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Leisure Law Insider - Vol. 5 (January 2025)

Negotiating Mixed-Use Branded Hotel and Residential Contracts

January 22, 2025

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Key Take: *Owners and developers of mixed-use hotel projects must have the right advisors and legal consultants to succeed long-term.*

Negotiating license and management contracts for mixed-use branded hotel and residential projects can be quite complex. Having the right team of highly experienced hospitality business and legal advisors in place from the very outset of project planning and development is often crucial for avoiding critical and costly mistakes in brand license and management contract negotiations that could impact the future operational and financial success of the project.

In this article, we share some key considerations and recommendations for you to keep in mind when planning for and negotiating brand license and management agreements for mixed-use projects garnered from our many decades of experience in advising clients in mixed-use branded hotel and residential contract negotiations.

Market Considerations

First, be sure that market demand characteristics and the competitive landscape are fully vetted and that they warrant development of the mixed-use project, with each being conducive to the development of the hotel and residential components as conceptualized. Sometimes there are obvious, but often overlooked, market questions that should be answered in the early planning stages of development. These include:

- Is there ample hotel market demand at projected levels of annual occupied room nights and average daily room rates sufficient to support new hotel development at the overall estimated cost of new hotel development?
- Will the market support sales of residential units at the targeted monthly sales pace and average sales price per square foot commensurate with overall estimated costs of residential development?

- Will the quality and caliber of hotel facilities and services, and targeted clientele, be consistent with and complementary to that of the residential component of the project and vice versa? So often there is a disconnect in this regard leading to serious conflicts, dissatisfaction, and even litigation brought by residential unit owners against project developers, hotel owners, and hotel brand managers.
- How many competing projects are there in the relevant market area, including projects under development and in the planning stages of development that, if built, could impact the viability of the project?
- Are there significant identifiable and tangible points of differentiation and competitive advantage of the subject project that are sufficient to warrant performance metrics above that of the existing and future competition?

Selecting the Right Brand

Be sure to select the “right” brand for the project. No matter how well the project is conceived and developed, including its facilities, finishes, and services, selecting the right brand that aligns with the vision and target market of both the hotel and residential components is crucial for the overall success of the project. Often, our assignments include advising developers on brand identification and selection. This typically involves:

- Determining the right brands for consideration for the project and their availability for the project.
- Determining brand experience and track record in the relevant market, especially their experience in mixed-use hotel and residential projects.

- Assessing brand strength and brand reach relevant to attracting the targeted hotel and residential clientele for the project.
- Determining depth of corporate and regional capabilities of the brand to support the project.
- Evaluating brand performance indices against competing brands in the market in terms of average occupancy, average daily rooms rates (ADR), and revenue per available room (RevPAR) pertaining to hotel operations, and residential pricing premiums and sales absorption pace premiums over the competition for branded residences.

Another key consideration often overlooked is competition from other brands within the same brand family, for example St. Regis and Ritz-Carlton within the Marriott brand family, Waldorf Astoria and Conrad from Hilton, and Thompson and Andaz from the Hyatt brand family, that might compete for and draw customers from the same brand loyalty program and central reservations system.

Selection and affiliation with the right brand can significantly enhance the value and appeal of both the hotel and residential components and significantly enhance the mixed-use project developer's overall return on investment.

Negotiating Brand Definitive Agreements

Know the types of brand agreements that must be negotiated. Often, our clients are surprised to learn that multiple agreements must be negotiated and entered into with the brands for various aspects of licensing and management of hotel and residential components of the project. Each of the definitive agreements can often be complex and lengthy as to terms, provisions, and restrictions. These mixed-use agreements typically include:

- **Residential Marketing Brand License Agreement**: This is for use of the brand name and marks in marketing residential units for sale. Key negotiating considerations include length of term; brand protections, both as to a specific area of protection for the selected brand and protection against competing brands within the same brand family; the basis for calculating licensing fees that might be determined as a percentage of sales, typically in the range of 2 to 6% of residential sales prices, or in tiered fixed amounts depending on levels of aggregate sales revenues attained; the staging of payments; and levels of brand marketing support the brand will provide in the marketing and sales of units.

