

## **Current Issues in the Negotiation of Hotel Management Agreements**

In one of the most active hotel development, financing and resale markets in recent decades, existing management agreements reflect many different approaches to the owner/management relationship. These approaches arise in the business realities of local supply and demand, the intended quality of the hotel and its target market. Differences in state and local law also play some role.

The terms of management agreements in current negotiation also demonstrate an increasing tension between the business goals and expectations of equity investors and lenders, on the one hand, and the brand-affiliated companies which deliver increasingly centralized services in development, operation, marketing and technical support. More than ever before, management agreements are negotiated and performed in a landscape of disputes carried out in litigation or arbitration, often for very high stakes and with substantial industry attention.

At no point in recent history have so many forms of management agreements been in use at a single time, or have so many different balances been struck between owners, lenders and management companies in their complex relationships. The length of the agreements and nuances of their terms are more challenging for those who negotiate, document and seek to enforce these agreements. To speak now of an "industry-standard" management agreement or of "market terms" is probably incorrect.

Not surprisingly, sophisticated investors continue to receive substantially different and better terms than novice owners. Sophisticated lenders require and obtain modifications of management terms as conditions of their financing. In terms of their requirements for financing, the standards of sophisticated lenders are well in advance of those of the rating agencies which set guidelines for the securitization market. These sophisticated lenders are also well ahead of the regional and local lenders who are only occasional participants in the hotel market. Owners of any size, however, must anticipate the application of the "best practices" by all future lenders in order to protect their ability to refinance their hotels and, ultimately, to realize upon their investments. In counseling owners in regard to management agreements, the central issue is not how best to maximize current income or short term return. It is the question of overall strategy for a successful investment, including for an exit from that investment by refinancing and/or sale.

Hotels now in operation are managed under several different forms of agreements entered into in past years. The oldest of these agreements include a small number of agreements first negotiated in the 1960's and 1970's. These are generally long-term agency agreements relating to large properties and were originally entered into with major insurance companies or other institutional owners. Some have terms of up to fifty (50) years. Most have been amended repeatedly and are now approaching expiration unless extended by an amendment. These agreements typically give the owner discretion over capital expenditure and reserves and substantial budget approval rights. They contemplate hands-on asset management, with the owner in an on-going dialogue with the manager. Entered into before the creation of statistical databases and STR reports, RevPAR, Competitive Sets and similar concepts are unknown to these contracts. Performance-based termination provisions are also lacking, the owner having understood the fee structure (base fee calculated on gross revenues plus an incentive fee calculated on gross operating profit) to have aligned the profit goals of owner and manager. Through the sharing of profit inherent in the incentive fees, the manager was to make money when the owner made money.

The reality of how owners and management companies made profits and negotiated their agreements changed significantly in the 1980's.

- In the same manner as real estate development generally, hotel development in the early and middle years of the decade was spurred by tax-shelter investment which de-emphasized return on investment from day to day operation. The market changed

abruptly after the tax reforms of the late 1980's. Without tax benefits, many hotels did produce returns sufficient to attract investors or support refinancing.

- Hotel agreements in the early 1980's routinely specified a capital reserve contribution level of 3% of gross revenues. Possibly sufficient where the owner was an institution prepared to plan for and make periodic additional investments to catch up capital replacement deficiencies, that level of reserve was grossly inadequate for hotels that were meant to be closed-end investments and faced competitive pressures for continuing upgrade and expensive technologies. Inadequate return to investors was compounded by calls for new capital and increased reserves to remain competitive, without any increase in returns.
- Hotel management companies were themselves under increased earnings pressure as more became independently-reporting public companies or became divisions of larger public companies. The risks to stock price arising in the cyclical, highly variable profits earned from incentive fees were difficult for these companies to accept. Some attempted to move hotel management to a business model in which the management earnings were more closely tied to gross revenues and a variety of per-room charges or allocations of overhead to owners, and thus less dependent on profits earned by hotels for owners and shared through the incentive fees. Among the most problematic of these charges were systematic, indirect charges to owners by the acceptance of payments from vendors dealing with managed hotels.

The changes of the 1980's spawned increasing conflict of interest between owners and management companies. The changes came as owners were already under pressure from the loss of value associated with diminished tax benefits, from accumulated capital demands, and general economic conditions. Hotel loan defaults increased, banks failed, and the Resolution Trust Corporation became one of the largest hotel owners. The conflicts of interest emerged as litigation in the early years of the 1990's. Many of these disputes arose in situations in which the new charges and new business model had been instituted in hotels operating under old-form agreements. Believing themselves entrenched under long term contracts, some management companies changed their business practices without notice to or consent by owners.

Until the mid-1990's, there was virtually no case law specific to hotels in a federal court or from an appellate court of a state that was a notable commercial forum. Cases had been relatively few, and the decisions were not viewed as having general application. That situation has changed significantly in a series of legal developments beginning in the late 1980's and early 1990's. Most of these arose where owners reacted to failures of hotel or capital demands by management companies.

- The most significant line of decisions related to the application of agency law to hotel operation. These cases developed from older California decisions holding that hotel management agreements, as agency agreements, could be terminated by the hotel owner as principal, at will and regardless of the terms of the written contract.<sup>1</sup> Under standard agency principles, the owner remained subject to an obligation to compensate the terminated management company in monetary damages if the termination was subsequently found to be without cause. These rulings, while fully consistent with classic agency principles, seemed to surprise some hotel management companies who had believed themselves fully entrenched

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*Robert E. Woolley et al. v. Embassy Suites, Inc. et al.*, 227 Cal. App. 3rd 1520, 278 Cal Rptr. 719 (Cal. App. 1st Dist. 1991); and *Pacific Landmark Hotel Ltd., et al. v. Marriott Hotels, Inc. et al.*, 19 Cal. App. 4th 615, 23 Cal. Rptr. 555 (Cal. App. 4th Dist. 1993).

in long term contracts and not at risk of termination as a result of new charges and actions in conflict of interest with the owner.

- Some management companies attempted to defend against termination in these early California cases by asserting that they held an “agency coupled with an interest” which was not terminable under agency law. This defense failed, because the courts applied a narrow reading to what constituted “an interest”. The courts limited the exception to “an interest” acquired by the agent in its own name and inherent to the agency, as a freight agent may acquire an interest in a cargo for which it advances some payment and therefore holds an agency to liquidate and repay itself.
- Another line of attempted defense was the argument that the owner’s agreement to a longer term or, in the case of a lender, its agreement to “non-disturbance” of the management company constituted a waiver of normal agency termination rights. Ultimately, in a comprehensive opinion of a federal appeals court upholding the rights of owners and of lenders succeeded to ownership to terminate management companies, the various theories of these defenses were reviewed and rejected. Non-disturbance was rejected as a waiver on grounds of the public policy underlying the agency law. *Government Guarantee Fund of the Republic of Finland v. Hyatt Corporation*<sup>2</sup> remains a guiding case for hotel management disputes.

One practical effect of *Government Guarantee* was to allow owners to deal with unsatisfactory management or suspected misconduct by proceeding first to terminate the management companies and thereafter to litigate the issue of whether damages were due because the termination was without “cause”. This allowed the owners to end an unsatisfactory management relationship quickly and finally, without risk of appeal or reversal. As agents and thus fiduciaries, management companies then faced the burden of proving that their business practices and indirect charges were proper under fiduciary standards, and at best could hope for monetary damages for early termination. This forced management companies to deal with the issues of whether they had due authorization by the principal and whether the management companies had met their duties of disclosure in regard to accounting and operating practices that involved or benefited their affiliates. They would not be compensated for hidden profits. Aggressive business practices adopted in prior years left the management companies highly vulnerable. As hotels failed, forensic accounting investigations and actions by trustees in bankruptcy were particularly vigorous in pursuing issues of conflict of interest and the disgorgement obligations of agents. The consequences of the *Government Guarantee* case touched many management companies in regard to brand-wide practices. The decision continues to affect relationships with owners and investors. The fact that some companies are now publicly traded has brought attention to filed cases, verdicts and settlements. The magnitude of the claims has made even procedural developments and the issues of reserves taken for litigation material to stock price and to negotiation of future agreements.

Today, many provisions of draft management agreements put forth by management companies deal, directly or indirectly, with efforts to negate or reverse the effects of *Government Guarantee* and the rights of owners under agency law. Among the most commonly proposed provisions of this type are those which in substance (1) disclaim or negate agency and assert independent contractor status, (2) authorize or permit the management company and affiliates to engage in actions or business activities potentially in conflict with the owner’s interests, (3) authorize indirect charges or overhead allocations, (4) limit disclosure obligations or duties to account, (5) provide or imply other waivers of fiduciary duties, or (6) limit the remedies available to owner to negate those specific to agency – accounting, termination, disgorgement, etc. Some brand groups have turned to the “man-chise”, in which there are separate management and franchise agreements with the same corporate group. Only the management

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<sup>2</sup>

95 F.3rd 291 (3rd Cir. 1996).

agreement is viewed as vulnerable to agency termination, with the economic benefits being concentrated in the franchise agreement which is expected to survive. Additionally, management companies have turned to the use of arbitration without any assurance of discovery under federal rules of procedure as an additional safeguard. Most aggressively, some companies have sought to make use of a specific change in Maryland law in 2004 which purports to deny, retroactively, the remedy of termination and to make other changes in agency law unfavorable to hotel owners subject to the laws of Maryland.

A second line of legal development emerged from the battles between lenders and other creditors (including management companies) for ownership of revenues and control of hotels after loan defaults. Lenders had dealt with hotel revenues as collateral in a variety of ways, sometimes as a form of rents to be included in an assignment of rents and sometimes as an interest in personal property such as cash, accounts receivable, and deposit accounts. Most lenders had assumed that the revenues belonged to their borrower and were its to pledge. Somewhat inconsistently, lenders had sometimes dealt with management companies as quasi-tenants, granting "non-disturbance rights" and viewing the management contract as assets to be assigned as part of the pledged collateral in the same manner as an assignment of leases. Lenders awakened late to the problems that they faced in their arrangements with management companies. Poor management or an unfavorable contract was a potential cause of debt default, damaging to the value of the collateral, and an impediment to sale. Management companies viewed as tenants could assert possessory claims upon revenues and other collateral and could become the most serious competitors for proceeds. Lenders had taken pledges of hotel revenues as rents, only to discover that were not deemed to be rents from tenant leases, or were not clearly the property of the owner, or were claimed to be subject to senior liens or offsets by the management company. Lenders insufficiently prepared to deal with these issues -- which included many established institutional lenders -- incurred millions of dollars of losses as proceeds were shared with management companies, including debtor affiliates, as competing creditors. Lending to hotels became very problematic.

A solution to these problems became possible after the 1994 amendment of the bankruptcy laws with the support of the Resolution Trust Corporation, institutional lenders and hotel companies. This amendment provided that hotel revenues could be treated in bankruptcy as rents and thus controlled by the secured lender as post-petition cash collateral.<sup>3</sup> The solution, however, was not perfect and often did

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<sup>3</sup> Sec. 363. Use, sale, or lease of property

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property *and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title*, whether existing before or after the commencement of a case under this title.

Sec. 552. Postpetition effect of security interest

(a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

....

(b)(2) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, and notwithstanding section 546(b) of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the

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not mesh with other terms of the management or loan documents. This has continued as an area of legal dispute, with hotel management companies again seeking “non-disturbance” and related rights in a frenzied hotel market.

In the most sophisticated segments of the market, we continue to see management agreements negotiated by owners to force alignment of the interests of owner and manager. These agreements provide as a condition of the right to manage that the management company must achieve certain of the owner's investment objectives. This is usually achieved through the devices of an “owner's priority” return, a preferred or guaranteed return to the owner enforced by a variety of devices. These devices may include subordination of some or all management fees to the priority payments and/or debt service, and/or giving the owner a termination right in the event that cash distributions are inadequate for current debt service or for refinancing. We are also seeing performance tests based not on a cash amount but on the margin of profit or distributable cash achieved by the management company, expressed as the percentage of accrued gross revenues. These tests, and in particular the margin test, respond directly to the problems of undisclosed overhead allocations, phantom revenues or hidden profits taken by the management company which have escalated much more quickly than have revenues.

We are also seeing sophisticated lenders and owners require specific protection for identified exit strategies essential to their own return. On the upside, when the hotel is successful, the owner wants to realize the profit by refinancing or sale. The ability to refinance can be protected in the management agreement by specific rights to assign the management contract and pledge the hotel assets, and rights to compel the management to provide required legal confirmations and subordinations or otherwise satisfy the requirements of a new lender. Owners now recognize that the ability to sell or to achieve a full market price may require the management agreement to be terminable by the seller or a new owner. Thus, a provision for termination on sale for based on a compensation formula may be required. Management companies are pushing back, seeking to retain some consent or control rights over financing, to avoid a contractual obligation to subordinate to a lender, and to remain with a property through and after a sale or foreclosure. Management companies are also seeking to obtain rights to participate directly or via an affiliate as the buyer in any sale on favorable terms, as by way of rights of first refusal which are materially unfavorable to owners.

