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# The Pros and Cons of Hotel Franchise Agreements

## Brands Wield Broad Oversight over Properties

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SPECIAL TO BANKER & TRADESMAN

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There are good reasons for hotel owners to affiliate with national brands such as Marriott, Hyatt and Hilton. Hotel brand owners offer proven operating programs, staff training, marketing support and reservations systems, and restrictions on similarly branded hotels from operating nearby.

They also enable hotel owners to flag their properties with brands associated with desirable levels of comfort and guest services.

But these benefits come with costs, which are documented in hotel franchise agreements between brand owners, known as franchisors, and hotel owners and operators, known as franchisees.

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Franchise agreements are designed to generate income for hotels by associating them with a well-known brand, but franchisors demand extensive control over hotel management decisions.

### Calculating Royalties and Franchise Fees

Franchise agreements are designed to protect the franchisor's brand and generate fee income for the franchisor. Typical franchise agreements require franchisees to operate under the brand for several years, while observing franchisor standards, paying licensing fees to franchisors, committing to property improvement programs and giving franchisors veto power over changes in ownership or management.

Franchisees bear hefty termination fees if they terminate their franchise agreements early, or when franchisors terminate agreements because of franchisee defaults. Prospective franchisees have limited power to negotiate franchise agreements, yet some provisions are open to discussion.

Premium franchisors can charge franchise fees in the range of 4 percent to 6 percent of gross room revenue (net of room taxes). This percentage often rises when franchisees enroll in brand marketing and online reservation plans.

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However, franchise fees are negotiable. For newly constructed or renovated hotels, and hotels that are new to the brand, franchisors will sometimes agree to lower these fees initially, then gradually increase them when the hotel's income stream is expected to stabilize. Also, hotel owners should make sure that franchise fees are tied to gross room revenue, and not to other sources of revenue unrelated to the brand, such as food, drink, and spa services.

## Change of Ownership Comes with Risks

While franchisees may own their hotel properties, they do not own franchisors' brands.

Franchisees do not have an unrestricted right to sell their properties with brands in place. Those who sell their hotels without franchisor assent, risk termination of their franchise agreements and assessment of termination fees.

Sales of stock or other equity interests in franchisees are also likely to trigger termination of franchise agreements and resulting fees, especially if the sales result in a change of control of the franchisee.

Nevertheless, franchisees can seek flexibility here. Franchisors might agree not to unreasonably withhold consent to brand transfers to another existing franchisee or experienced operator. Franchisees should also ask franchisors to allow transfers of equity interests that do not result in a change of control, or that arise from gifts or inheritance.

Banks and other institutional lenders make loans to hotels based on hotel revenues, which often depend on hotel brand recognition and other amenities derived from franchise agreements.

## Comfort Letters Give Lenders Assurances

Franchisees should request that franchisors address lender concerns with "comfort letters" assuring that lenders can continue operations under franchise agreements if they take control of the hotel after a franchisee's default on its loan obligations.

Banks and other institutional lenders make loans to hotels based on hotel revenues.

Comfort letters typically require franchisors to notify lenders when franchisees breach franchise agreements, and allow lenders to cure franchisees' defaults and install replacement franchisees for the hotel property.

From a lender's perspective, the loan documents should make it clear that a franchisee's default under the franchise agreement is also a default under the lender's loan documents.

## Oversight of Management, Improvements

Because franchisors require that hotels using their brands adhere to brand standards, franchisors insist on controlling which hotel management firms operate franchisees' properties.

Franchisees must respect these concerns, while insisting that franchise agreements provide workable mechanisms to terminate and replace unsuccessful hotel managers.

Franchise agreements also often require franchisees to periodically install expensive replacements, upgrades, and improvements to hotel properties.

Franchisees should negotiate how often franchisors can impose these property improvement programs, the scope and cost of such programs and the possible availability of key money from the franchisor to offset program costs.

Franchise agreements list numerous events of default that enable franchisors to suspend franchisees' access to services or terminate the agreement. Events of default include nonpayment of franchise fees, failure to observe brand standards and sale of the property or change of management without franchisor consent.

Franchisees should require that franchisors give them notice and cure periods for defaults where appropriate, before franchisors exercise rights and remedies.

Hotels owners must think carefully before affiliating with a recognized national brand. Once they decide to do so, they should not accept an offered franchise agreement without ensuring that the agreement gives them appropriate legal protections. ◀

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