

# New York Law Journal

## Real Estate Trends

WWW.NYLJ.COM

VOLUME 256—NO. 33

An **ALM** Publication

WEDNESDAY, AUGUST 17, 2016

### REAL ESTATE LITIGATION

# Lifting the Veil on Hotel Management Expenses



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Historically, New York City has not had enough hotel rooms to meet demand. More recently, however, a construction boom has resulted in additional rooms coming online at a furious pace that is expected to continue until the end of this decade. Driven by the low cost and availability of financing, and local government initiatives designed to spur growth in the city's tourism industry that have eased the approval and permitting process, not to mention the perceived long-term investment stability for hotels, developers are adding hotel rooms all over Manhattan, as well as in areas not traditionally known as lodging destinations such as downtown Brooklyn. Despite this sharp increase in supply, occupancy rates remain strong and industry experts expect occupancy to

continue to outpace supply until at least 2018.<sup>1</sup> This dynamic also is in play in southern Florida and other "hot spots" across the country.<sup>2</sup>

One consequence of this market environment is that many investors and developers without significant hospitality industry experience are jumping into the hotel business for the first time. Naturally, these parties are looking to partner with an experienced, brand name hotel management company to help them navigate this complex industry and achieve success. When evaluating potential operator partners, developers rightly focus on choosing the appropriate brand for their hotel business, including the sales and marketing prowess that each potential partner can offer.

What is often overlooked, however, is the cost structure built into hotel management agreements (HMAs). While at first glance most HMAs contain industry-standard cost structures, and all that is to be

negotiated is the size of the management fee, all is not always as meets the eye. The devil, as always, is in the details.

This article explains the common HMA cost structure and explores some common related pitfalls, and the factors a developer should consider during the due diligence and negotiation process. We also consider steps that may be taken by the owner of an existing hotel that is concerned it is being overcharged by its hotel operating partner.

### HMA Costs

The hospitality industry landscape continues to be dominated by fee-based managers engaged by ownership to operate the business of their hotel(s). HMAs have taken on increasing importance as the framework of what is often a decades-long relationship. HMAs typically run for a term of at least 20 years, often with options to extend the term even longer.

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Regardless of the hotel management company, the cost structure set forth in an HMA is generally the same. Most commonly, the hotel operator is paid: (i) an annual base management fee equal to a percentage of the hotel's gross revenues, as well as an incentive fee equal to a percentage of the hotel's operating profit; (ii) an annual centralized services fee (sometimes known as a chain services fee) equal to a percentage of the hotel's gross revenues; and (iii) reimbursement out of gross revenues for any costs incurred in providing management or centralized services.

In exchange for the payment of a base management fee and, depending on the hotel's performance, an incentive fee, a hotel operator generally provides a range of services, including: (i) establishing policies and procedures for the control of revenue and expenditures, the purchasing of supplies and services, the control of credit and the scheduling of maintenance; (ii) paying accounts payable and collecting accounts receivable; (iii) maintaining books of control and account; (iv) arranging for and supervising public relations, marketing and advertising; (v) procuring and replacing as required all necessary fixed asset supplies and inventory supplies; (vi) preparing and delivering accountings and annual operating statements; (vii) ensuring

that the hotel's facilities are maintained in good repair and condition; (viii) receiving, holding and disbursing funds and maintaining the hotel's bank accounts, and paying costs and expenses necessary for the proper and efficient operation of the hotel; (ix) paying all taxes and similar charges; (x) recruiting, employing, supervising, directing and discharging hotel employees; and (xi) establishing prices, rates and charges for services provided in the hotel.

This structure, where the base management fee is equal to a percentage of gross revenues, and the

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incentive fee is tied to operating profit, is designed to encourage the operator to run the hotel efficiently and to achieve a high profit margin as well as a high level of gross revenues.

The centralized services fee is intended to be a "pass-through" fee to reimburse the operator for services which, for reasons of efficiency, are provided by the operator on a group basis (rather than individually at each hotel) to some or all of the hotels in the operator's network. These services typically

include global, national and regional sales office services, centralized training services, area sales and revenue management offices, as well as all marketing, advertising and reservations services. The centralized services fee is usually a set percentage of gross revenues identified in the HMA, or is capped at a certain percentage (i.e., the fee cannot exceed a specified percentage of gross revenues).