Lenders and owners also seek protection on the downside, or when a hotel fails to achieve performance goals and the investors or lenders face low cash flow or a difficult exit. In anticipation of such situations, lenders and owners will seek clarity as to the maximum amount of their exposure, the priority of their rights, the compensation for termination of the management company, and the relative rights of the parties to determine whether, when and on what economic terms the management company may be allowed or required to give up control. Management companies respond by seeking to maximize their options to obtain more funds from the owner or lender, to remain in the property and continue to earn fees, or receive the maximum compensation if forced to leave. Management companies have in many cases become affiliates of much larger company groups or otherwise affiliated with entities with the capacity and interest to acquire hotels. This adds a further element of conflict, as when a management company with first offer or first refusal rights may be motivated to drive down the performance or value of a hotel under its control to facilitate a cheap purchase for an affiliate or open a space in a market for another hotel.

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case and to amounts paid as rents of such property *or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties*, then such security interest extends to such rents *and such fees, charges, accounts, or other payments* acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise. (*Emphasis added.*)

Separate from their concerns with exit strategies, owners and management companies continue to negotiate over the ability of the management companies to derive profits from sources other than the stated base fees and incentive management fees, or to take actions adverse to the investors and lenders. A number of prominent cases relating to brand-wide management practices and hidden profits have been decided or, after extensive public litigation, have been settled in the last decade. These have added to the knowledge of investors and lenders about the practices of the management companies in the hotel industry, and to the concerns of management companies that they may face substantial claims. This knowledge has increased the awareness of the stakes on each side, and has provoked a wide variety of responses by owners and lenders. Some management companies have chosen to expand their affirmative disclosures and the transparency of their fee and profit arrangements. Others have chosen a different path, trying to obtain advance waivers from owners and lenders to allow continued actions which constitute conflict of interest without legal consequence. The issues for all parties have also been affected by the industry's greater use of the regulated public debt and equity markets and of rated debt obligations to raise funds – the consequence of concealment or hidden financial terms may be much more severe than when these issues first arose in essentially private arrangements.

Investors and lenders appear to have entered a period of intensifying scrutiny for their bottom lines. Their focus on areas of unsatisfactory performance and declining return on investment has increased sensitivity toward the terms of the management arrangements. Overbuilding and excessive supply coming on stream raises issues of conflict of interest by the brands that are facilitating competition with the hotels that they manage. To the extent that these factors may contribute to unsatisfactory results, the contracts with deal or fail to deal with them will be intensively scrutinized and may be the subject matter of the next round of dispute and renegotiation.

# **HOTEL MANAGEMENT AGREEMENT**

**BY AND BETWEEN**

\_\_\_\_\_  
**as OWNER**

**And**

\_\_\_\_\_  
**as OPERATOR**

**And**

\_\_\_\_\_  
**as SERVICE AFFILIATE**

**Hotel:**

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## HOTEL MANAGEMENT AGREEMENT

THIS HOTEL MANAGEMENT AGREEMENT (this "Agreement") is made as of \_\_\_\_\_, 200\_, between \_\_\_\_\_, a \_\_\_\_\_ corporation ("Owner"); and \_\_\_\_\_, a \_\_\_\_\_ corporation ("Operator"); and \_\_\_\_\_, a \_\_\_\_\_ ("Service Affiliate")<sup>1</sup>.

### RECITALS

A. Owner is the owner of [fee title] to certain land, improvements and personal property<sup>2</sup> comprising a hotel known as "\_\_\_\_\_" and situated at \_\_\_\_\_, more particularly described in Exhibit A (collectively, the "Hotel"). The Hotel contains \_\_\_\_ hotel rooms, public and meeting spaces, a restaurant and business facilities.

B. Operator is presently engaged and experienced in and has all<sup>3</sup> licenses, permits and authorizations required for the operation, maintenance and management of hotels similar to the Hotel.

C. Service Affiliate is a wholly owned and controlled subsidiary of Operator.

D. Owner desires to engage Operator as agent<sup>4</sup> to operate, maintain and manage the Hotel, and to engage Service Affiliate to employ staff of the Hotel and to conduct its day-to-day

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<sup>1</sup> This agreement presumes the use of a separate employing entity that is the subsidiary of the operator. This is a liability insulation device used by some operators, which may or may not be effective to distance the owner and operator from employer liability. This device is being replaced more generally by creation of a free-standing management company subsidiary as the assignee for each management contract.

<sup>2</sup> Hotels and their businesses are highly dependent on personal property, and lenders are increasingly focused on taking that property as collateral. Unfortunately, older agreements sometimes suggest that operators, and not owners, have title to and control the personal property and cash. This is an increasingly important issue for lenders.

<sup>3</sup> In practice, some or most permits may be issued to the property or the owner. This is to some degree dependent on local law, but termination rights may be frustrated if the owner has not been vigilant in preserving its ability to control these licenses.

<sup>4</sup> In short term agreements, the operator may function as an independent contractor with limited agency rights to bind the owner to contracts for normal operation. An owner employing an "independent contractor" with a broad right of indemnification from the owner has the burdens of a principal in an agency relationship without being clearly entitled to the protections normally given to principals. In longer-term contracts, the relationship is in substance now usually one of agency. Some management companies now accept this but seek non-terminable agencies "coupled with an interest". No court has to date upheld a hotel management agreement as such an agency. Other management companies try to obtain waivers of agency or agreement not to assert the existence of agency in any dispute. The common law of agency is unlikely to allow a potentially self-serving label to prevail over the substance of a fiduciary relationship, but there is little doubt that owners injure themselves by agreeing to such terms.

operations, and Operator desires to accept such engagement, on the terms and conditions set forth herein.

## AGREEMENT

NOW, THEREFORE, in consideration of the mutual agreements herein contained, the parties hereto agree as follows:

### ARTICLE I

#### DEFINITIONS

##### Section 1.1 Definitions.

As used herein, the following terms shall have the meanings ascribed to them below:

"Adjusted Gross Revenue" shall have the meaning set forth in Section 8.1(b).

"Affiliate" shall mean any person or entity that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, Operator or Owner, as the case may be. Control shall be determined by reference to the regulations of the Securities & Exchange Commission.

"Affiliated Entities" shall have the meaning set forth in Section 3.8(c).

"Annual Budget"<sup>5</sup> shall have the meaning set forth in Section 3.2(b).

"Annual Guaranteed Base Fee" shall have the meaning set forth in Section 8.2(a).

"Annual Subordinated Base Fee" shall have the meaning set forth in Section 8.2(a).

"Architectural Services"<sup>6</sup> shall have the meaning set forth in Section 3.17(b).

"Architectural Services Fee" shall have the meaning set forth in Section 3.17(b).

"Base Management Fee" shall have the meaning set forth in Section 8.2(a) and shall include the Annual Guaranteed Base Fee and the Annual Subordinated Base Fee.

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<sup>5</sup> The concept of Annual Budget used in this agreement is one of a comprehensive business plan that is the primary communication and control mechanism between Owner and Operator. This is significantly different from the non-binding annual estimate used in older management agreements.

<sup>6</sup> This agreement emphasizes the precise description of services and related fees imposed by the management company and its affiliates. This departure from older agreements reflects the explosion of affiliate charges imposed on hotels by operators in the last decade, often without owners' knowledge or consent. The net result of these charges has been to make the base management fee a major source of profit to management companies, and to create a conflict in interest between owner and management company. Pro-management company agreements have recently begun detailed foreclosure of such transactions. This appears to be defensive and intended to avoid claims of conflict of interest or hidden profits. Owners may not read these terms with the attention that they need.

"Books and Records" shall have the meaning set forth in Section 7.1(a).

"Capital Budget" shall have the meaning set forth in Section 3.2(a)(3).<sup>7</sup>

"Capital Reserve Account" shall have the meaning set forth in Section 6.3.

"Cash Available for Disbursement"<sup>8</sup> shall mean the cash held in the Operating Account at the end of each month from operations of the Hotel or any other source, after payment of all Expenses of the Hotel then accrued and payable, and cash transfers to the Capital Reserve Account required by Section 6.3 and to the FF&E Reserve by Section 6.4. Cash Available for Disbursement shall not include (1) insurance and condemnation proceeds, (2) proceeds from any mortgaging, refinancing, or sale of the Hotel or from any other capital transaction, (3) amounts held in the Capital or FF&E Reserve Accounts, and (4) amounts necessary to maintain sufficient Working Capital as determined by Owner, including any deposits made by Owner for such purpose.

"Central Office Marketing Services" shall have the meaning set forth in Section 3.9(b).

"Construction Management Services Fee" shall have the meaning set forth in Section 3.17(a).

"Departmental Expense Percentage"<sup>9</sup> (utilizing the term "Departmental Expense" as defined in the Uniform System) as referred to in Section 3.2(c) shall mean \_\_\_\_%.

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<sup>7</sup> Surprisingly, capital budgets and multi-year forecasts are virtually unknown in older hotel management agreements. This may have been a consequence of the idea that an owner was liable for any amount of capital calls. Such information might have highlighted the capital deficit that plagued the industry in the mid 1990's, and accumulated as operating expenses were deferred by short term decisions in order to maximize the appearance of profit. Incentive fee structures based on gross operating profit or net operating income also contributed to the problem. Many management companies continue to resist responsibility for capital planning, and provisions for capital budgets may be intensively negotiated. This is particularly important as hotels age into their second and third decades, where capital issues become much more significant.

<sup>8</sup> This concept is used to test the performance of the operator and may be the standard for the owner's right to terminate the operator. Some management companies will seek to resist accountability for the bottom line performance of the hotel, arguing that they should only be tested by net income from operations. There will be extended debate over which "Expenses" are considered in assessing the management company's performance, and the minimum performance that the management company must achieve to avoid termination or to take up an extension term. On the owner's side, the issues are how minimal a cash flow the owner will tolerate in a long term agreement, what risks of operation the owner will absorb itself, and how long the owner is prepared to retain a management company when the owner's investment objectives are not achieved.

<sup>9</sup> This concept, like the concepts of "Overall Expense Percentage" and "Undistributed Expense Percentage," are devices for permitted variation from and within budget. In contrast to some other types of business operators, hotel management companies may resist budget compliance obligations more strongly. This reflects in part a historic problem with budget manipulation by on-site managers whose performance is disproportionately evaluated by budget achievement, and who are motivated to produce achievable budgets rather than accurate ones. Discretionary expenditure categories may be routinely over-budgeted with the unstated intention of reallocating the funds to

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"Employer" shall mean \_\_\_\_\_, a \_\_\_\_\_ corporation, which is herein the Service Affiliate.

"Expenses" shall have the meaning set forth in Section 8.1(c).

"Expiration Date" as referred to in Section 2.1 shall mean \_\_\_\_\_, 19\_\_ as that date may be extended pursuant to that Section or as that date may be accelerated pursuant to Article XI.

"First-Class"<sup>10</sup> shall mean a standard of operation equivalent to the mean performance level of the hotels know as \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_ or such additional or substitute properties of equivalent quality designated by Owner from time to time.

"FF&E Reserve Account"<sup>11</sup> shall have the meaning set forth in Section 6.4.

"Fiscal Year" shall mean Owner's fiscal year, which is presently 12 months ending \_\_\_\_\_. In the event that this Agreement ends on a date other than \_\_\_\_\_, the then-current Fiscal Year shall be deemed to end on that date.

"Franchise Agreement" shall mean the franchise agreement, if any, granting to Owner<sup>12</sup> a franchise or license to use the distinctive trademarks, tradenames, signs, emblems, color schemes and other readily recognizable symbols of a national or international lodging chain and providing such additional benefits as access to a national reservations system.

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other less discretionary categories. Thus, a limitation on reallocation within the budget is a serious issue to the managers.

<sup>10</sup> Management agreements historically referred to the standards of the particular brand as the standard of operation. Repositioning of chains to higher and lower market niches, changes in marketing concepts within chains, and capital calls to support new chain programs have all caused owners to seek more neutral standards as points of reference. Those agreements retaining the idea of chain standards may now define those standards with much more detail and may prohibit radical changes in those standards. Definition of standards by reference to a "competitive set" is increasingly common.

<sup>11</sup> The FF&E Reserve Account is dealt with independently of the Capital Reserve Account. The former is intended to provide for interior fixtures and furnishings while the latter is intended to deal with major building systems, roofs, facades, etc. Because this agreement does not provide for mandatory capital calls against the owner common in older agreements, the management company will give far more attention to the adequacy of reserves and its discretion in spending those reserves. As has become increasingly apparent to owners, FF&E and capital reserves may have been spent in the last decade on upgrades and new marketing ideas (such as in-room faxes, printers, improved telephone lines and coffee services) to the neglect of fundamental capital replacement. Those replacements are now be funded out of capital calls and new investment, a practice that may be inconsistent with the owners' long term investment goal of self-sustaining businesses.

<sup>12</sup> Franchise rights may be granted to the operator rather than the owner. This typically disadvantages to the owner and may force it to retain an operator to retain the brand name benefits. Management companies with an affiliated brand name typically do not separate and franchise the brand services or name. To do so would expose them to franchiser regulation. Outside the U.S., brand managers take a contrary view, because franchise fees have tax advantages.

"Governmental Impositions" shall have the meaning set forth in Section 3.12(a).

"Gross Revenue" shall have the meaning set forth in Section 8.1(a).

"Hotel Records" shall have the meaning set forth in Section 3.4(a).

"Incentive Management Fee" shall have the meaning set forth in Section 8.2(b).

"Incentive Percentage"<sup>13</sup> as referred to in Section 8.2(b) shall mean \_\_%.

"Laws and Regulations" shall have the meaning set forth in Section 3.11(a).

"Lien" shall have the meaning set forth in Section 3.13(b).

