



Owner/Management Contracts Greatly Affect Return Potential

Maximizing the return on hotel ownership depends largely on three factors: the terms of the acquisition, the terms of debt financing and an effective long-term working relationship between ownership and management, including a management agreement that respects each party's interests. The owner/management (O/M) relationship, unlike the first two factors, is more dynamic and subject to the vicissitudes of economic cycles.

In recent years, the O/M relationship has changed significantly. Court decisions have clarified the parties' duties to one another. Technological advancements have increased the value of intellectual property while decreasing the cost of creating and using such property. Also, the proliferation of hotel investing syndicates, such as REITs, has given owners a stronger voice in establishing and enforcing their rights.

Understanding current issues surrounding the O/M relationship may help create potential competitive advantages for both owners and managers. For instance, recent decisions have established that, in the absence of an ownership interest or an agreement expressly limiting one's duties, management companies are agents acting as the owner's fiduciary—the highest legal standard. Consequently, the manager must place the owner's interests above its own.

Owners engage managers in order to maximize profit and they almost always agree to share NOI as an incentive fee. Yet many managers receive supplier rebates or obtain services from affiliates even when they are entitled to an NOI incentive fee. Owners must understand and managers must be aware of the conflict between the manager's fiduciary duty and incentive fee on the one hand and its profit opportunities from rebates and affiliate transactions on the other.

There are at least two fundamentally different philosophical approaches managers can take to operate within the law in O/M relationships. Conventional wisdom says that managers should acknowledge that the O/M interests are not aligned, disclose that they may profit independently from transactions that it enters into for the owner and obtain effective waivers if possible. But this is hardly a selling point when courting a client.

It doesn't have to be that way. Owners want and need effective buying power and know that it will increase NOI, but only

if the manager is not getting rebates or inappropriately profiting from its affiliates. Managers that forego under-the-table profits, but bring significant procurement power to the O/M relationship may command a greater incentive fee. Owners will willingly share incentives, though, if they also benefit from the O/M relationship. In such instances, owners and managers will have aligned interests.

Arguably, the customer list is the owner's most important asset after the real estate itself. Hotels trade on multiples of NOI, which is, in part, a function of revenues derived from customers. But questions always arise, such as who owns the customer information? If the owner does not own the customer list can he sell it either separate from the property or as part of a

sale of property, or use it if the owner terminates the management company or changes flags? If the owner can't sell it, what is the consequence to the value of his property? Does the manager own it? Even if the manager does not own it, does the manager have a right to use the customer list for its own benefit without compensating the owner? With all of these questions, owners must understand the impact of the management and franchise agreements with respect to their property in order to protect themselves.

Every day, the manager collects customer information on the owner's behalf. This information, if derived by the manager in its agency capacity and not in its franchise capacity, is, in the absence of an agreement to the contrary, likely to be deemed the owner's property. This is not necessarily true in the franchise relationship, in which no principal or agent fiduciary standard is implied.

With respect to branded management companies, there are reasonable arguments on either side as to who owns the customer information. To date, the law is clear—ownership is a matter of contract in the franchise context. Owners need to understand this and engage advisors who can protect their interests. The key is to understand how information is developed and used and to institute licensing rights that enable both parties to achieve their objectives. Professional owners are moving in this direction. ■

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