The devil in definitions in every hotel management or franchise agreement

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At the beginning of almost every hotel management or franchise agreement there are about ten pages of defined terms used throughout the body of those agreements. Otherwise prudent hotel owners and managers having comfortable familiarity with what they believe is boilerplate often have a tendency to skim the yawn-inducing defined terms in favor of a more detailed review of the "real" parts of their management or franchise agreements. Much as Eve should have resisted the Serpent's urgings to pluck the apple, hotel stakeholders should resist the temptation to avoid detailed review of a hotel agreement's first few pages. As is so often true, the Devil is in the details, in this case, the definitions. His pitchforks, while frequently hidden in the long text of definitions, are nevertheless quite sharp. Don't get stuck.

A "Category" of One

Hotel Brands such as Hilton, Marriott or Starwood have sub-brands such as Conrad, Residence Inn or Westin, usually referred to as a "system" of hotels operated under the sub-brand. The obligations and privileges contained in hotel agreements are generally applicable on a uniform basis to hotels within the System. Standardization with regard to quality, look and feel, and guest experience makes lots of sense from the perspective of both the brand and the hotel owner. Within each system of hotels, there may be a "category" of certain hotels with respect to which a brand may reasonably mandate different obligations or offer alternative privileges, based upon certain criteria (e.g., geography, nationality, urban, or suburban). Any hotel deemed by the brand to be within a category defined by the brand must comply with the brand's requirements applicable to the category. A category under the prevailing definition, however, is whatever the brand says it is, and it may change from time to time, just as the requirements applicable to it may change. Rather than have a category containing "all hotels on Atlantic Ave. in Boston having a really cool rotunda," which would refer only to the Boston Harbor Hotel and present a risk of that hotel's being singled-out for unfavorable treatment, the hotel owner should require that a defined category be comprised of not less than several system hotels, such as "northeast urban luxury hotels."

"Competitor?" Not Yet.

For good reasons mainly involving protection of its intellectual property and business processes, Marriott does not want Hilton or its affiliates to own a hotel licensed under a Marriott brand. Accordingly, hotel management and franchise agreements contain draconian provisions applicable to any person defined as a "competitor" having an interest in the hotel. Should a competitor acquire an interest in the hotel, the licensing brand will typically have the right to terminate its hotel agreement, assess a multiple of ordinary liquidated damages upon termination, or purchase the affected interest before the competitor acquires it. The hotel's owner must therefore maintain a vigilant commitment to avoidance of business with its brand's competitors. Clearly, Hilton is a competitor with respect to Marriott and presents an easy case, but a "competitor" as defined in hotel agreements also typically includes any person or its affiliate that owns or has an interest in a brand licensing or operating a minimum number of limited or full service hotels. Arguably, a lender which has provided corporate financing to a competing brand and has a security interest in all of the brand's assets to secure repayment of the loan has an "interest" in that brand and could, in fact, take over that brand upon default under the loan. If that same lender becomes an investor with the hotel owner, has a competitor acquired an interest in the hotel? Given the increasing complexity of financing arrangements involving hotels and the numbers of parties engaged in investment banking activities, and in order to preserve flexibility in its financing options, the hotel owner would be wise to ask that the definition of competitor be modified to exclude persons that merely have the potential to become competitors upon exercise of their rights with respect to the competing brand. Unless the bank in the foregoing example actually forecloses its interest and becomes the owner of the competing brand, and so long as it is not exercising any control over management of the competing brand, it should not be viewed as a competitor.

Losing "Control"

The power to direct the management or policies of a person is "control." Changes in control of the hotel owner trigger a number of undesirable consequences under the hotel agreements, including transfer review fees and a requirement that the hotel be upgraded under an expensive Property Improvement Program (PIP). If the hotel agreements are entered into before the hotel owner's capital structure is final, there is a risk that upon admission of investors, control of the owner may change. For example, a fairly typical arrangement would involve the hotel owner's giving its principal investors the right to approve certain major decisions. The hotel owner would retain day to day control and the right to initiate all decisions, yet the owner would no longer have the right to direct management. Having an exception in the "control" definition for the grant of major approval rights will solve the problem. For its part, the investor will likely wish to have the brand agree that it may transfer its interest to a third party or exercise rights under the hotel owner's organizational documents to assume control without triggering the adverse consequences of a change of control under the hotel agreements.

What's in my "Hotel?"

"Hotel" is generally defined as the entire site and all buildings on the site where the hotel is located. The consequences of having a portion of the site or its buildings included within the definition of hotel are numerous. All parts of the hotel must comply with brand standard, all Gross Revenues from the hotel will be included in calculation of reserve requirements, and the Hotel must be upgraded on a regular basis. If, however, there are portions of the site or buildings that do not interact with the hotel in any meaningful way or affect guest experience, they should be excluded from the definition of hotel. For example, a building might have retail or office space under the same roof, but accessible only through an entrance separate from the hotel lobby. Such separate space should not be subject to standard requirements, contribute to a reserve, or be at risk of any PIP. Care should also be taken to exclude from the definitions of "Gross Revenue" or "Gross Room Revenue" any income against which the Brand should receive no fee or impose any reserve requirement. Examples of such income include parking revenue, cable or internet charges, and equipment rentals.

"System": Is that all there is?

Where hotel agreements define an Area of Protection (AOP), a geographic area surrounding the owner's hotel within which the brand may not allow another hotel to be opened, the prohibition is limited to "system" hotels. A system hotel is a hotel having the same sub-brand name as the owner's hotel. Given the increasing proliferation of hotel sub-brands, however, it is possible that a brand hotel operating under another system may, in fact, compete with the hotel. I have begun to propose a new definition: "competing hotel." A competing hotel is any hotel which would be placed in the owner's competitive set and should not open within the AOP. After all, the owner does not care what the Competing Hotel is called, but only whether it adversely affects the results of the owner's hotel.

Much substance is contained in the definitions section of hotel agreements. So, start at the beginning, and read top left to bottom right. Don't flirt with the devil.

About this month's author

Kenneth MacKenzie, the principal owner of Certainty3, located at 31 State St., Boston. Formerly McKenzie was the co-leader of the Hospitality and Recreation Group at Goulston & Storrs. MacKenzie represents institutional investors, private equity funds, investment managers, pension funds, university endowments, REITs, major lending institutions and developers in the acquisition, financing and disposition of all classes of real estate assets both nationally and internationally. MacKenzie specializes in transactions involving hospitality assets and has significant experience in large-scale joint-ventured deals, often involving non-profit institutions such as universities or hospitals. He frequently assists clients in structuring their responses to RFPs for complex mixed-use projects. MacKenzie received his A.B. from Dartmouth College and his J.D. from Boston University School of Law, where he graduated magna cum laude. MacKenzie is admitted to practice law in the state of Massachusetts.