

---

# Hotels and leisure

## Key terms for hotel management agreements Issue 3 – Performance

---

June 2016

This is the third in a series of short briefing notes identifying key issues for discussion when agreeing the terms of a hotel management agreement (the ‘HMA’). We briefly identify the typical position adopted by each interested party and further issues for consideration when negotiating from such a position.

**Issue 1** covered ‘the Term’ and **issue 2** covered ‘Hotel Financing’.

---

‘Ranked top tier in  
Hotels and leisure’  
*Legal 500 UK, 2015*

---

‘Knowledgeable,  
commercial and very  
accessible’  
*Chambers Global 2015*



### Performance

Hotel management agreements are typically long term agreements with limited ability for owners to bring the arrangements to an end prior to the end of the contractual term. Well advised owners will want to ensure there are mechanisms for measuring and ensuring the financial performance of the hotel and suitable recourse for the owner against the operator where such performance falls short. There are a number of different provisions which can be inserted into an agreement to encourage and monitor performance of the operator, including incentive fees, performance tests and the payment of an owner’s priority.



### The operator’s position

Incentive fees are prevalent in most management arrangements and are typically structured either by reference to a profit margin or a percentage of profit. Incentive fees are by their nature ‘an incentive’ to perform well but they do not trigger the threat of termination. Where an owner requires greater assurance of performance, a ‘performance test’ can be used. A performance test will typically permit an owner to terminate the HMA without payment of compensation to the operator where the hotel’s financial performance fails to meet, over a set period of time (typically two to three operating years), certain financial performance levels. Operators will want restrictions governing when the performance test will be applied, specifically seeking to exclude any performance failure resulting from events outside the operator’s control such as force majeure, development to adjoining land, disputes and owner performance. Operators will also seek to have the ability to make cure payments where the performance test is failed.



### The owner's position

Though common in HMAs, performance tests are notoriously difficult to enforce. Accordingly owners should consider having more than one performance mechanism in an HMA. Incentive fees are one of the mechanisms becoming increasingly important for both owners and operators – this in theory means that operator will see increased financial rewards to the extent that revenue is being generated at the hotel. However, to ensure a return on investment, owners may also require the payment of an owner's return (also known as owner's priority), that is a an agreed amount of return, which will become payable before any payment to operator of incentive fees. This pushes operators to seek to increase revenue so that they can receive their fees.



### The lender's position

The key concern for lenders is the revenue stream to which owner is entitled and which will be used to satisfy their debt. Accordingly the payment of an owner's return may be required by lenders, at least for the duration of the debt. In addition, a lender may require the operator to subordinate its rights by requiring the payment of the incentive fee to be deferred in circumstances where payment of the incentive fee would reduce available cash in the hotel operating account below the level required to meet the on-going operating costs.



### Negotiation considerations

Various additional commercial arrangements can be agreed to balance the interests of the parties. Parties should consider the following:

Though incentive fee formulas and performance tests may often be presented as standard provisions, in actual fact these can be areas of detailed negotiation between the parties, particularly any exceptions applied to such provisions, such as force majeure or development of adjoining properties.

Parties will need to consider what deductions will be made from the revenue amounts on which incentive fees will be calculated. Owners will often push to exclude certain amounts from the operating income upon which the incentive fee will be calculated, such as the FF&E reserve amount or any owner's priority amount, in order to incentivise the operator to generate more revenue but also lower operating expenses.

When negotiating incentive fees, owners may push for tiered percentages against budgeted or past performance, i.e. a higher percentage will be payable to operator if they meet a certain level of the budgeted operating income, which ensures that the operator is only rewarded with the incentive fee after the owner has reached a certain level of return.



### Did you know ...

While performance mechanisms such as performance tests and incentive fees are common in the market, not all experts agree that these tests truly test and reward operators on the basis of how well they operate the hotel, but rather they reflect market trends. Accordingly some experts suggest that owners should also consider the hotel's performance through the REVPAR index, that is measuring the share of the market that the operator has been able to capture through its management of the hotel.



### For more information

Our global legal practice is highly experienced in all aspects of the hotel and leisure industry and advised hotel owners, developers, lenders and many of the world's top hotel and leisure operators on all aspects of their operations. Through our extensive global platform of lawyers we are able to provide a co-ordinated legal service catering to all aspects of our clients' legal needs – from a single project boutique hotel development, to a multi-jurisdictional hotel portfolio acquisition. Our previous track record in the hotel and leisure sector has not only given us insight into the often complex legal requirements of the industry, but has also enabled us to build an in-depth understanding of the commercial and practical aspects of our clients' business. Our global offices can offer you the skills and experience required in this growing and diversified sector.

If you would like further information please contact [Nick Clayson](#) or [Louisa Lynch](#) or your local Norton Rose Fulbright contact.

[Global hotels and leisure web link](#)

[Global hotels and leisure brochure](#)

Norton Rose Fulbright US LLP, Norton Rose Fulbright LLP, Norton Rose Fulbright Australia, Norton Rose Fulbright Canada LLP and Norton Rose Fulbright South Africa Inc are separate legal entities and all of them are members of Norton Rose Fulbright Verein, a Swiss verein. Norton Rose Fulbright Verein helps coordinate the activities of the members but does not itself provide legal services to clients. References to 'Norton Rose Fulbright', 'the law firm', and 'legal practice' are to one or more of the Norton Rose Fulbright members or to one of their respective affiliates (together 'Norton Rose Fulbright entity/entities'). No individual who is a member, partner, shareholder, director, employee or consultant of, in or to any Norton Rose Fulbright entity (whether or not such individual is described as a 'partner') accepts or assumes responsibility, or has any liability, to any person in respect of this communication. Any reference to a partner or director is to a member, employee or consultant with equivalent standing and qualifications of the relevant Norton Rose Fulbright entity. The purpose of this communication is to provide information as to developments in the law. It does not contain a full analysis of the law nor does it constitute an opinion of any Norton Rose Fulbright entity on the points of law discussed. You must take specific legal advice on any particular matter which concerns you. If you require any advice or further information, please speak to your usual contact at Norton Rose Fulbright.