Practice Update

Alternatives to 'Key Money' in Hotel Management Agreements

December 6, 2017

By Ronald S. Kornreich

The competition for branded hotel operators to secure long-term management agreements can be fierce, even with the recent consolidation in the hotel sector. Savvy hotel owners and developers often engage in a competitive bid process (e.g., seeking RFPs) and weigh not only the name recognition, reputation and quality of the brands but also the financial incentives they may be willing to offer.

Often the financial incentive takes the form of "key money" — where the operator contributes cash to the hotel owner in exchange for a long-term management agreement. The cash is typically paid at or within a short period before or following the hotel's opening.

In most cases, key money paid by the hotel operator amortizes or "burns off" during the term of the management agreement. That is, the owner does not have to repay the key money except when the management agreement is terminated prior to the expiration of its stated term.

The amount of key money depends on various factors including the size and location of the hotel, projected fees over the life of the management agreement and the competition for the hotel from other operators, including whether brands are

Related People

Ronald S. Kornreich

Related Work

Hospitality

Hospitality Acquisition and Development

Hospitality Operational Matters

“boxed out” from managing due to exclusivity/area of protection restrictions. A hotel with strategic value to a brand, such as a trophy property in a gateway city, could generate a significant key money contribution.

Nevertheless, key money is not the right fit for every owner or operator, or every hotel. What follows provides a brief overview of some of the advantages and disadvantages to key money, as well as some of the other financial incentives that operators use to secure long-term management arrangements.

Key Money

One primary advantage of key money is that it is straightforward and relatively easy to negotiate, once the parties agree on the amount and timing of the payment. Because key money is a sum certain that generally does not vary based on future exigencies, the owner is assured of the key money payment (provided the hotel opens), and many of the complexities in an operating profit guarantee (described below) do not come into play.

That is not to say that owners and operators do not negotiate the terms of key money contributions heavily. Besides the amount and timing of the contribution, points of contention may include the circumstances in which the owner must repay or the operator may reduce the key money.

For example, an owner may push to have the key money forgiven if the management agreement terminates due to the operator’s event of default or failure of a performance test. An operator may push to have the key money repaid if the hotel achieves certain performance thresholds or is sold. Sometimes an operator will insist that the amount of key money to be provided by it at hotel opening be reduced if the owner fails to meet construction or opening milestone dates.

Whether key money is the right incentive may also depend on the particular owner or operator, and the particular hotel. For example, some smaller operators may not have the cash on hand to offer a key money payment. Some owners have sufficient debt and equity financing and prefer incentives that increase operating returns, such as a fee “ramp up” (described below). An owner who plans to sell its hotel within a relatively short “hold” period may prefer incentives that increase the value of the hotel to prospective buyers to an upfront cash infusion.

Fee Discounts

Some operators, and owners, prefer a discount on base management fees to a key money contribution. This is what many call a “ramp up,” since the base management fee, which is based on a percentage of the hotel’s gross receipts, is reduced during a specified number of years at the start of the operating term before “ramping up” to the “standard” fee.

While a ramp up and key money are not always mutually exclusive, an owner may “trade” all or a greater amount of key money for a more significant fee discount — essentially exchanging upfront money for increased profitability in the early years of the operating term. This can be desirable for an owner who has sufficient debt and equity financing and is more concerned about meeting its debt service and reducing its costs during the hotel’s initial stabilization period.

If the hotel is sold during the ramp-up period, the ramp up would then benefit the buyer and, perhaps through an increased purchase price, the seller. Key money, on the other hand, benefits only its recipient.

Sometimes a sale of the hotel can create complications with regard to key money. If, as is often but not always the case, a hotel owner does not have to repay the key money upon a sale (provided the management agreement continues in place), the buyer would likely assume the contingent key money payment obligation despite not having received the key money payment. This issue does not come into play with a ramp up.

Equity Contributions

Some operators are willing to provide equity contributions to secure a management agreement. Frequently the equity investment takes the form of "sliver equity," where the operator purchases a small interest (usually 10 percent or less) in the owner, though some operators are willing to partner with a developer or buyer of a hotel and make a more substantial investment.

One advantage to an equity relationship is that it aligns to some extent the financial interests of the owner and the operator, since the operator, as an equity investor, will be entitled to a share of, and presumably incentivized to optimize, hotel profits. However, a number of challenges arise when an operator also becomes an equity partner.

First, the owner and the operator need to agree on the value of the equity — the percentage of the owner the operator will receive in exchange for an equity contribution.

Second, the parties need to discuss if the operator may be required to fund additional capital in the future and the effect of additional capital on the operator's equity percentage (e.g., dilution).

Third, the equity relationship may make it more difficult for the owner to terminate the management agreement with the operator. Typically, the owner, as principal, can terminate the operator, as agent, for any reason, subject to a claim for wrongful termination. However, if the agency relationship is considered an agency coupled with an interest, as it would likely be with an equity investment, an owner's ability to terminate could be impeded.

Fourth, any termination of the management agreement carries with it a host of related issues, including:

- Who acts on behalf of the owner in enforcing the management agreement and making decisions regarding termination?
- Does the owner have the right to buy out the terminated operator's equity position?
- Does the terminated operator have the right to "put" its interest to the owner?
- What method will determine the buyout price?
- If the terminated operator remains an equity owner, who selects the successor operator?
- If the terminated operator remains an equity owner, what rights will it have over major decisions, and what financial reports and books and records will it have right to access?

These issues can result in lengthy, complex negotiations that often make equity contributions a costly and time-consuming option relative to key money.

Operating Profit Guarantees

As an alternative to key money, some operators are willing to provide to owners an operating profit guarantee. A guarantee can take various forms but typically requires the operator to pay the owner the amount by which the hotel's profit (usually GOP) in an operating year falls below the agreed target profit level.

Guarantees typically run for a specified number of years, sometimes commencing at the start of the operating term and other times at stabilization. Often the operator's liability under the guarantee is subject to a cap. Sometimes the operator is able to negotiate a requirement that the owner refund amounts paid to it under the guarantee to the extent the hotel generates excess profits in subsequent guarantee years.

The primary advantage of the guarantee is that it provides assurance to the owner of a sufficient return and incentivizes the operator to manage the hotel profitably.

However, guarantees are not as “guaranteed” as key money. Sometimes they contain exclusions that negate the guarantee payment obligation if the cause of the profit shortfall is, for instance, the owner’s default, a major renovation, the failure to achieve brand standards, general adverse and market conditions, and other events beyond the operator’s control.

In addition, if the hotel achieves the target levels of profitability, it is possible that the owner will never receive any guarantee payments. In that case, it is likely the owner will have forgone a guaranteed key money payment in exchange for an operating profit guarantee that ultimately was of little or no value.

A “hot” property may very well be eligible for key money or other financial incentives. Owners and operators should consider carefully the pros and cons of the various alternatives.

This update originally published in *Law360* on December 6, 2017.

This Akerman Practice Update is intended to inform firm clients and friends about legal developments, including recent decisions of various courts and administrative bodies. Nothing in this Practice Update should be construed as legal advice or a legal opinion, and readers should not act upon the information contained in this Practice Update without seeking the advice of legal counsel. Prior results do not guarantee a similar outcome.