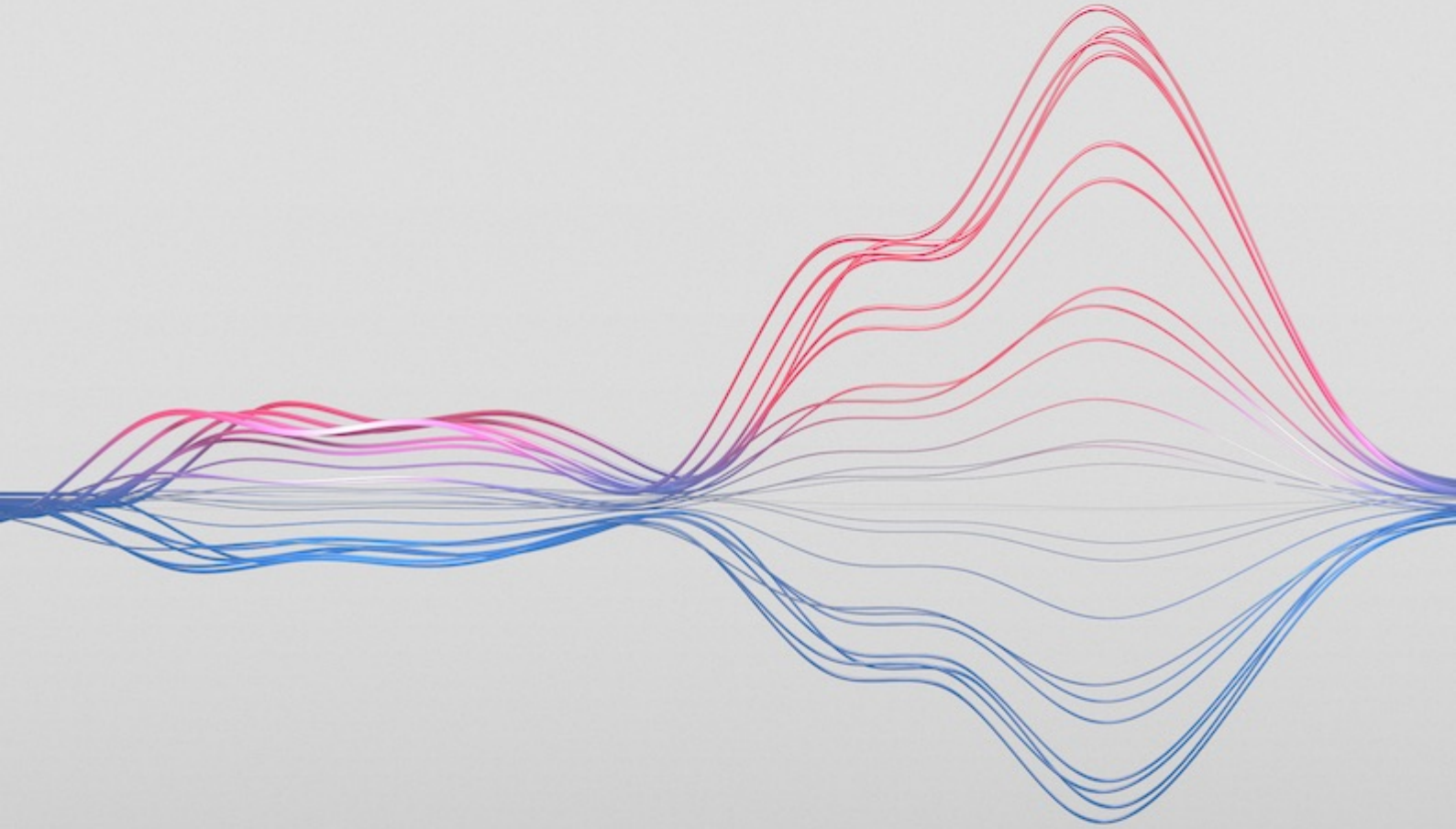
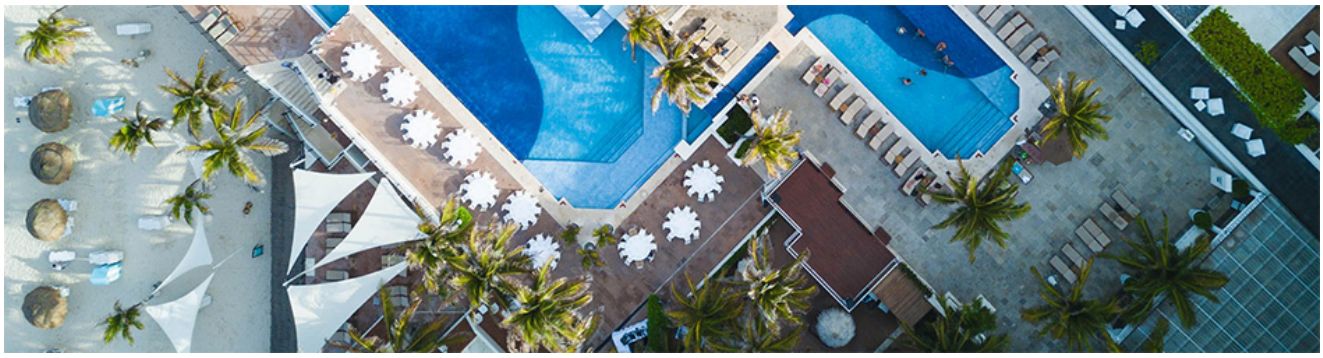
SAUDI ARABIA