"Management Fees" shall mean the Base Management Fee and the Incentive Management Fee.

"Monthly Reports" shall have the meaning set forth in Section 7.2(a).

"Mortgage" shall have the meaning set forth in Section 3.13(a).

"Net Income Before Debt Service" shall have the meaning set forth in Section 8.1(d).

"Non-Competition Area" as referred to in Section 13.2 shall mean the area within a \_\_ mile radius of the Hotel.

"Notice" shall have the meaning set forth in Section 13.1.

"Operating Account" shall mean the account or accounts into which any monies received by Operator or the Service Affiliate from the operation of or otherwise in connection with the Hotel, and amounts funded by Owner as Working Capital, may be deposited pursuant to Section 6.1.

"Operating Budget" shall have the meaning set forth in Section 3.2(a).

"Operating Forecast" shall have the meaning set forth in Section 3.2(a)(4).

"Operator's Notice Address" shall mean:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Attn: \_\_\_\_\_

Re: \_\_\_\_\_

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<sup>13</sup> This agreement provides for a single incentive fee. In fact, many owners are paying graduated incentive fees that apply different rates to different tiers of income or cashflow achievement. Some owners are also capping the overall fees, without or with CPI escalators, to avoid windfall to operators when external inflation factors produce an unintended result. These caps are one reason that management companies have turned their attention to fees for services or allocated charges. These are effective in avoiding caps.

with a copy to:

\_\_\_\_\_  
\_\_\_\_\_

New York, New York \_\_\_\_\_

"Overall Expense Percentage" as referred to in Section 3.2(c) shall mean \_\_\_\_%.

"Owner's Bank Account" shall mean a bank account to be designated in writing by Owner for the purpose of receiving the payments due Owner pursuant to Sections 6.1(b) and 6.2(b).

"Owner's Notice Address" shall mean:

\_\_\_\_\_  
c/o \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_

Attn: \_\_\_\_\_

with a copy to:

\_\_\_\_\_  
\_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_

Attn: \_\_\_\_\_

"Permitted Mortgage"<sup>14</sup> shall mean a mortgage or lien on all or any part of the Hotel which secures an indebtedness that, together with the indebtedness secured by all other Permitted Mortgages then in effect, does not exceed the greater of \$\_\_\_\_\_ or \_\_\_\_% of the appraised value of the Hotel, and does not require for debt service in its first year more than \_\_\_\_% of Net Income Before Debt Service for the most recently completed Fiscal Year. Each percentage shall be determined as of the time that the lien of such Permitted Mortgage attaches to the Hotel or part thereof.

"Renovations" shall have the meaning set forth in Section 3.17(a).

"Replacements Budget" shall have the meaning set forth in Section 3.2(b).

"Service Contract Limit" as referred to in Section 3.8(a) shall mean \$[\_\_\_\_\_].

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<sup>14</sup>

Because the operator's rights are now subordinate to the rights of a secured lender, the operator will seek protection from the overleveraging of property. Given its choice, the operator will restrict the owner to a low loan-to-value ratio and a high debt service coverage ratio. We typically recommend that the owner's priority amount be the projected cash flow needed to service a normal amount of debt at this ratio, plus any excess necessary to attract equity investors. This tends to discourage management companies from imposing too high a ratio test.

"Service Contracts" shall have the meaning set forth in Section 3.8(a).

"Special Services" shall have the meaning set forth in Section 4.2(b).

"Special Termination Notice" shall have the meaning set forth in Section 11.1.

"Three-Year Budget"<sup>15</sup> shall have the meaning set forth in Section 3.2(f).

"Threshold" as referred to in Section 8.2(b) shall mean [\_\_\_\_\_] <sup>16</sup>.

"Undistributed Expense Percentage" as referred to in Section 3.2(c) shall mean 10%.

"Uniform System" shall mean the "Uniform System of Accounts for Hotels" (8th Revised Edition. 1986) of the Hotel Association of New York City, Inc., as approved by the American Hotel & Motel Association and as revised from time to time.<sup>17</sup>

"Working Capital" shall mean the excess of current assets over current liabilities, provided that "current" shall be determined according to realization within a 60-day period.

## ARTICLE II

### APPOINTMENT; TERM

Section 2.1 Appointment; Term. Owner hereby appoints Operator and Operator hereby accepts its appointment as the exclusive operator of the Hotel, and Operator undertakes and agrees to perform all of the services and to comply with all of the provisions of this Agreement upon all of the covenants and conditions hereinafter set forth for a term commencing on the date of this Agreement and expiring on the Expiration Date, unless sooner terminated pursuant to Article XI. The date otherwise set as the Expiration Date shall automatically be extended from year to year for additional one-year periods on the same covenants and conditions contained herein, unless either Operator or Owner has given written notice of such party's election not to extend this Agreement and such notice is received by the non-terminating party at least ninety (90) days prior to the date otherwise set as the Expiration Date. By its acceptance of this appointment, Operator represents and warrants that (i) it and the Service Affiliate are each duly organized, validly existing, in good standing under the laws of the state of their incorporation or formation, qualified to do business in the state in which the Hotel is located and has all requisite power and authority to enter into and perform their obligations under this Agreement, (ii) the person signing this Agreement for each of them is duly authorized to execute this Agreement on their behalf, and (iii) it has secured and will keep in effect during the term hereof all necessary licenses, permits and authorizations to enable Operator and Service Affiliate, and all agents and employees acting

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<sup>15</sup> As discussed above in regard to the Capital Budget, any form of longer term budgeting is a radical departure from past practices.

<sup>16</sup> This amount is intended to represent the level of net income or net cash flow that the operator must achieve to earn an incentive fee. The operator may earn its incentive fee only on the amount in excess of the Threshold. A threshold for these purposes may be set at the level of distributable income needed to meet debt service coverage obligations plus delivery of an acceptable return to investors.

<sup>17</sup> The new version, "Uniform System of Accounts for the Hospitality Industry" is described as the 9<sup>th</sup> edition. The change in name has however made its direct incorporation in older agreements problematic.



on the behalf of either, to perform all of their duties under this Agreement and shall notify Owner immediately should any such license, permit or authorization no longer be in effect or in good standing.

### ARTICLE III

#### DUTIES OF OPERATOR

##### Section 3.1 General.

(a) Operator shall operate, manage and maintain the Hotel and all of its facilities and activities in a diligent, careful and vigilant manner as a First-Class commercial hotel in accordance with the standards imposed by the Franchise Agreement and in order to maintain the condition and character of the Hotel and with the primary goal of maximizing the present value of Owner's cash flow from the Hotel. Operator shall provide such facilities and services at the Hotel as are normally provided by operators of First-Class commercial hotels, consistent with the Hotel's facilities. Operator agrees to act in accordance with the best standards of hotel and motel managers in the general area in which the Hotel is located, to apply prudent and reasonable business practices in Owner's best interests in operating, renting and managing the Hotel, and in granting complimentary rooms, food and beverage and to take whatever measures are necessary or prudent to provide for the security of the Hotel and its guests. Operator shall use all reasonable efforts to promote the maximum possible amount of profitable trade, commerce and business for the Hotel.

(b) This Agreement is of agency between Owner and Operator. During the term of this Agreement, Operator agrees to supervise and direct the management and operation of the Hotel on behalf of Owner and for Owner's account, in strict accordance with the standards set forth herein. Without limiting the generality of the foregoing, Operator shall perform all of the duties indicated in this Article III in consideration of its Annual Guaranteed Base Fee.

##### Section 3.2 Budgets.

(a) Within thirty (30) days after the date of this Agreement and on or before \_\_\_\_\_ of each year thereafter, Operator shall submit to Owner, for its approval, all of the following:

(1) a statement of estimated income and expenses in reasonable detail for each month of the ensuing Fiscal Year (or current Fiscal Year with respect to the first such statement) prepared on a form approved by Owner (the "Operating Budget") and including schedules of (i) Hotel room rates, (ii) occupancy levels, (iii) complimentary accommodations and services, (iv) categories of income, (v) all operating expenses to be incurred in operating the Hotel, including as separate line items amounts budgeted for repairs and maintenance, for advertising and business promotions, and for any item contemplating to an Affiliate of Operator, (vi) other fixed costs and expenses to be incurred in operating the Hotel, including all items included in taxes, rent, insurance, Mortgage payments and additions to the Reserve, and (vii) Cash Available for Disbursement.

(2) detailed budget estimates of monthly replacement expenditures for the ensuing Fiscal Year (or current Fiscal Year with respect to the first such statement) prepared on a form approved by Owner (the "Replacements Budget") and including separate estimates for (i) expenditures for capital equipment not included in FF&E and (ii) expenditures for fixtures, furnishings and equipment.

(3) detailed budget estimates of monthly capital expenditures for the ensuing Fiscal Year (or current Fiscal Year with respect to the first such statement) prepared on a form approved by Owner (the "Capital Budget") and including estimates for expenditures for renovations, alterations, rebuilding, replacements, additions and improvements in and to the Hotel.

(4) a narrative description of the Operator's plans and goals (the "Operating Forecast"), including a detailed marketing plan (specifying, among other things, rack rates being charged

at hotels similar in nature and in the general vicinity of the Hotel), for operating the Hotel for the ensuing Fiscal Year (or current Fiscal Year with respect to the first such statement) and, with respect to the two Fiscal Years thereafter, a forecast by summary category of operational income, expenses and capital requirements. The Operating Forecast shall indicate the source of Operator's information and shall be revised to contain such additional information as Owner and Operator may, from time to time, deem appropriate.

(b) Operator's submission of the Operating Budget, the Replacements Budget and the Capital Budget pursuant to Subsection (a) above shall constitute the "Annual Budget." If Owner shall disapprove the proposed Annual Budget or any portion thereof submitted by Operator in accordance with Subsection (a) above, Owner shall specify with particularity the reasons for its disapproval and Operator shall, after consultation with Owner, submit to Owner a new proposed Annual Budget or appropriate portion thereof within \_\_\_\_\_ (\_\_) days after the date of Owner's disapproval of the same, in form and content reasonably satisfactory to Owner. The foregoing procedure shall be followed until the Annual Budget is fully approved by Owner. Operator shall have \_\_\_\_\_ (\_\_) days to respond to Owner's objection by submitting a revised proposal. Until such time as the new proposed Annual Budget is approved by Owner, the portion approved, if any, shall become effective and the Annual Budget for the previous Fiscal Year, if available, with such changes as Owner may designate, shall remain in effect with respect to the portion of the proposed Annual Budget disapproved by Owner. Notwithstanding the foregoing, portions of the Annual Budget for the previous Fiscal Year shall be subject to the variations permitted under subsection (c) below. In conjunction with the preparation and approval of the Annual Budget, Owner and Operator shall cooperate to establish an approved Annual Budget that is appropriate for the required standard of operations of the Hotel and for the Hotel's level of occupancy.

(c) During the Fiscal Year covered by the approved Annual Budget, Operator shall use its best efforts to comply with such approved Annual Budget or any portion thereof approved by Owner and shall use its best efforts not to deviate therefrom or change the manner of operation of the Hotel, without the prior written consent of Owner. Notwithstanding the foregoing, Owner and Operator acknowledge that the approved Annual Budget will be an estimate of revenue and expense and Operator shall not be required to obtain Owner's prior approval for additional expenditures (1) which exceed the approved Annual Budget by not more than the Departmental Expense Percentage for each department's total expenses, the Undistributed Expense Percentage for each category of undistributed expenses and the Overall Expense Percentage overall, or (2) which, with respect to a single expenditure, exceed the budgeted amount by \$\_\_\_\_\_, or (3) which are required to meet emergency conditions as provided in Subsection (g) below. To the extent that revenues do not achieve budgeted levels, Operator shall use its best efforts to decrease Expenses below budgeted levels in a corresponding amount to maintain the level of overall profitability previously budgeted.

(d) Owner and Operator shall meet periodically at a time and place designated by Owner, for the purpose of reviewing Hotel operations including profit and loss statements, Operator's performance, capital expenditures, forecasts of Cash Available for Disbursement for the balance of the current Fiscal Year, and making any revisions to the previously approved Annual Budget required by Owner in its sole discretion in order to maintain or improve the departmental profits and margins as originally budgeted.

(e) Until such time as the initial Annual Budget is approved by Owner, Operator shall use all reasonable efforts to comply with the previous operator's most recent Annual Budget as revised and approved by Owner.

(f) Operator shall submit to Owner along with the proposed Annual Budget, on or before \_\_\_\_\_ of each Fiscal Year during the term hereof, the following summaries prepared on a form approved by Owner (the "Three-Year Budget"):

(1) an annual summary of the estimated income and expenses for the ensuing Fiscal Year and the two Fiscal Years thereafter.

(2) an annual summary of the estimated replacement and capital expenditures for the ensuing Fiscal Year and the two Fiscal Years thereafter. Such summary shall include the estimates of (i) expenditures for capital equipment not included in FF&E, (ii) expenditures for fixtures, furnishings and equipment, and (iii) expenditures for renovations, alterations, rebuilding, additions and improvements in and to the Hotel.

(g) Whenever, by reason of circumstances beyond the reasonable control of Operator, emergency expenditures are required to be made to ensure that the standards specified in this Agreement are maintained, Operator may make such emergency expenditures not included in the approved Annual Budget, provided that the expenditure for any one such occurrence may not exceed \$\_\_\_\_\_ without the prior consent of Owner, unless Owner cannot be contacted through all available means for a decision within twenty-four (24) hours after the emergency, in which event Operator shall have the right to make any such expenditures up to \$\_\_\_\_\_ for any one such occurrence.

