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Reduce risk of management termination

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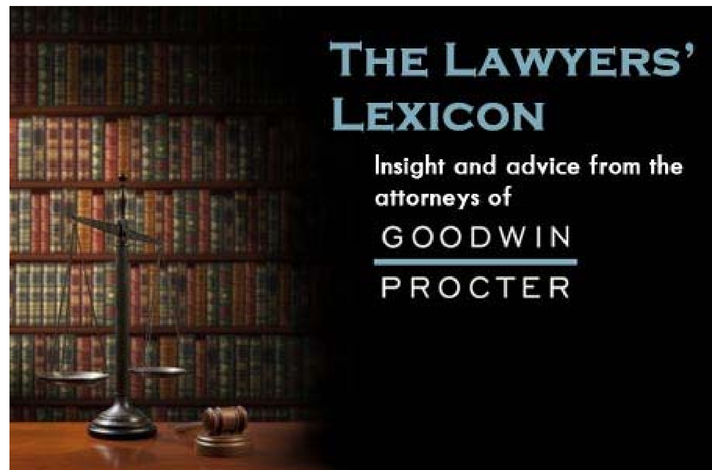
Story Highlights

- Three headline-grabbing lawsuits raised concerns about the enforceability of hotel management agreements.
- Owners and operators should collaborate on solutions outside of the management agreement that will reduce uncertainty over the duration of the contract without changing its terms.
- If owners and operators work together to incentivize adherence to the optimal terms through mechanisms such as easements and lease/purchase options, they restore the value of the contract at no appreciable costs beyond the negotiation of the terms.



During the past few years, three headline-grabbing lawsuits raised concerns about the enforceability of hotel management agreements. In their wake, public discourse generally characterized the lawsuits as presenting a difficult choice to hotel owners and operators: whether they should deviate from their preferred management agreement terms in order to increase the likelihood the contract will be enforced for its full duration. Owners and operators, however, might eliminate the need for drastic changes by negotiating a less disruptive solution, such as an independent, recordable instrument that discourages breaches of the contract.

A revived threat to long-term management contracts
The recent lawsuits revive a slumbering dispute that receded from the landscape more than a decade earlier. During the 1990s, four cases held that long-term hotel management contracts create an agency relationship between owner and operator, which allows the owner to terminate the contract at any time regardless of its stated term, unless the operator holds an "interest" in the hotel. If the owner effectuates such a termination, it is obligated to pay damages to the operator, but owners might be able to use a variety of legal tactics to delay or avoid paying such damages.

In response to the court decisions, owners and operators adopted various changes to their management agreements. Some operators took a minority ownership interests in the hotels they operated, which created an independent "interest" in the hotel. Joint ownership relationships, however, are not always desired by operators and/or owners (or their lenders).

Many owners and operators instead made clear in their management agreements the operator had an independent interest in the hotel (e.g., the operator's intellectual property or right to restrict a transfer in ownership). Other operators continued to use long-term management agreements but characterized themselves as independent contractors to the owners, rather than agents, seeking to alter their legal rights and obligations. Maryland took a more direct approach and enacted new legislation providing that a principal's common law right to terminate its agent at any time does not apply in the hotel management context.

For more than a decade, these changes appeared to discourage attempts to prematurely terminate management agreements. But in 2009, the owner of the former Four Seasons Resort Aviara attempted to prematurely terminate its management contract.

In 2011, the owners of the former Waikiki Edition and the former

Fairmont Turnberry Isle followed suit. These three incidents constitute fewer than 0.1% of the hotels governed by management contracts, but the possibility that owners might be able to prematurely oust operators has caused operators to once again search for protection in alternative contract terms or forms.

Alternative solutions

While the options first put forth during the 1990s merit consideration again today, if an owner and an operator intend to enter into a long-term management contract, they should collaborate on solutions outside the management agreement that will reduce uncertainty during the duration of the contract without changing its terms.

One possible solution is a negative easement. A negative easement is an interest in land that allows the owner of the easement to prohibit specified uses of the land. A conservation easement, for example, allows the easement holder to prohibit development of the burdened land. Easements can be permanent or only for limited duration.

When a hotel owner and an operator enter into a management agreement, the owner could also grant the operator a negative easement that allows the operator to prohibit the use of the property as a hotel or residences, unless it is managed by the easement holder. The easement could be drafted to expire on the same day the management agreement is scheduled to expire, or at any such time the management agreement is terminated in accordance with its terms (and not by an owner pursuant to its agency powers). The easement would otherwise survive regardless of the status of the management agreement.

Owners and operators might consider granting the operator an option to purchase, or an option to lease, the hotel. The management agreement could prohibit the operator from exercising the option while the management agreement is in effect or if the management agreement is terminated in accordance with its terms. The options are likely to only appeal to operators if they are transferable and if the sale price and/or rent are sufficiently below market rate as to reflect the value the operator adds to the hotel through its management of the property up until the option is invoked. Owners (and the owners' lenders) should not be overly concerned about under-pricing the options given that the options would be meant only as a back-up plan. No option could be exercised without the owner first attempting to terminate the management agreement outside of its terms.

It is not certain a court would enforce an operator's easement or below-market option to purchase or lease the hotel. Nevertheless, the existence of the recordable rights, and the operator's ability to sue for damages arising out of a breach of a management agreement while also seeking an injunction in support of their recorded interest in the property, would discourage attempts to prematurely terminate an operator.

The need for cooperation

Hotel owners might question why they should grant operators recordable rights in their hotels, particularly if the owner was reluctant to agree to a long-term management agreement in the first place. But if the owner agrees to a set duration, it is in the interest of both parties to reduce uncertainty over the enforceability of that duration.

Uncertainty over the duration of hotel management agreements might lead operators to decrease their valuations of prospective management agreements without an equal decrease in owners' perceptions of the cost of the management agreements. In short, the actions of a handful of owners might decrease the size of the pie every owner/operator pair must divide among themselves in the negotiation of new agreements.

Owners and operators should not expect to restore the pie to its original size by altering the terms of the management agreements. As an initial matter, any changes to the management agreement will move the parties away from their optimal relationship. (If the parties were, on the whole, better served by the operator holding a minority share in the hotel, then they would not need the remote chance of a possible attempted termination to push them there.)

In addition, even if owners and operators adopt new contractual relationships, there is no guarantee the operator's long-term management rights will be safe. First, courts have held each management agreement must be construed on a fact by fact basis. It is effectively impossible for owners and operators to know whether a given change will endow the operator with a sufficient "interest" in the hotel to prohibit early termination. Second, as illustrated by the former Waikiki Edition, even if the owner does not have the power to terminate the contract, the owner might still escape the management contract through bankruptcy.

On the other hand, if owners and operators work together to incentivize

adherence to the optimal terms through mechanisms such as easements and lease/purchase options, they restore the value of the contract at no appreciable costs beyond the negotiation of the terms.

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