In turn, the reimbursable costs (which often are undefined) are intended to cover any other expenses that the operator incurs in the operation and management of the hotel.

### Common Pitfalls

While each of these fees and costs are designed for a particular purpose, the lines are easily blurred. As a practical matter, it is often difficult for a hotel owner to accurately discern what specific functions of its operator are to be provided in exchange for the base management fee, as opposed to what services qualify as centralized services or reimbursable costs. This is compounded by the fact that, in most owner-operator relationships, the hotel operator controls the book and records of the hotel and therefore unilaterally decides how to allocate specific charges. Since a hotel's profit-and-loss statements contain hundreds or even thousands of line

items, it requires many hours and the assistance of trained professionals to understand the methodology employed by the hotel operator.

Given this lack of transparency, there are instances of hotel operators “double” or even “triple” charging hotel owners by assessing a centralized services fee and/or reimbursable charge for services that should have been provided by the operator in exchange for the base management fee. One common example of this situation occurs when a hotel operator is unable or unwilling to perform a service that is its responsibility under the HMA, and instead engages a third party to perform the service, charging the cost back to the hotel. This can happen in situations as wide-ranging as when an operator responsible for maintaining the hotel’s facilities engages a third-party landscaper and charges the expense back to the hotel, or when an operator engages a third-party industry analytics firm to assist it in setting rates for the hotel, and charges the expense to the hotel even though it is the operator’s obligation to establish rates.

Since these are top-line deductions, improper charges can significantly erode a hotel’s profits and thus the owner’s return.

### Prudent Safeguards

To guard against such overcharges, it is advisable for a developer-owner

to insist on clear HMA language detailing what services are to be provided for the base management and centralized services fees, as well as what types of expenses shall be reimbursable. While it is impossible to categorize each expense that may be incurred in advance, by stating the parties’ intentions clearly it will protect the owner in any subsequent dispute by providing it, at a minimum, a basis for a claim that an improper charge is a breach of the covenant of good faith and fair dealing. *Dalton v. Educational Testing Serv.*, 87 N.Y.2d 384, 389, 639 N.Y.S.2d 977, 979 (1995) (“Implicit in all contracts is a covenant of good faith and fair dealing in the course of contract performance.”) Since hotel operators generally act as agents for the hotel owner, as principal, it may also permit the owner to assert a claim for breach of fiduciary duty, including but not limited to the duty of loyalty. *Birnbaum v. Birnbaum*, 73 N.Y.2d 461, 466 (1989) (“[I]t is elemental that a fiduciary owes a duty of undivided and undiluted loyalty to those whose interests the fiduciary is to protect. This is a sensitive and inflexible rule of fidelity, barring not only blatant self-dealing, but also requiring avoidance of situations in which a fiduciary’s personal interest possibly conflicts with the interest of those owed a fiduciary duty.”)

The owner also should insist on the right to receive detailed

reports explaining how charges/services have been allocated, and to regularly request and review such reports with the assistance of an experienced industry professional. Current hotel owners concerned with the lack of transparency in its current hotel operator relationship should request similar detail, relying on the rights in most HMAs to conduct audits and review the books and records of the hotel. Owners also should be careful to object and not pay any improper charges, as any payments may bar later recovery. *Dillon v. U-A Columbia Cablevision of Westchester*, 100 N.Y.2d 525, 526 (2003) (“[T]he voluntary payment doctrine...bars recovery of payments voluntarily made with full knowledge of the facts, and in the absence of fraud or mistake of material fact or law.”)



1. “HVS Market Connections Showcase City Performance,” *Hotelnewsnow.com* (June 23, 2016), available at <http://www.hotelnewsnow.com/Articles/51990/HVS-Market-Connections-showcase-city-performance#Manhattan>.

2. “STR: US Hotel Pipeline for May 2016,” *Hospitalitynet.org* (June 14, 2016), available at <http://www.hospitalitynet.org/news/4076626.html>.