### Section 3.3 Personnel.

(a) In conformity with the approved Annual Budget, Employer<sup>18</sup> shall employ, train, pay, supervise, promote and discharge all employees and personnel necessary for the operation of the Hotel, including, without limitation, the general manager, sales manager, controller and food and beverage director of the Hotel; provided, however, that the employees paid from the Hotel shall not include any persons who are properly the personnel of Operator's or Employer's regional or central office or any other personnel of Operator or Employer who do not work full time at the Hotel on solely the business of the Hotel. Employer shall use due care to select qualified, competent and trustworthy employees and personnel. Each person so hired by Employer shall be an employee only of the Employer. Employer shall have in its employ at all times a sufficient number of capable employees to enable Operator to properly, adequately, safely and economically manage, operate and maintain the Hotel. At no time shall the employees of Operator or Employer and/or any independent contractors engaged by Operator or Employer with respect to the Hotel and/or their employees be considered employees of Owner. Employer shall comply in all respects with all federal, state and local Laws and Regulations governing its employees, including, without limitation, workers' compensation, social security, unemployment insurance, hours of labor, wages, working conditions and other employer-employee subjects. With respect to the general manager and director of sales of the Hotel, Owner reserves the right to direct Employer to hire, retain or terminate any particular individual seeking or serving the position of general manager, director of sales or controller. Upon notice by Employer of intent to hire a particular individual as general manager, director of sales or controller, Owner shall have the right to review and approve or reject such candidate before such candidate is hired and becomes Employer's employee.

(b) Employer, as the sole employer, shall have the duty and responsibility to negotiate with any labor union lawfully entitled to represent its employees at the Hotel. If such negotiated employment agreements may be operational expenses of the Hotel, Employer shall keep the Owner fully informed as to the progress of any negotiations and any agreements that are reached. Nothing in this Subsection (b) shall require Employer to employ persons belonging to labor unions.<sup>19</sup> Notwithstanding

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<sup>18</sup> This form of contract assumes that the owner has elected to employ on-site personnel through a separate entity. This device has not proven particularly effective in regard to liability claims, limitation of obligation for employment practices, or dealing with labor organizing. Nonetheless, the structure is still followed by some owners.

<sup>19</sup> Owners face great difficulty in insulating themselves and their hotels from union and other labor and employer obligations. While some effort may be made to assign such obligations within the management agreement, the contract provisions will not decide the obligations. Owners should receive specific independent advice on labor, tax, ADA and other liabilities that arise from statutory

(continued)

the foregoing, Employer shall not enter into negotiations with any hotel workers' labor union regarding the wages and working conditions of the Hotel's employees without the prior written consent of Owner. In addition, Employer shall consult with Owner during the course of any negotiations with such labor union as to terms acceptable to Owner, and shall conduct such negotiations within parameters agreed to by Owner. Employer shall use diligent efforts to settle and compromise all controversies and disputes arising under any labor union contracts affecting the employees of the Hotel upon such terms and conditions as Employer may deem to be in Owner's best interests, provided that no settlement or compromise shall be binding upon Owner unless and until Owner shall have approved the same in writing.

(c) No personnel of the Hotel or of any Affiliated Entities may occupy a room or use services at the Hotel for any period without payment at third party rates unless Operator has obtained Owner's prior written approval.<sup>20</sup> Employer may not hire any individuals for employment at the Hotel who are related to the officers, directors, or shareholders of Operator or Employer without Owner's prior written approval.

(d) Without intending to create any rights in or obligations to third parties, Operator guarantees to Owner the full and prompt performance by its Service Affiliate as Employer of all obligations of Employer to Owner or third parties, including without limitation obligations in regard to remittance of tax withholding collections.

#### Section 3.4 Records.

(a) Operator shall supervise and maintain (or cause Employer to maintain) complete books, records, files and documents relating to the operation, management and maintenance of the Hotel, including, without limitation, the Books and Records, pursuant to Articles VI and VII hereof, and all necessary or appropriate receipts, insurance policies, notices of violation, bid documentation, contracts, leases, warranties, employment records, plans and specifications, inventories, correspondence, tenant records, maintenance records and similar records (collectively, the "Hotel Records"). The Hotel Records shall be the sole property of Owner, shall be maintained on non-proprietary systems, and shall be delivered to Owner at any time upon Owner's request. The Hotel Records and information contained therein shall be deemed confidential and shall not be published, transmitted or released by Operator to any party or used for any other purpose without the prior written consent of Owner. If Operator publishes, transmits or releases any such documents or information, Owner shall have the right to have the provisions of this Agreement specifically enforced by any court having equity jurisdiction without being required to post bond or other security and without having to prove the inadequacy of available remedies at law, it being acknowledged and agreed that any such breach will cause irreparable injury to Owner and money damages will not provide an adequate remedy to Owner. In addition, Owner may take all such other actions and remedies available to it under law or in equity and shall be entitled to such damages as it can show it has sustained by reason of such breach.

(b) As the employer of the personnel at the Hotel, Employer shall prepare and be responsible for the execution and filing of all forms, reports and returns required by all applicable federal,

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(continued from previous page . . .)

law and should not rely on the terms of the management agreement to transfer responsibility elsewhere. Owners should be cautioned that they are inescapably employers for some purposes.

<sup>20</sup>

With a few exceptions, management companies have routinely granted large discounts and complimentary benefits to employees and affiliates. Some management companies continue to argue that these are customary practices, but owners are increasingly mandating that no such benefits be given [or that they be tightly controlled]. In the current market, the concessions of frequent traveler programs are outpacing employee programs as owner concerns.

state or local Laws and Regulations in connection with unemployment insurance, workers' compensation, disability benefits, job safety, Immigration and Naturalization Service compliance and reporting, tax withholding, pension, profit-sharing and other employee benefit plans, and Social Security. If any violations of such applicable Laws and Regulations shall occur as a result of any act or omission by Employer, all costs, fines and penalties resulting therefrom, if any, shall be paid by Operator or Employer without reimbursement by Owner. Operator shall prepare and, at Owner's request, be responsible for the execution and filing of all real property and personal property tax returns. If any additional forms are required to be filed by the Owner pursuant to applicable Laws and Regulations, Operator shall be responsible for the preparation of such documents for execution and filing by the Owner. Operator shall prepare for review, approval and, where appropriate, certification by Owner's independent accounting firm, all financial statements as they relate to the operation of the Hotel and information related to the operation of the Hotel for inclusion in Owner's federal and state income tax returns and other governmental filings.

### Section 3.5 Tenants and Guests.

(a) Operator shall maintain business-like relations with guests, tenants, licensees and concessionaires of the Hotel whose service requests shall be received, considered and recorded in systematic fashion in order to show the action taken with respect to each and, after thorough investigation, report complaints of a serious nature to Owner with appropriate recommendations. If any such complaint may give rise to any criminal liability or material adverse financial consequence on the part of either Operator or Owner, Operator shall immediately give oral notification thereof to Owner, to be followed within forty-eight (48) hours thereafter by a written memorandum outlining the factual basis of such complaint, to the extent known to Operator, together with a copy of any written communication(s) received from the complaining party and any appropriate recommendation.

(b) If requested by Owner, Operator shall negotiate leases, subleases, licenses and concession or other agreements for commercial and office space or outside service arrangements, if any, at the Hotel. If requested by Owner in the particular instance, such leases, subleases, licenses or concessions may be executed by Operator as agent for Owner. Prior to execution, Operator shall submit to Owner for Owner's review and approval, the final form of each lease, sublease, license and concession or other agreement affecting the Hotel.

(c) Operator shall bill and collect with due diligence the rents (including base, percentage and additional rents), charges and other income due from guests, tenants, concessionaires and other users of the Hotel, and enforce compliance with all terms of all leases, subleases, licenses and other agreements by all appropriate means including the following: (i) dispossessing guests, tenants or other persons in possession after appropriate legal proceedings if required, (ii) canceling or terminating any lease, sublease, license or concession agreement for breach or default thereof by a tenant, licensee or concessionaire, (iii) engaging collection agencies and/or legal counsel to file and prosecute actions to recover any rent or other income and/or to recover possession of any leased space, and (iv) when appropriate, settling, compromising or releasing such actions; provided, however, that Owner shall approve (A) the cancellation of any lease, sublease, license or concession agreement having an unexpired term of six months or more, (B) the engagement of legal counsel or institution of any legal proceedings, (C) the selection of collection agencies and/or other consultants, and (D) the settlement, compromise and release of any legal proceedings, in each case prior to any such action being taken by Operator, and provided further that any necessary legal fees or costs incurred in legal proceedings approved by Owner shall be borne by Owner, subject to Section 10.1 hereof. Operator shall not "write-off," forgive or otherwise defer any receivable or rent without the prior written approval of Owner. Operator shall notify Owner in writing of any tenant, licensee or concessionaire more than fifteen (15) days in arrears in the payment of rent or other charges or otherwise in default under the terms of its lease, license or concession, as the case may be, and shall recommend such action as Operator deems necessary or advisable to cause the defaulting party to cure the default.

(d) Unless otherwise required by law or directed by Owner, all security deposits collected from tenants shall be deposited in an interest bearing account (separate from the Operating

Account) in Owner's name, designating Operator and Owner each as authorized signatories, in \_\_\_\_\_ or in such other bank selected by Owner.

Section 3.6 Advertising and Promotion. Subject to compliance with the approved Annual Budget and the prior written approval of Owner as to the form and substance of any advertisement or promotional activities relating to the Hotel, Operator shall arrange, contract and pay for all advertising and promotional activities necessary for the successful operation of the Hotel. No such advertisement shall indicate that Operator owns or has the authority to offer the Hotel for sale nor shall such advertisement otherwise hold Operator out as a broker. Barter programs, frequent traveler incentives, and similar promotional activities shall be deemed to be included in advertisement and promotional

### Section 3.7 Maintenance and Repairs.

(a) Operator shall keep the Hotel and the fixtures, furniture and equipment therein in good order, repair and condition, including, without limitation, (i) making necessary and ordinary replacements, improvements, additions and substitutions to the end that the Hotel shall be maintained and furnished as a First-Class commercial hotel, in compliance with all applicable Laws and Regulations and the Franchise Agreement, (ii) investigating advisable preventive maintenance programs, submitting to Owner recommendations and proposals for such programs and performing such necessary preventive maintenance as shall be approved by Owner in an Annual Budget approval or otherwise in writing, and (iii) regularly inspecting the physical condition of the Hotel.<sup>21</sup> Operator shall not authorize any replacements, improvements, additions or substitutions not included in the approved Annual Budget without the prior written approval of Owner. All such repairs, improvements or replacements shall be made with as little interruption to the operation of the Hotel as is reasonably possible.

(b) If any such repairs or maintenance shall be made necessary by any condition against the occurrence of which Owner has received or is entitled to the benefit of the guarantee or warranty of any contractor or supplier, Operator shall invoke said guaranties or warranties in Owner's or Operator's name.

### Section 3.8 Services and Purchases.

(a) Subject to the limitations imposed by the approved Annual Budget, Operator shall in its name procure competitive bids for, negotiate, enter into, administer, pay as an Expense and enforce service contracts required in the ordinary course of business in operating the Hotel (such permitted contracts, the "Service Contracts"), including without limitation, contracts for water, electricity, gas, telephone, detective agency protection, vermin extermination, cleaning, elevator and boiler maintenance, air conditioning maintenance, laundry service, dry cleaning service, trash removal, landscape maintenance, snow removal, window cleaning and all other services which are provided in a First-Class commercial hotel. All authorized Service Contracts may be signed by Operator as a disclosed agent of Owner. Copies of all Service Contracts shall be promptly forwarded to Owner after the execution thereof. With respect to any Service Contract providing labor or materials for the Hotel, Operator shall use all reasonable efforts to obtain a lien waiver from the contractor contemporaneously with the

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<sup>21</sup> This obligation may prove highly controversial. Accountability for maintenance and physical condition suggests culpability for deferred items and inadequate maintenance, and therefore for future capital deficits. Some operators have failed to show the discipline necessary to manage capital needs in balance with short-term profit goals. Further, marketing driven upgrade directives from central management divert capital resources to visible "front of the house" expenditures at the cost of longer term property investment. This is an expanding issue given aging hotels and a weaker market where hotel brands are fighting to compete.

execution thereof. Owner's prior written authorization shall be required for any Service Contract which either (i) provides for aggregate payments of more than the Service Contract Limit or (ii) does not contain a provision permitting the Service Contract to be canceled without penalty by Owner upon thirty (30) days notice or less. In making arrangements for any Service Contract, Operator shall take full advantage of, and see that Owner receives credit for, all available rebates, commissions, discounts and allowances.<sup>22</sup>

(b) Operator shall supervise and purchase or arrange for the purchase in the most economical manner of all food, beverages, inventories, provisions and supplies which in the normal course of business are necessary and proper for the maintenance and operation of the Hotel. In making arrangements for any purchase, Operator shall take full advantage of, and see that Owner receives credit for, all available rebates, commissions, discounts and allowances.