Hotel Management Agreements



Introduction



One cannot discuss the evolution of hotel management agreements (HMAs) without first talking about the separation of hotel ownership and hotel operations; a transformation of the major chains' business models, more commonly known as an "asset light" strategy. Today the form taken by hotel operators in HMAs is an important factor in the effective working of the market in hotel investment. DLA Piper's Hospitality and Leisure Sector Group has negotiated HMAs for a myriad of different clients across the H&L landscape (owners, investors, operators (both branded and white label) and lenders) in all of the world's key jurisdictions.

Many consider hotel management agreements to be borne out of a modified lease for the Hong Kong Hilton back in 1963, and the main terms included in it underpin most HMAs to this day. All major chains today have, to one degree or another, expanded nationally and internationally through a combination of franchise and management, and all have their own "form" or template agreements. In summary, over the last few years, we have found that trends that started as a result of the financial crisis of the last decade have continued to develop. In many markets the advent of recession made operators more risk averse. Traditionally HMAs were a means to limit operators' exposure to fixed rental payments when revenues were dropping. In less developed markets, even with a degree of economic recovery, operators have continued to use HMAs in this way. In more developed markets, such as Spain and the United Kingdom, we have seen increased complexity in agreements, a symptom of owners becoming more knowledgeable and seeking more control and input on the operation of their hotel, although owners continue to take the lion's share of commercial risk in developments.

Another important factor, as with any real estate investment, is the attitude of those who are providing the money, be it equity or debt. Leases were the traditional mainstay of hotel developments and indeed Germany remains a country where hotel deals are commonly based around leases. However, as investors have started to see the increased returns from ownership, the boom in arrangements like ground leases and other market changes is essential to have an understanding of investors and be able to work with them in a scenario of increasingly complex legal arrangements.

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General

Are Hotel Management Agreements (HMAs) common in the jurisdiction?

Yes, this is the method by which most intentionally branded hotels are operated.

If not HMAs, what are the alternatives / what is commonly used?

In recent years, we are starting to see more international operators becoming increasingly willing to enter into Franchise Agreements. This is as a result of having an increasing number of hotel owners that are appropriate partners for a franchise arrangement and an increasing use of asset managers in the hotel sector.

Is it common or usual for the HMA to be governed by (i) local laws; (ii) the laws of one of the parties' country of incorporation; or (iii) an alternative jurisdiction?

The starting point for international operators is that the HMA will be governed by the laws of an alternative jurisdiction (eg English law); however, it is not uncommon for international operators to contemplate agreeing to local law where this is a sensitive issue for owners. This is often the case for government related entities, for example.