- **Brand Technical Services Agreement**: This is for technical brand support in the design of facilities, furnishings, equipment, and systems and review and approval of these designs in accordance with established brand standards. Key negotiating considerations include contractually identifying and "locking in" the applicable brand standards that may otherwise change over time; negotiating the basis and amount of technical services fees, usually fixed amounts, and terms and timing of services to be provided and related payments; negotiating the pre-opening budget for hotel and residential components; and identifying and restricting pass-through brand costs and reimbursable expenses.
- **Hotel Brand Management Agreement**: This is a long-term agreement for brand operation and management of the hotel component of the project typically spanning a minimum of 20 years, and typically with automatic renewal provisions sometimes bringing the total term to up to 60 years or more. This will likely be one of the most complex of the definitive agreements. Key negotiating considerations include length of term; basis for calculating base and incentive management fees; basis and limitations on shared pass-through corporate charges and expenses; budget adherence;

performance-based termination rights; owner approval rights of executive hotel personnel; area brand protection; who employs the hotel staff (in most cases the manager but sometimes the hotel owner); and identification of applicable brand standards.

- **Shared Facilities Management Agreement or Reciprocal Easement Agreement**: This is an agreement between multiple property owners, such as the hotel owner, the residential unit owners, and the related condominium or homeowners' association, that allows the various constituents to share access and use of common or shared facilities such as hallways, swimming pools, health clubs and associated facilities, parking facilities, rooftops, utility towers, sometimes building balconies and exteriors, and other similar shared facilities. These agreements allow the various parties to develop and operate all the shared facilities as a single unit despite, in some cases, varying ownership of each component. Key negotiating considerations include the responsibilities and obligations of each party to the agreement; basis and limitations on the sharing of costs; budget approval rights of each party; responsibility for and approval of capital improvements; and operational standards. Hotel brands will usually require that the hotel owner has control over these facilities in mixed-use branded hotel and residential projects to assure that the quality of brand standards are adhered to.

- **Homeowner Association (HOA) Management Agreement or Condominium Association (CA) Management Agreement**: This is a long-term agreement that typically spans from 3 to 20 years depending on state HOA and CA laws and regulations for brand operation and management of the residential component of the project. These agreements are typically initially entered into between the project developer and the hotel brand and assigned by the project developer to the related condominium or homeowners association when the developer turns the association over to its members. Key negotiating considerations include length of term; basis for calculating management fees; basis and limitations on shared pass-through of corporate charges and expenses; budget adherence; performance-based termination rights; basis of cost-sharing between the hotel and residential components; and identification of applicable brand standards.

Other Fee and Cost Considerations

Be sure to understand the full overall fee structure, including any upfront fees, ongoing royalties, and performance-based incentives. Make sure these are clearly defined and agreed upon. Ask the brand representative of each brand you are considering to provide you with a proforma fee summary that includes the basis, breakdown, and calculation of each type of fee and royalty as well as any mandatory brand centralized services cost allocations that the property will be responsible for paying. Make sure you understand the drivers of the cost allocations and negotiate any relevant caps on the cost allocations that are not dependent on the volume of business at your property. We recommend that owners consider requesting and negotiating for a “most favored nation” clause when it comes to fees, royalties, and mandatory centralized services cost allocations such that if any other owner of a hotel of the same brand in the same territory (such as the United States) negotiates a more favorable term for any of these items, your agreement is modified to match the terms of the more favorable agreement.

Operational Considerations

Consider the operational implications of licensing a brand to a residential development. This includes the level of finishes required by the brand, involvement of the brand in the day-to-day operations, the total cost of having the brand involved, the experience and successes of the brand to manage the day-to-day residential operations, and the brand operating standards that need to be maintained.

Legal and Regulatory Compliance

Ensure that the agreements comply with applicable state and local laws and regulations. This may include zoning laws, building codes, condominium and homeowners association laws, and other regulatory requirements. Make sure you understand if local ordinances allow for rental of residential units on a transient basis through a hotel-operated residential rental program, which is a particularly important consideration to potential hotel profitability and viability for the hotel owner. Also, you should understand whether restrictions can be placed on residential owners prohibiting short-term rentals through sharing platforms like Airbnb that would compete with the hotel brand managed rental program.

Stakeholder Engagement

Engage with all relevant stakeholders, including developers, brand representatives, and legal advisors, to ensure that all aspects of the contract are thoroughly reviewed and agreed upon.

By keeping these considerations in mind, you can navigate the complexities of negotiating branded hotel and residences contracts more effectively. If you need more detailed information or specific advice, feel free to ask us at REH Capital Partners or Akerman.

REH Capital Partners is a nationally recognized firm of real estate and hospitality advisors, providing clients with strategic advice and expert assistance on a wide range of business and financial matters, with a special focus on complex business situations.