(c) With respect to any Service Contract (and before any compensation is paid for services performed if no written contract is entered into) or other agreement for the purchase of supplies, equipment or other property proposed to be entered into with or benefiting Operator or any Affiliate of Operator (hereinafter collectively referred to as "Affiliated Entities"), Operator shall disclose such affiliation to Owner and shall procure at least two independent bona fide bids from entities which are not Affiliated Entities, shall provide Owner with copies of such bids, and shall, and by proposing such contract is automatically deemed to, represent and warrant that (i) the Affiliated Entities will perform the service for the lowest available price and (ii) the bid or price to be charged by the Affiliated Entities is fair, competitive and reasonable.<sup>23</sup>

### Section 3.9 Central Office Services.

(a) Operator shall provide, without any separate charge or reimbursement therefor, corporate executive and administrative services in support of the Hotel, including general and executive supervision, consultation, planning, policy making, monitoring compliance with the Franchise Agreement, corporate finance, personnel and employee relations, research and development, and the services of Operator's technical, operational and marketing experts making periodic inspections and consultation visits to the Hotel.

(b) Operator shall also provide on a shared basis with other hotels operated by Operator or its Affiliates various Central Office Marketing Services (the "Central Office Marketing Services"), including: (i) telemarketing research, (ii) national trade show representation, (iii) national rooms contracts negotiations, (iv) professional, amateur and collegiate sports contracts, (v) individually created direct marketing campaigns, and (vi) outdoor and directory solicitations at net rates to Owner. The ordinary expenses of the Central Office Marketing Services, if any, shall be equitably allocated among the sharing hotels (on a per occupied room basis) and shall be included as an operating expense

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<sup>22</sup> Rebate, discount and bulk purchase programs are widespread in the hotel industry. Unfortunately, the financial benefits have not always reached the owner and have been absorbed by the operator or its affiliates. This is intended to create an express obligation to obtain and pay over the benefits to the owner unless otherwise agreed by the parties. Rebate programs have also drawn hotels into the problems of manipulated income with the timing and amount of rebates. At least one hotel company chose in 2004 to restate its profits due to such rebate arrangements with a cable and television provider.

<sup>23</sup> Many management companies will argue that these clauses are not workable, and they are in fact intended to be highly restrictive. Affiliate transactions that involve charges in addition to the base and management fee carry a substantial risk of conflict of interest and, absent convincing evidence of benefit, many owners now prefer to forego the possible benefits to avoid the potential exposure to self-dealing.

in the proposed Annual Budget; provided, however, that the annual cost to Owner of Central Office Marketing Services shall not exceed \$\_\_ per room and shall include no item of overhead, profit or capital expense and no expense incurred in performing obligations incurred in consideration of the Annual Guaranteed Base Fee. Operator shall provide Owner with a monthly statement in sufficient detail to support any charges for Central Office Marketing Services allocated to the Hotel, if any, and the calculation of the allocation to the Hotel and Owner shall reimburse Operator for the Hotel's properly allocable share of such Central Office Marketing Services.<sup>24</sup>

#### Section 3.10 Permits.

(a) Unless Owner specifies otherwise, Operator shall apply for, obtain and maintain in the name of Owner, all licenses and permits required in connection with the management and operation of the Hotel and the facilities (including restaurant, bar and lounge facilities) located therein. Owner shall execute and deliver any and all applications and other documents and otherwise cooperate to the fullest extent with Operator in applying for, obtaining and maintaining such licenses and permits.

#### Section 3.11 Compliance with Law.

(a) Operator shall comply with and cause the Hotel to comply with and abide by all present and future statutes, laws, rules, regulations, requirements, orders, notices, determinations and ordinances of any federal, state, county or municipal government and appropriate departments, commissions or boards having jurisdiction over the Hotel or the workers employed at the Hotel, including, without limiting the foregoing, the state liquor authority, and the requirements of any insurance companies covering any of the risks against which the Hotel is insured (all of the foregoing are collectively referred to as the "Laws and Regulations"). If, in any instance, the cost of compliance with any applicable Laws and Regulations exceeds its line item in the Approved Budget for such item by \$\_\_\_\_\_, in any instance, Operator shall immediately seek Owner's consent before authorizing any such expenditure.<sup>25</sup>

(b) In the event Operator receives notice of or becomes aware of a violation or circumstances likely to result in a violation of any applicable Laws and Regulations, Operator shall immediately deliver to Owner written notice of such violation or circumstances and, subject to Owner's consent where required under Subsection (a) being given, take all remedial action necessary for compliance with such applicable Laws and Regulations; provided, however, that Owner may contest any such violation and, if Owner elects to contest such violation, Operator shall, upon written notice from

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<sup>24</sup> This is another area in which potential for self-dealing and the difficulty of effective audit have driven owners to seek a simpler solution. Management companies are also recognizing the risk of future claims and the problem of contingent liabilities arising from issues of cost allocation. Therefore, some companies are moving toward a single charge for all chain services based on a percentage of gross revenues or a similar formula. In exchange for this charge, the management company forgoes all other reimbursement or allocation of expense, excepting only a possible reservation fee for each room actually booked through its system. In contrast, some other companies are moving toward extremely aggressive and broad rights of allocation protected by prior disclosure of these practices and other affiliate changes.

<sup>25</sup> The hotel industry has encountered extraordinary costs due to such changes in law and insurance standards, such as asbestos abatement requirements, ADA regulations, mold and restrictions on the continued use of certain chemical-based fire suppression systems. Seismic reinforcement requirements may add future costs. Owners now recognize that investment in full compliance is not always justified and other scenarios may be appropriate, including containment, closing the hotel or altering its use.



Owner of Owner's intent to contest, postpone compliance pending the determination of such contest, if so permitted by such Laws and Regulations.

### Section 3.12 Payment of Taxes: Removal of Liens.

(a) Operator<sup>26</sup> shall, except as provided in Subsection (c) below, pay when due as an Expense all taxes, assessments and governmental charges or levies (hereinafter collectively referred to as "Governmental Impositions") imposed upon the Hotel or upon the operations conducted thereat or upon any of Owner's property at the Hotel, real, personal or mixed, or upon any part thereof under the Operator's management and control, including all interest and penalties thereon. As used herein, Governmental Impositions shall include, without limitation, all social security taxes, unemployment insurance taxes, withholding taxes and similar charges imposed on Operator in connection with any employees or personnel of Operator.

(b) Operator shall, except as provided in Subsection (c) below, take all necessary steps to prevent the creation of any claim for lien or encumbrance or security interest (hereinafter collectively referred to as a "Lien") against the Hotel or any part thereof or any fund, receivable or other asset relating to the Hotel, other than a Lien created or consented to by Owner. In the event a Lien is asserted against the Hotel or any part thereof, Operator shall immediately give Owner notice thereof and shall, within twenty (20) days after such notice is given, take all reasonable steps necessary for contract or removal thereof unless Owner notifies Operator within such twenty (20) day period that (1) Owner wishes to contest such Lien or (2) Owner has consented to such Lien.

(c) Operator shall review the appropriateness of all bills for Governmental Impositions applicable to the Hotel and shall advise Owner of the amount of any Governmental Impositions that should be challenged and, if so, the course of action recommended to obtain a reduction of such Governmental Impositions. If Operator is notified by Owner that Owner intends to contest any Governmental Imposition or Lien upon the Hotel, Operator shall not pay such Governmental Imposition or Lien, but, upon request of Owner, shall set aside the amount necessary to pay such Governmental Imposition or Lien, plus interest and penalties, in an interest bearing reserve account (or shall deposit such amount with a third party if so directed by Owner); provided, however, that if any such interest or penalty payment is imposed on Owner by reason of (1) the failure of Operator to make a payment required to be made by Operator under this Agreement when the funds therefor were available, or (2) the funds therefor were not available and Operator failed to so notify Owner (as required under Section 6.2), such interest or penalty payment shall be immediately paid to Owner by Operator. If requested by Owner, Operator shall institute appropriate protests or challenges to any Governmental Imposition or Lien that Owner desires to contest and all expenses incurred by Operator in contesting or seeking a reduction thereof, including legal, appraisal and accounting fees, if required, shall be considered operating expenses to be borne by Owner to the extent such costs are within the applicable line items in the Annual Budget last approved by Owner or are otherwise approved in writing by Owner.

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While many operators routinely pay real estate, other taxes and insurance premiums from the hotel, many have agreements that do not require them to perform those functions. In difficult economic conditions, operators distributed cash to themselves and asserted their non-disturbance rights to force the owner or lender to pay such costs while allowing the operator to remain in management. With the change to subordination of management agreements to the rights of lenders, operators may now need to deal with the payment of taxes and removal of liens to avoid termination by foreclosure. This reality is now reflected in express provision for the payment obligation on the same basis as other operating costs.

Section 3.13 Payments on Mortgage and Franchise Agreement.

(a) Operator<sup>27</sup> shall make all payments on or before the due date therefor required under any mortgage, deed of trust, reciprocal operating agreement, security agreement, equipment or chattel lease or other agreement now or hereafter encumbering the Hotel that constitutes an obligation of Owner (hereinafter collectively referred to as a "Mortgage"), provided a copy of any Mortgage has previously been delivered by Owner to Operator, and provided further that funds adequate for such payments in their proper priority are in the Operating Account. With respect to each payment of a Mortgage made by Operator, Operator shall deliver to Owner, not later than five (5) days after the due date, evidence that such Mortgage payment has been made. Operator shall fully and timely perform and observe all covenants (which Operator has the authority hereunder to perform) required to be performed or observed by Owner under any Mortgage.

(b) If requested by Owner, Operator shall make all payments on or before the due date therefor required to be made by Owner under the Franchise Agreement. Operator shall (i) perform all covenants (which Operator has the authority hereunder to perform) required by Owner to be performed under the Franchise Agreement, (ii) generally operate the Hotel in accordance with the terms and conditions of the Franchise Agreement and do nothing or permit or cause anything to be done which would constitute a violation of the Franchise Agreement, and (iii) if requested by Owner, represent Owner in conferences and negotiations with, and submissions and correspondence to, the franchisor under the Franchise Agreement.

Section 3.14 Notice to Owner. Operator shall promptly notify Owner in writing:

(a) in the event that the condition of the Hotel or any part thereof fails to comply with the standards of the Franchise Agreement, or any applicable Laws and Regulations, or the provisions any other agreement relating to the Hotel (including this Agreement and the Mortgage);

(b) upon receipt by Operator of any notice, demand or similar communication with respect to any obligation of Owner under applicable Laws and Regulations, the Franchise Agreement, any Mortgage, leases, subleases, licenses, concession agreements or any other agreement relating to Owner, the Hotel, or any portion thereof;

(c) upon receipt by Operator of any summons, notice, demand or similar communication regarding any action or threatened action at law or in equity or before any regulatory body relating to Owner, the Hotel, or any portion thereof;

(d) upon receipt by Operator of a statement of the amount of any Governmental Impositions;

(e) upon receipt by Operator of any notice or communication from an insurance carrier regarding insurance coverage or the insurability of the Hotel;

(f) in the event Operator makes an emergency expenditure pursuant to Section 3.2(g);

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<sup>27</sup> For the same reasons that operators are undertaking payment of taxes (see Section 3.12), operators are undertaking the obligation to pay secured lenders from the hotel accounts. Hotel loan documentation is providing more frequently for a specific cash cascade or priorities in the payment of various obligations. These clauses seem to be frequently ignored in practice as they are difficult to monitor.

(g) upon receipt by Operator of any notice of any threatened or pending condemnation, rezoning or other governmental order, proceeding or lawsuit involving the Hotel; or

(h) upon receipt by Operator of any notice or communication of any nature, written or oral, which may have a material adverse effect on the Owner or the Hotel.

Section 3.15 Transactions with Affiliates. In its management and operation of the Hotel, subject to the provisions of Section 3.8(c), Operator shall not purchase goods, supplies and services from or through any of its Affiliated Entities without express authorization from Owner after disclosure of all material terms of the affiliated relationship and the consideration received by them. Unless clearly set forth as a separate item for transactions with Affiliates in the proposed Annual Budget and approved as part of the Annual Budget, Operator shall not pay, or permit or cause to be paid, to any such Affiliated Entities a fee, rebate, discount or other consideration for the negotiation of contracts, the purchase from independent suppliers of goods, supplies and services, or other act pursuant to Operator's agency hereunder without Owner's prior written authorization.<sup>28</sup>

Section 3.16 Additional Operating Activities. Operator shall perform the following additional operational activities:

(a) Within thirty (30) days after the date of this Agreement, Operator shall conduct and submit to Owner, at Owner's expense, a full inventory and audit of all cash and assets at the Hotel (excluding any assets of guests, tenants, licensees and concessionaires). Such inventory and audit shall include, among other things, detailed reports on the quantities, qualities and condition of the assets on hand.

(b) If requested by Owner, Operator shall use diligent efforts to determine if any hazardous or toxic substance or waste is being used, released, disposed or discharged at or from the Hotel, including, without limitation, the engagement of professional environmental engineers to perform such environmental studies or tests as may be approved by Owner. Operator shall promptly notify Owner of any possible contamination, damage or liability arising from the use, presence, disposal or release of any hazardous or toxic substance or waste at, from or nearby the Hotel. If any hazardous or toxic substance or waste is discovered at the Hotel, Operator shall not disturb, release or dispose of (or permit to be disturbed, released or disposed of any such hazardous or toxic substance or waste except in strict compliance with a remediation and/or removal program approved by Owner.

(c) Operator shall prepare a life safety plan complying with all applicable Laws and Regulations, to be used in the event of fire or other casualty at the Hotel. Upon Owner's approval of such plan, Operator shall give appropriate notice thereof to all tenants, guests and concessionaires of the Hotel.

