The answer is: very carefully.

The first step is gathering some good prospects. A trip to any of the major trade conferences (Lodging, NYU, HELP, ALIS) will provide you with a plethora of choices, as will a few inquiries with some well placed hotel brokers or lenders. When winnowing down the list, remember that there is no "one size fits all" approach. If you are a decision maker with a REIT or private equity fund, then perhaps it is best to engage a franchisor or a larger management company to operate your asset(s). Larger operators can sometimes bring economies of scale and more diverse experience levels to bear. However, smaller regional operators are sometimes more "hands-on," knowledgeable about local markets, flexible with contract terms, and cost efficient.

Speaking of cost.... Although there are many different payment structures, most third party operators will want to be paid - at a minimum - a "base" management fee that is usually a monthly fee paid in arrears based on a percentage of gross sales. Guaranteed minimum and/or maximum base management fees are often negotiated, as are "incentive" fees that reward operators for hitting certain performance targets, and performance termination thresholds that allow operators to be terminated on short notice (and often without much cost to the owner) if certain targets are not met. Finally, it is not uncommon for a third party operator to be asked to contribute capital to the owner in exchange for "sliver equity," so that the operator will have some "skin in the game." In fact, some franchisors won't approve smaller third party management companies unless they also have a share of ownership.

The length of the term of the agreement will vary dramatically depending on the circumstances. A foreclosing lender or opportunity fund that only intends to hold the hotel asset for a short period of time (under 3 years, for example) will often want to enter into a management agreement that is terminable upon short notice to the management company. In such circumstances, the management company will often be the legal agent of the owner, with little or no independent control. However, in "long term hold" situations, third party operators will look for long term arrangements (sometimes over 50 years) during which the operator will have almost exclusive control of the business, and will legally be an independent contractor, as opposed to an agent. In such circumstances, the third party management agreement will often prohibit the owner from selling the hotel without also assigning the management agreement, and may require the owner to obtain non-disturbance agreements from its lender(s) that will allow the management agreement to remain in effect even after a foreclosure.

Long term management agreements require careful drafting so that the owner will not lose all control rights over the hotel. The management company should remain obligated to operate the hotel to certain standards, while always having primary regard for the maximization of profits for the owner. Budgetary controls should limit the operator's ability to, except in emergency or rare circumstances, spend money outside of an owner-approved budget - and should hold the management company responsible for any prohibited expenditures. Most importantly, the management company should never be granted a possessory interest in the property, as doing so could result in the owner being unable to regain possession of the hotel in the event of a dispute.

Although the risk of economic loss generally continues to rest with the owner, a carefully drafted management agreement will include cross indemnities that may result in the third party management company bearing the cost of certain negligent or grossly negligent actions. For example, while the ordinary costs of payroll and employment generally are passed through to the owner, expenses arising from a third party manager's failure (or sometimes the failure of the senior level employees of such third party manager) to properly supervise or train the hotel employees may be an expense solely of the third party manager.

Provisions regarding ownership and control of bank accounts must also be carefully drafted. While owners (and sometimes their lenders) may want all of the money to be deposited into accounts in the name of and under the direct control of the owner or the owner's lender, sophisticated third party managers will want, at the very least, a payroll account funded by the owner in the third party manager's name and under the manager's control. In this way, payroll will be made even in the event the owner fails to fund or declares bankruptcy. In addition, many operators require the maintenance of minimum balances for operating accounts and FF&E escrow accounts.

In conclusion, although it is certainly possible to turn over the reins of your hotel to a third party manager, there are many complex issues to be carefully considered before doing so.

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