Are there any significant or unusual points to note in respect of tax on HMA payments in the jurisdiction?

It largely depends on corporate structures. In general, both owners and operators should be aware of VAT and withholding issues on payments and of the application of double tax treaties.

Term and termination

Is there a standard contract period of an HMA?

Between 15 and 25 years for the initial term with up to two renewals of 5 or 10-year terms.

Is the term usually fixed? Are early exit or similar options included (contractual or implied)?

Fixed term.

Is it usual to include fees / liquidated damages for early termination?

While it is not typical, it is sometimes possible; however, local law considerations apply as to the effectiveness of liquidated damages provisions.

What is the usual position in respect of renewal?

Renewal upon the mutual agreement of the parties or at operator's discretion.

Fees

Is there a standard fee structure for HMAs (eg base + incentive)?

Base fee (as a percentage of total revenue) and incentive fee (as a percentage of gross operating profit).

What other fees and charges are there (such as royalties, accounting, marketing, license fees, etc.)?

There is usually a license fee (as a percentage of total revenue), a centralized services fee (usually based on the services used at the hotel) and a marketing fee (which is often a percentage of room revenue).

Are owners typically required to set aside funds for fixtures and fittings?

Yes, a separate fixtures and fittings account must be contributed to each month.

Performance and operations

What is the usual standard imposed on an operator in respect of the operation of the hotel?

A standard usually needs to be negotiated into the HMA – it may be possible to negotiate that of a similar operator, eg luxury hotels in the country.

What performance measures are commonly used in the jurisdiction?

A performance test commonly has two limbs – one is a test against the RevPAR of the Hotel compared to a competitive set of hotels and the other is a comparison against actual total revenue compared to the budgeted total revenue. Failure of the test is if the Hotel has a RevPAR of less than 80-90% of the Competitive Set and if the actual total revenue is less than 80-90% of the budgeted total revenue.

For an operator to fail the test, typically it must fail both limbs of the test for two consecutive years. The HMA may allow the operator to "cure" a failure of the performance test by making a payment. HMAs that provide a "cure right" for the operator usually limit how many times such a cure right can be used by an operator (often no more than twice during the initial term).

Is an operator or owner guarantee common in the jurisdiction?

No, however international operators will likely require the title holding entity of the Hotel (PropCo) to enter into a non-disturbance agreement if the contracting party to the HMA is a different entity (OpCo).

What is the usual position in respect of employees? With whom does the liability for the employees sit?

Due to KSA law and regulations, it is always the hotel owner who employs the hotel employees.

Is it usual to have a non-compete clause, eg that no other property with that brand can open within a certain radius?

This is often negotiated as part of the deal.

Who is responsible for insurance?

The owner is responsible for property insurances and the operator may procure the operational insurances to ensure they are in place and meet their requirements.

Does the HMA give rights in real estate in the jurisdiction?

No.

Does the HMA need to be recorded against the property, if this is possible in the jurisdiction?

No.

Where financing is taken, is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?

This will depend on the operator and the bank. The use of NDAs has grown a lot in practice in recent years.

What other agreements usually sit alongside an HMA in the jurisdiction?

Technical Services Agreement, License Agreement and Centralized Services Agreement.

Transfers and assignments

What are the standard rights / restrictions in respect of transfer / sale of the hotel?

An owner typically cannot transfer without the consent of the operator. The operator will seek to prohibit transfer to a competitor (often broadly defined) or anyone subject to sanctions etc.

When a managed hotel is sold (either asset or share deal), is it usual in the jurisdiction that either the Operator's consent is required for the sale, or that the hotel may only be sold if the HMA transfers with the hotel?

Yes, definitely.

Do HMAs commonly include a right of first refusal for the operator to purchase the hotel?

This is less relevant in KSA due to the restrictions on foreign ownership of real estate. However, the wording is often still included in HMAs.

Is it usual to include provisions which enable the sale of the property with vacant possession ie without the brand?

Only if this is negotiated, and such a provision would include liquidated damages to be paid to the operator.

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