(d) Operator shall prepare a written waste recycling plan for the Hotel. If approved by Owner, Operator shall implement such plan and shall submit energy and water consumption reports of the Hotel, if, as and when requested by Owner.

(e) Operator shall perform any other service or activity incidental to the normal and professional operation of a property of a similar type and character to the Hotel or as otherwise reasonably requested from time to time by Owner.

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<sup>28</sup> This restates the principle reflected in Section 3.8. In the current market, this restriction will be vigorously opposed by major brand companies.

Section 3.17 Renovations.<sup>29</sup>

(a) If requested by Owner, Operator shall provide construction management services in connection with any renovations or refurbishment of the Hotel (collectively, "Renovations"). The scope of such services shall be mutually agreed to by Owner and Operator. As total compensation for construction management services provided by Operator, Owner shall pay Operator a fee (the "Construction Management Services Fee") in an amount equal to five percent (5%) of the aggregate cost to Owner for materials, equipment and labor furnished by third parties with respect to the Renovations, but excluding therefrom the cost of soft goods such as linens, bed spreads, curtains and draperies and case goods such as furniture, television sets and wall decorations. The Construction Management Services Fee shall be paid upon completion of the Renovations of such Renovations required six months or less. If the Renovations period exceeds six month, the payments shall be monthly based on work completed.

ARTICLE IV

OPERATING EXPENSES OF THE HOTEL

Section 4.1 Operating Expenses of the Hotel.

(a) Subject to the provisions of Articles III and V and Section 7.2(d) hereof, all authorized expenses incurred by Operator in performing its obligations under this Agreement shall be borne by Owner and, to the extent funds are available, paid out of the Operating Account. All debts and liabilities to third parties which Operator is authorized to incur as agent under this Agreement are and shall be the obligations of Owner, and Operator shall not be liable for any of such obligations by reason of its management, supervision and operation of the Hotel for Owner; provided, however, that to the extent such debts or liabilities arise by reason of any gross negligence, default or violation of law by Operator in the performance of its duties or undertakings under this Agreement, debts and liabilities shall be the obligations of Operator and not paid by Owner.

(b) Payments from the Operating Account shall be made in the priority specified in this Section 4.1(b) unless otherwise authorized by Owner in writing. In the event that funds are insufficient to pay all amounts due at any level of priority, payment shall be made first to matters at that level most likely to give rise to liens and thereafter as Operator deems advisable. Payments shall be made according to the following levels:

- |         |   |
|---------|---|
| First:  | to remittance of tax and other withholding mandated by law and to payment of payroll.                           |
| Second: | to payment of insurance premiums then due.  |
| Third:  | to payment of real estate taxes and other Governmental Impositions to avoid the accrual of penalties and liens. |
| Fourth: | to debt service under any Permitted Mortgage.   |
| Fifth:  | to Expenses accrued and payable, provided that no payment   |

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<sup>29</sup> Fees for participation in renovation and capital projects have become routine and expensive. Many owners prefer to hire outside contractors to act as owners' representatives, and the right to do so without payment to the operator should be preserved.

shall be made to an Affiliated Entity unless all payables of equal or greater age due to non-Affiliates have been paid.

Sixth: to Reserves and other payments, including payment of Mortgages other than Permitted Mortgages.

#### Section 4.2 Reimbursement of Operator.<sup>30</sup>

(a) Except as provided in Article V, Operator shall be reimbursed for all out-of-pocket costs and expenses incurred in rendering services to the Hotel to the extent these are provided for in the approved Annual Budget or otherwise authorized by this Agreement. Operator shall pay, without reimbursement from Owner except as provided in Subsections (b) and (c), the costs of the services described in Section 3.9 and its headquarters/corporate level employees (as distinguished from employees actively engaged on a full-time basis in the direct operation of the Hotel with respect to whom Operator is reimbursed as to all costs as herein provided) who may be engaged in the performance of duties under this Agreement and those expenses set forth in Section 5.1.

(b) The cost, fees, compensation and other expenses of any persons engaged by Owner or Operator with Owner's authorization to perform duties of a special nature, directly related to the operation of the Hotel (the "Special Services"), including, but not limited to, independent auditors, employment search firms, and the like, shall be operating expenses subject to the Annual Budget as approved by Owner and not the responsibility of the Operator. Such Special Services shall be limited to those matters (to be first approved by Owner) that are not included in the scope of the duties to be performed by Operator hereunder and which would involve the Owner's engagement of a third party to perform such services. If Owner approves of the use of Operator's headquarters/corporate level employees to provide any such Special Services, and the cost has been identified and approved for Special Services in the Annual Budget, then the reimbursement to Operator shall be at the per diem salary rate for those personnel but not to exceed the reasonable and customary costs, fees or expenses charged by third parties for such services.

(c) Subject to the limitations of the Travel Budget attached hereto as Exhibit C, as the same may be revised from time to time by Owner and Operator, Operator shall be reimbursed for any travel expenses of Operator's central office employees providing services for the Hotel pursuant to this Agreement; provided, however, that in all cases travel costs shall be equitably allocated among all hotels operated by Operator or its Affiliates in the same metropolitan area.

### ARTICLE V

#### EXPENSES BORNE BY OPERATOR

Section 5.1 Expenses to be Borne by Operator. The following shall be expenses of Operator and shall not be charged to or borne by Owner.

(a) All costs, expenses (except as provided in Section 4.2 hereof), salaries, wages or other compensation of any regional or other headquarters/corporate level employees of Operator, excepting only employees who are regularly employed full-time at the Hotel by Employer.

(b) Any expenses of Operator's principal or branch offices.

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<sup>30</sup> See note under Section 3.9 regarding reimbursements and allocated costs.

(c) Any expenses for advertising or promotional materials that feature Operator's name or activities.

(d) Any part of Operator's capital expenses.

(e) Operator's overhead or general expenses, including but not limited to telephone, telex, duplicating, stationery and postage expenses incurred at Operator's principal or branch offices, except as may be expressly assumed by Owner pursuant to the terms of this Agreement.

(f) Any travel expenses of Operator's central office employees in excess of the expenses permitted to be incurred under Section 4.2(c).

(g) Any interest or penalty payment with respect to a Governmental Imposition or Lien upon the Hotel imposed on Owner by reason of (1) the failure of Operator to make a payment required to be made by Operator under this Agreement when the funds therefor were available, or (2) the funds therefor were not available and Operator failed to so notify Owner (as required under Section 6.2). Notwithstanding the foregoing, Operator shall not be liable for any such interest or penalty payment relating to Governmental Impositions or Liens contested pursuant to Subsections (b) and (c) of Section 3.12.

(h) Any cost for which Operator is liable under Section 10.1 hereof and the cost of any increased insurance premiums (but only to the extent relating to the term of this Agreement) directly attributable to claims experience based on the action of Operator, its agents or its employees.

## ARTICLE VI

### BANK ACCOUNT AND DISBURSEMENT OF FUNDS

#### Section 6.1 Accounts.

(a) All monies received by Operator in connection with the operation of the Hotel, including amounts furnished by Owner to maintain sufficient liquid Working Capital or derived from claims, insurance, or otherwise, shall be received and held in trust<sup>31</sup> by Operator for the benefit of Owner and shall be deposited in an Operating Account in Owner's name, designating appropriately insured representatives of Operator and Owner as authorized signatories, in \_\_\_\_\_ or in such other bank as is selected by Owner. Such account or accounts shall be maintained in compliance with any requirements then imposed by a lender under a Permitted Mortgage. Such monies shall not be commingled with other funds belonging to Operator. Any funds received by Operator from capital transactions or from sources (1) other than operations of the Hotel or (2) deposits by Owner, such as insurance and condemnation proceeds and proceeds from the mortgaging, refinancing, or sale of the Hotel, shall be paid promptly to Owner. Operator shall have the authority to draw on the Operating Account for the purpose of making all disbursements provided for in Article III and pay all other operating expenses of the Hotel permitted to be paid pursuant to the provisions of this Agreement including, to the

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<sup>31</sup> Lenders have become increasingly concerned with the clear delineation of ownership of cash receipts. This arises from a series of challenges to lenders' liens by operators claiming prior entitlement to a share in revenues or otherwise seeking leverage on recovery of damages in a bankruptcy. In some cases, lenders require that their own names appear on operating accounts. Because a first lien position is so essential to lenders, and because the 1994 bankruptcy law amendments clarified security lien requirements for hotels, management companies appear more willing to deal with revenues as trust funds for lenders, when lenders think to request this.

extent payable, the Management Fees due pursuant to Section 8.2; provided, however, that no payment which, under the provisions of this Agreement, requires Owner's consent and approval, or which is not authorized under the Annual Budget approved by Owner, shall be made without Owner's prior written consent.

(b) In addition to any payments made to Owner pursuant to Section 6.2(b) during the term of this Agreement, Operator shall make monthly disbursements to Owner, by bank wire transfer to Owner's Bank Account or intra-bank transfer, of Cash Available for Disbursement within 15 days following the end of each calendar month. Operator shall also mail to Owner, forthwith upon Operator's receipt of same, a copy of the bank wire transfer confirmation.

(c) Checks drawn on the Operating Account or other documents of withdrawal from the Operating Account shall be signed by two (2) designated and appropriately insured representatives of Operator approved by Owner. Operator may endorse any and all checks drawn to the order of Owner for deposit into the Operating Account. The Operating Account shall provide that, upon Owner's written direction, Operator and its representatives may be removed as authorized signatories on such account upon termination of this Agreement.

(d) Each bank account must have at least one representative of Owner as an authorized signatory.

#### Section 6.2 Working Capital.

(a) It is the mutual intention of Owner and Operator that Working Capital be maintained at all times which will be sufficient to make all disbursements provided for in Article III or otherwise approved by Owner so as to permit the uninterrupted and efficient operation of the Hotel in accordance with the Annual Budget approved by Owner. If, at any time during the term of this Agreement, the amount of cash in the Operating Account is determined to be insufficient by Operator, Operator shall give Owner immediate written notice of the amount of such deficiency. Owner shall deposit the amount requested by Operator or such lesser amount as Owner may determine in its sole discretion<sup>32</sup> in the Operating Account within fifteen days after receipt of such notice.

(b) To the extent that, at any time during a Fiscal Year, the Owner determines that the cash in the Operating Account exceeds the amount necessary to maintain sufficient Working Capital, Operator shall return to Owner upon Owner's instructions such excess cash up to the amount, if any, previously deposited by Owner during such Fiscal Year for the purpose of maintaining sufficient Working Capital.

#### Section 6.3 Capital Reserve Account.

(a) During the term of this Agreement, a reserve cash account (the "Capital Reserve Account") shall be established and maintained to cover expenditures for capital improvements and replacements. Contributions to the Capital Reserve Account shall be made pursuant to Subsection (b) below. Disbursements from the Capital Reserve Account shall be subject to the approved Annual Budget and to the requirements of any lender under a Permitted Mortgage.

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Note that the owner has absolute control of the decision to advance and invest additional funds. This is very different from the practice in older agreements and will be intensely negotiated here and in regard to other possible cash deficit situations.

(b) An amount shall be contributed to the Capital Reserve Account each month equal to<sup>33</sup> the greater of (1) \_\_\_% of Adjusted Gross Revenue for such month or (2) such other amount as required pursuant to the Franchise Agreement or any Permitted Mortgage then in effect. The contribution to the Reserve shall be subordinate to the payment of any Mortgage and if there are insufficient funds in the Operating Account to make the required monthly contributions, Operator shall notify Owner and Owner may fund the amount necessary to increase the Reserve to an adequate amount to provide for the current capital expenditures pursuant to the approved Annual Budget.

(c) Owner may elect prior to final approval of each Annual Budget to reasonably increase the percentage amount of funding to the Reserve for the ensuing Fiscal Year and shall notify Operator in writing of such increase.

(d) The Reserve shall be maintained in a separate account established and maintained in the same manner as the Operating Account, provided that funds not required for current expenditure shall be invested by Operator in investments designated by Owner. Interest, if any, accruing on any such funds as well as any proceeds received from the sale of furniture, fixtures and equipment shall be added to the Reserve and at Owner's option may decrease the required funding. If at any time the accumulated unallocated balance in the Reserve exceeds an amount equal to \_\_\_% of Adjusted Gross Revenue during the immediately preceding Fiscal Year, further contributions shall be suspended until the accumulated unallocated balance in the Reserve does not exceed such limit.

#### Section 6.4 FF&E Reserve Account.

(a) During the term of this Agreement, a reserve cash account (the "FF&E Reserve Account") shall be established and maintained to cover expenditures for replacements and additions to fixtures, furniture and equipment.

(b) The FF&E Reserve Account shall be subject to the same terms and conditions as the Capital Reserve Account. The funds of the two Accounts may be held in a common account but shall not be otherwise commingled.

### ARTICLE VII

#### BOOKS, RECORDS AND STATEMENTS

##### Section 7.1 Books and Records.

(a) Operator shall keep accurate, complete and detailed books and records including, without limitation, books of account, tax records, Guest records, front office records and other records (hereinafter collectively referred to as the "Books and Records") in which shall be entered fully and adequately every transaction with respect to the operation of the Hotel, all substantially in accordance with the Uniform System, with such exceptions as may be required by the provisions of this

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<sup>33</sup> Because operators may not have unlimited rights to call capital from owners, and because they risk loss of management if capital deficits accumulate, they will seek substantial capital and FF&E reserves. On the other hand, the use of net cash flow to the owner, after reserves and other cash costs, as the test for incentive compensation and performance standards should put the operator at risk if it demands reserves that are too high. This tension should trigger a realistic assessment of the long-term reserves required by the hotel. Managers usually seek to have performance tests on net income accrual and to avoid the test of ultimate cash flow.



Agreement. The Books and Records shall be kept on the basis of such accounting year (calendar or fiscal) as Owner may direct, and on the accrual method of accounting.

(b) The Books and Records shall be kept at the Hotel; provided, however, that, subject to Owner's prior written approval, certain books and records may be kept at Operator's Principal Office Address pursuant to the adoption of a central billing system or other centralized service. In the event that such a system is proprietary to Operator or licensed by it, Owner shall receive a license for use without charge.

(c) The Books and Records shall be available to Owner and its representatives at all times for examination, audit, inspection and transcription and shall be delivered to Owner at any time upon Owner's request. Operator shall maintain such control over the Books and Records as is required to protect them from theft, error, fraudulent activity or use for purposes other than operation of the Hotel. All of the Books and Records and all information contained therein shall at all times be the property of Owner. Upon any termination of this Agreement, all of the Books and Records forthwith shall be delivered to Owner and no copies retained except as required by law.

#### Section 7.2 Monthly Reports.<sup>34</sup>

(a) Operator shall deliver to Owner on or prior to the 15th day of each calendar month the following (hereinafter collectively referred to as the "Monthly Reports"):

(1) a balance sheet for the Hotel as of the end of the preceding calendar month;

(2) a statement of income and expenses (including all supporting departmental schedules of revenue and expenses) on an accrual basis and showing the results of the operation of the Hotel for the immediately preceding calendar month and Fiscal Year-to-date;

(3) supporting schedules for such preceding calendar month and Fiscal Year-to-date showing (i) a monthly cash summary detailing all cash activity and reconciling beginning and end cash balances, (ii) an aged schedule of delinquent accounts receivable and type of charge and an aged schedule of unpaid bills and accrued expenses, (iii) a payroll list showing the occupation of and wages paid to all employees hired by Operator for purposes of this Agreement, (iv) the computation of the Base Management Fee and all other fees due Operator hereunder, (v) the detail of all complimentary accommodations or services, and (vi) the detail for Central Office Marketing Services charged pursuant to Section 3.9(b) including the detailed calculation of their allocation;

(4) a variance report including the detailed calculation of their allocation showing results of the operation of the Hotel for the preceding calendar month and Fiscal Year-to-date as compared to the Annual Budget approved by Owner and the same time period of the previous Fiscal Year;

(5) a check register showing all paid invoices indicating date paid, amount paid and check number;

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<sup>34</sup> While many management companies will argue that these reports require substantially more information than has been historically provided to owners, the reports in fact follow the outline of information packages routinely provided by hotel managers to their own senior management. Some owners review these standard packages and, where acceptable, adopt that format as the owner's required report.

- (6) all bank statements and reconciliations;
- (7) the cash disbursements journal; and
- (8) to the extent not set forth above, those reports and other items described in Exhibit D attached hereto.

(b) Upon request, Operator shall deliver to Owner the following:

(1) a schedule of computation, funding and uses of Capital and FF&E Reserve Accounts as compared to the approved Annual Budget for capital expenditures by month for the Fiscal Year-to-date;

(2) a reforecast of income and expenses for the remainder of the current Fiscal Year as compared to the approved Annual Budget; and

(3) an Operator's report explaining variances, the basis for reforecasts, changes in competition and market conditions and other items as suggested in the Uniform System.

(c) The Monthly Reports shall (1) be prepared in a form satisfactory to Owner, (2) be certified to Owner by a financial officer of Operator, (3) be derived from the Books and Records maintained by Operator at the Hotel or at Operator's Principal Office Address, (4) follow the general form set forth in the Uniform System, and (5) be accompanied by such supporting evidence as shall be reasonably required by Owner. Upon request, Operator shall also furnish to Owner a statement of changes in financial and cash position and a forecast of changes in financial and cash position.

(d) In the event Owner wishes to dispute any statement or report as detailed in Subsections (a), (b), or (c) above, Owner shall give Operator written notice thereof. If Operator and Owner are not able to reach an agreement on the items disputed by Owner, Owner's independent certified public accounting firm shall be retained by Owner and Operator to audit the Books and Records of the operation of the Hotel to render a report of its findings to Operator and Owner. Such findings shall be binding on both parties and any necessary adjustments shall be made. In the event such findings result in a variation in favor of Owner of 3% or more between the total amount of profits or losses originally reported by Operator and the total amount of profits or losses adjusted pursuant to such findings, Operator shall pay all costs of the accounting firm in making its findings. In all other cases, Owner shall pay for the services of the accounting firm.

**Section 7.3 Annual Statements.** Within forty-five (45) days after the end of each Fiscal Year during the term of this Agreement, and within 45 days after the termination of this Agreement, Operator shall deliver to Owner a balance sheet, a statement of income, a statement of changes in financial position, and a statement of cash flow, including all supporting departmental schedules of revenues and expenses, certified, as true, correct and complete by a financial officer of Operator, together with an opinion thereon after a certified audit rendered by a firm of independent certified public accountants selected by Owner, showing (1) assets employed in the operation of the Hotel and the liabilities incurred in connection therewith during such Fiscal Year, (2) the results of operations of the Hotel during such Fiscal Year, (3) variances to the approved Annual Budget and prior Fiscal Year, (4) the Gross Revenue and the Adjusted Gross Revenue of the Hotel during such Fiscal Year, and (5) a computation of the Management Fees and all other fees paid to Operator hereunder for such Fiscal Year. Operator shall cooperate with Owner and its independent certified public accounting firm in connection with the review and certification of the foregoing statements. The cost of preparation of all such balance

sheets, statements of change in financial position and profit and loss statements, together with the cost of certification thereof, shall be an operating expense of the Hotel paid by Owner.<sup>35</sup>

## ARTICLE VIII

### MANAGEMENT FEES

Section 8.1 Definitions. As used in this Agreement, the following terms shall have the following meanings:

(a) "Gross Revenue" shall mean all income and revenue of every kind resulting from the operation of the Hotel and all of its facilities and received by Owner (or Operator on behalf of Owner), as determined in accordance with the Uniform System, including, without limitation, all income and revenue received from transient guests, tenants, licensees, concessionaires and other persons occupying space at and/or rendering services to the guests of the Hotel (but not the gross receipts received by such tenants, licensees, concessionaires and other persons); provided, however, that Gross Revenue shall not include any of the following:

- (1) the proceeds of any loan to Owner;
- (2) any deposits made by Owner; and
- (3) security deposits (except as applied or forfeited).

(b) "Adjusted Gross Revenue"<sup>36</sup> shall mean Gross Revenue in any Fiscal Year after deducting the following items (whether paid or unpaid) accruing during such Fiscal Year to the extent included in Gross Revenue:

(1) federal, state and municipal excise, sales and use taxes collected directly from patrons, guests or users of the Hotel or as a part of the sales prices of any goods, services or displays, such as gross receipts, admission, cabaret or similar or equivalent taxes;

(2) any vending machine revenues from machines not owned by Owner (other than sales commissions or other remuneration received by Owner with respect to such machines);

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<sup>35</sup> The form applicable standards and required procedures for hotel audits are disputed between many owners and managers. Many hotels are "audited" under a standard of a "special report" which may fall substantially short of a G.A.A.P. presentation. Each owner should consider the audit standards and procedures with its own independent accountant to ensure that the provision specifies the correct report.

<sup>36</sup> An adjusted gross revenue number is used to purge the gross revenue number of items which tend to inflate the revenue total without actually arising from the operator's efforts or which do not add to the owner's real income. Further deductions may be required for in-house entertainment, deemed income from frequent traveler redemptions or concessionary room use, etc. Management companies have in some cases unfortunately adopted accounting practices that tend to inflate gross and adjusted revenues, leading to disputes with owners. One of the most common abuses is booking concessions income collected by the hotel as hotel income, and the 90% or 95% remitted to the concessionaire as an expense. After the application of base fee and central service charges, this can result in a net loss to the owner on the concession arrangement.

(3) the proceeds payable to Owner by reason of any hazard or business interruption insurance policies, title insurance policies or items of a similar nature;

(4) the proceeds of any permanent taking by condemnation or eminent domain by any public or quasi-public authority of all or any part of the Hotel;

(5) any reversal of any contingency or tax reserve;

(6) any cash or credit rebates or refunds paid to patrons, guests, lessees, concessionaires or other users of the Hotel, any correction of overcharges, the price of any merchandise given in exchange of other merchandise which does not result in additional income (or, if such exchanges result in additional income, that part of the price of such merchandise equal to the price of the returned merchandise), and any other items of the nature of those items set forth herein;

(7) any allowance for bad debts;

(8) the proceeds to Owner from the sale or other disposition of the Hotel or any part thereof or other assets of Owner not sold in the ordinary course of business;

(9) any payments made directly to Owner to induce it to enter into any lease, agreement or other transaction in connection with the Hotel;

(10) any proceeds from settlement of legal proceedings;

(11) interest on the Reserve; and

(12) travel agents' commissions.

(c) "Expenses"<sup>37</sup> shall mean all operating, maintenance and other costs and expenses of every kind, whether deemed capital or ordinary, whether deemed capital or ordinary, resulting from the ownership, operation and maintenance of the Hotel and all of its facilities and incurred by Owner (or Operator on behalf of Owner), as determined in accordance with the Uniform System, including, without limitation, real and personal property taxes and assessments, insurance premiums, ground rent, if any, equipment rentals, the Base Management Fee, fees paid for Central Office Marketing Services and Special Services, franchise fees, the Construction Management Services Fee and the Architectural Services Fee, if any, salaries and wages of Hotel employees and personnel, including payroll taxes and costs of employee benefits, charges (including supplies of every kind) for cleaning and sweeping, common area maintenance charges, merchants' association dues, security guard service, exterminating service, guest transportation, reservation services, the cost of food and beverages sold or consumed, trash and disposal service, heat, air conditioning and utilities (including taxes thereon), water and sewer charges, charges pursuant to Service Contracts, legal fees, accounting and computer expenses, license and permit fees, operating supplies, advertising and promotional expenses, an amount equal to the then applicable percentage of Adjusted Gross Revenue to cover expenditures for capital improvements and replacements to the furniture, fixtures and equipment of the Hotel, all expenses incurred in connection with the leasing of commercial space at the Hotel, including brokers' and finders'

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<sup>37</sup> This is not the same as operating expenses for purposes of GAAP on the Uniform Systems of Accounts for Hotel. This concept includes all cash items that may be paid from revenues and is intended to eliminate manipulation of compensation by shifting payments between capital and ordinary expense categories or by removing the expenditure from the hotel's accounts by deeming it an "owner's cost" that falls below the net income line..

commissions, and payments and expenses in order to induce new tenants to relocate to the Hotel; provided, however, that Expenses shall not include any of the following:

- (1) rental payments under capital leases;
- (2) non-cash items such as depreciation and amortization of fees and expenses;
- (3) all repayments of principal and payments of interest and other charges related to any mortgage or deed of trust encumbering the Hotel; and
- (4) taxes imposed on Owner measured by Owner's income.

(d) "Net Income Before Debt Service" shall mean, with respect to any Fiscal Year, the excess of Adjusted Gross Revenue over Expenses.

Section 8.2 Management Fees.<sup>38</sup> Owner shall pay Operator, as compensation for its services during the term of this Agreement the Management Fees as set forth in this Section:

(a) Owner shall pay to Operator, to the extent earned, a Base Management Fee consisting of:

(i) the Annual Guaranteed Base Fee in an amount equal to the result obtained by multiplying the Adjusted Gross Revenue for each Fiscal Year or portion thereof, during the term of this Agreement, by \_\_%, and

(ii) in the event that Net Income Before Debt Service for the Fiscal Year year-to-date equals or exceeds [debt service under all Permitted Mortgages multiplied by 1.\_\_\_\_], an Annual Subordinated Base Fee in an amount equal to the result obtained by multiplying the Adjusted Gross Revenue for each Fiscal Year or portion thereof, during the term of this Agreement, by \_\_%.

(b) Owner shall pay to Operator, to the extent earned, an Incentive Management Fee consisting of an amount equal to the result obtained by multiplying the Net Income Before Debt Service for the Fiscal Year in excess of the Threshold by the Incentive Percentage.

(c) Annual Guaranteed Base Fee shall be paid monthly within fifteen (15) days following the end of the month in which earned and shall be based on the monthly income and expense statement for the preceding month and the schedule of the computation of the Base Management Fee submitted by Operator to Owner pursuant to Section 7.2(a). The Base Management Fee shall be withdrawn by Operator from the Operating Account, subject to adjustment if Owner objects to the income and expense statements or the schedule upon which the Base Management Fee computation is based, in which case the dispute shall be settled in the manner set forth in Section 7.2(d). Any adjustment in the Base Management Fee for any Fiscal Year necessary after receipt by Owner of the balance sheets and income and expenses statements provided for in Section 7.3 (including any amount necessary to make up any deficiency in the payment of the Base Management Fee) shall be made and paid within ten (10) days after the receipt thereof by both parties.

(d) The Incentive Management Fee shall be paid annually within thirty (30) days after Owner's receipt of the audited annual financial statements prepared as set forth in Section 7.3.

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<sup>38</sup> See the detailed notes on each fee category in the "Definitions" article of this agreement.

(e) If this Agreement is terminated at other than the end of a Fiscal Year, the amount of the Base Management Fee and the Incentive Management Fee due for such partial Fiscal Year shall be prorated accordingly.

## ARTICLE IX

### INSURANCE<sup>39</sup>

Section 9.1 Insurance Carried by Owner. Owner or, at Owner's request, Operator shall obtain and shall pay as an Expense, the following insurance coverage in the form of policies which shall name Owner, Operator, Owner's mortgagee and/or ground lessor (if any) and such entities as shall be required under the Franchise Agreement as additional named insureds, as their interests may appear:

(a) An "all risk" policy (including, at Owner's option, Difference in Conditions coverage which shall include earthquake, flood, collapse and/or sinkhole) insuring all real and personal property, in an amount not less than the full replacement cost value, without coinsurance; such insurance to be written on a stipulated or agreed amount basis. Operator shall also assist Owner in determining the need to carry additional coverages such as Contingent Liability from Operations of Building Laws, Demolition Cost and Increased Cost of Construction.

(b) Insurance on the Hotel against loss or damage from an accident to and/or caused by boilers, heating apparatus, pressure vessels, pressure pipes, electrical or air conditioning equipment, in such amount as Owner shall deem advisable. Additional provisions providing coverage for removal of contaminated equipment and/or hazardous or toxic substances contained within such equipment to approved disposal sites shall be considered and obtained if deemed appropriate by Owner.

(c) Business interruption insurance against the perils enumerated in Subsections (a) and (b) above, in amounts determined by Owner.

(d) Comprehensive general liability insurance including personal injury; discrimination and humiliation (if available); products and completed operations liability; liquor law liability; innkeeper's legal liability; blanket contractual liability; advertising liability; automobile liability, including owned, non-owned or hired vehicles; garage liability and garage keeper's legal liability; marine and wharf liability (if applicable), and having not less than \$10,000,000 combined single limit coverage for personal injury or death of any one person, for personal injury or death of two or more persons in any one occurrence, and for damage to property resulting from any one occurrence. These policies shall be specifically endorsed to provide that the insurance will be deemed primary and that any other insurance available to Owner shall not be called upon by these policies to contribute to a loss.

(e) Workers' Compensation in statutory amounts and Employers' Liability coverage with limits of liability of not less than \$500,000 and such similar insurance as may be required by applicable Laws and Regulations for an employer to possess. Operator shall submit in advance to Owner for Owner's approval any workers' compensation dividend, retention or retrospective rating plans covering more than one location, because Operator, as an employer, manages more than one hotel, along with the allocation formula that is to be applied. In the event Operator fails to do so, Owner shall have the right to reject any penalty or surcharge resulting from such allocation formula.

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<sup>39</sup> Hotel insurance is significantly different from insurance carried on rental or commercial real property. Carriers generally available for hotel insurance may also have lower ratings than insurers of some other commercial real estate.

(f) Fidelity insurance, and money and securities insurance on a blanket basis covering Operator and all employees of Operator who have access to or are responsible for the handling of Owner's funds and tenant security deposits, in such amounts as Owner and Operator shall deem advisable but in no event less than \$500,000. All such policies shall specify that any loss involving funds of Owner shall be payable to Owner.

(g) Insurance providing coverage of the indemnification by Operator contained in Section 10.1, in form and substance acceptable to Owner.

(h) Such additional insurance as may be required by any mortgagee of the Hotel or any part thereof or under the terms of the Franchise Agreement, together with such additional insurance as is customarily obtained and maintained by prudent owners or operators of similar properties and businesses.

#### Section 9.2 General.

(a) Certified copies of policies, containing all conditions applying to the Hotel, shall be delivered to Owner not less than 30 days prior to the expiration date of all policies of insurance that must be maintained under the terms of this Agreement. All policies shall contain an endorsement providing a 30-day written notice of cancellation, material change or nonrenewal to Owner and Operator. In addition, all policies shall provide that losses, if any, payable under business interruption policies shall be adjusted with and payable to Owner and Operator as their interests may appear, and losses, if any, payable under property damage policies shall be adjusted with and payable to Owner alone or Owner and any mortgagee of Owner.

(b) To the extent waivers of subrogation are acceptable to the carrier, each policy of insurance shall provide by separate endorsement that the carrier shall have no right of subrogation against either party hereto, their agents, employees, officers and directors.

(c) The limits provided for hereunder may be increased from time to time to give effect to increases in current liability exposure and inflationary cost increases. Changes in the amounts and types of insurance provided for hereunder shall be made as part of the Annual Budget review process.

(d) All deductibles applicable to any of the required insurance shall be acceptable to Owner.

(e) All insurance shall be written with companies approved by Owner and Operator, licensed in the state in which the Hotel is located and rated A with a financial see Category XI or better by the latest Best's Insurance Key Rating Guide, unless otherwise approved by Owner.

(f) At Owner's request, Operator shall provide information pertaining to Operator's policies and procedures governing claims, emergency preparedness, loss prevention and allocation of insurance premiums among hotels covered by the same blanket policies.<sup>40</sup> Operator shall promptly investigate and make a full written report to Owner and all appropriate insurance carriers regarding all alleged accidents and/or alleged claims for damages relating to the ownership, operation, management and maintenance of the Hotel, including any damage or destruction to the Hotel and the estimated cost of repair, and shall prepare any and all other reports required by any insurance company in connection

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<sup>40</sup> Blanket policies covering multiple hotels and affiliated captive reinsurance subsidiaries are widely used. The benefits and risks of these insurance vehicles should be understood before group or chain insurance is accepted.

therewith. Operator shall acquaint itself with all terms and conditions of the policies obtained pursuant to Section 9.1, cooperate with and make all reports required by the insurance carriers and do nothing to jeopardize the rights of Owner and/or any other party insured under such policies.

(g) Notwithstanding anything to the contrary contained in this Article, if, at any time, Owner shall determine to effect any of the insurance coverages required by this Article under blanket policies covering the Hotel and any other properties of Owner or its affiliates, then upon notice to Operator, Operator shall terminate or not renew any insurance policies as Owner may direct and shall cooperate with Owner in obtaining the blanket policies designated by Owner. If, as of the date of this Agreement, Owner shall have insurance policies in effect covering any or all of the risks required to be insured pursuant to this Article, then a description of each insurance policy, including the name of the insurer, the name of the insured and additional insureds, the amount of coverage and the respective expiration date shall be set forth in Exhibit B annexed hereto and Operator shall not obtain insurance policies which duplicate the coverage provided by such policies until the expiration date set forth on Exhibit B or such other date as Owner may specify in writing.

## ARTICLE X

### INDEMNIFICATION

Section 10.1 Indemnification by Operator. Operator agrees to defend, indemnify and hold Owner free and harmless from and against all claims, costs, expenses, demands, attorneys' fees and disbursements, suits, liabilities, judgments and damages caused by the negligent acts, omissions, misconduct, or the failure to perform or exercise any of the duties, obligations, powers or authorities of Operator or Employer, Operator's or Employer's employees, or any independent contractor hired by Operator or Employer, and Operator agrees to reimburse Owner upon demand for any monies (including reasonable attorneys' fees and disbursements) which Owner is required to pay for any items which are the responsibility of Operator pursuant to the terms of this Section 10.1. Owner shall indemnify Operator only to the extent of the insurance coverage provided herein.<sup>41</sup> The provisions of this Section 10.1 shall survive the termination of this Agreement.

## ARTICLE XI

### TERMINATION OF AGREEMENT

#### Section 11.1 Termination by Owner.

(a) Notwithstanding anything to the contrary contained in this Agreement, Owner may terminate this Agreement (i) at Owner's discretion and without cause upon not less than thirty (30) days' prior written notice delivered to Operator (a "Special Termination Notice") and subject to payment

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<sup>41</sup> Broad indemnification by owners was typical in older agreements when owners had agreed to be subject to unlimited cash calls. With the growing trend toward non-recourse obligation on the part of owners, operators are being required to obtain and maintain insurance that protects owners from any obligation to contribute additional funds. The refusal to give recourse indemnification may also highlight the other risks that might have been left to the owner under older agreements. These include pension underfunding, uninsurable violations of law, discrimination, harassment, environmental contamination, tax non-compliance, and contingent operating liabilities such as self-insurance.



after termination of a "Special Termination Fee as set forth below in Section 11.1(b)<sup>42</sup>, (ii) for cause, including, without limitation, for any failure by Operator or Employer to observe or perform any or all of the covenants and provisions of this Agreement, immediately<sup>43</sup> upon notice to Operator and without payment of any termination fee or penalty, and (iii) without cause and without payment of any termination fee or penalty in the event that the Cash Available for Distribution<sup>44</sup> does not in any Fiscal Year equal or exceed \$\_\_\_\_\_ or does not in any two consecutive Fiscal Years equal or exceed \$\_\_\_\_\_ in each Fiscal Year.<sup>45</sup> Cash Available for Distribution shall be conclusively determined by the results set forth in the audited financial statements prepared pursuant to Section 7.3.

(b) In the event of a termination of this Agreement pursuant to a Special Termination Notice, Owner shall pay Operator as its sole compensation and liquidated damages for such termination an amount equal to three (3) times the annual average total of the Annual Subordinated Base Fee plus Incentive Fee earned by Operator in the three Fiscal Years last completed prior to the date of delivery of the Special Termination Notice.

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<sup>42</sup> There appears to be no standard set of termination rights consistent through the industry. The rights are highly negotiated. A right to terminate on sale without cause may be agreed, and may be accompanied by a first offer right in favor of the operator. First offers are however not generally in the interests of the owner as they add no value and may complicate a third party sale. First refusals should never be given. A general right to terminate without cause and without sale may be agreed, but are normally accompanied by a very substantial termination fee to protect the operator from loss of a profitable contract. However, an operator who makes little investment in the relationship by equity investment, performance guarantees or low base fees can expect to receive less protection against termination. Some form of contributions by major brands, while not particularly large, have become more routine.

<sup>43</sup> Cure rights may be offered for unintentional misconduct, but monetary defaults or intentional acts may not be subject to cure. Management companies will seek to restrict or frustrate termination rights by requesting arbitration prior to termination or requiring that the right to payment for termination be resolved before they turn over the hotel. Such provisions are very damaging to the owner's interest and ability to enforce the provisions as intended.

<sup>44</sup> See the detailed note under definition of this term. The majority of draft contracts put forth by management companies will seek to dilute or negate any performance test by numerous exceptions (disruption by a capital project, terrorism, general market conditions, force majeure) and to entrench the contract unless the hotel is operating below its competitive set. These terms are inserted by the management company primarily to create factual issues in any termination. Arbitration clauses are also used in this strategy. As a practical matter, a performance termination standard that cannot be unambiguously confirmed by court order on the basis of third party information will be ineffective. Very few standards in current contract are enforceable for practical purposes. A clear cash based test is essential if there is to be a meaningful threat of termination for poor performance.

<sup>45</sup> The one-year test will generally be based on failure to reach a lower number than that required for failure in a two-year test. The operator will seek force majeure protections or reduction of the required amounts based on a decline in performance shared by its competitors. However, unless the owner has a lender with a similarly generous and flexible view of debt service obligations, the owner must anticipate the possibility that performance can be inadequate to meet debt service, even if due to force majeure or industry-wide decline. In such cases, the right to terminate the operator for low performance may become a major factor in the owner's ability to restructure the transaction short of default and foreclosure or bankruptcy.

(c) The provisions of this Section shall not detract from or waive Owner's right under applicable law of agency to withdraw its authorization of an agent to bind Owner at any time and without cause at Owner's sole discretion.

Section 11.2 Termination by Operator. Notwithstanding anything to the contrary contained in this Agreement, Operator may terminate this Agreement, with or without cause, upon not less than one hundred eighty (180) days' prior written notice delivered to Owner. Unless such termination is with cause, Owner is entitled to all rights to damages for early termination that it may have under applicable law.<sup>46</sup>

Section 11.3 Other Termination. In the event a petition for bankruptcy is filed by or against either Owner or Operator, or in the event that either shall make an assignment for the benefit of creditors or take advantage of any insolvency act, either party hereto may forthwith terminate this Agreement upon written notice to the other. For purposes of this Section 11.3, the term "Operator" shall be deemed to include Employer.

Section 11.4 Settlement upon Termination.

(a) In the event this Agreement is terminated as herein provided (including an expiration of the term hereof), all obligations of the parties shall cease as of the termination date, provided, however, that (1) Operator shall be entitled to all Management Fees and other fees earned by Operator hereunder accruing to the date of termination; (2) Operator shall account to Owner with respect to all matters outstanding as of the date of termination and assign to Owner all of its right, title and interest under such agreements, contracts and leases (including the Service Contracts) with respect to the Hotel entered into by Operator on behalf of Owner (other than contracts between Operator and its employees); (3) Operator shall be liable to Owner for all of Operator's obligations accruing under this Agreement to such termination date; (4) Operator shall remove all its property from the Hotel on or before the date of termination; (5) Operator shall transfer to Owner all of the Hotel Records in the custody or control of Operator on or before the date of termination; and (6) Operator shall cooperate with Owner after termination to transfer to Owner or its designee all of Operator's rights under contracts relating to employees of Operator which Owner, in its sole option, decides to accept. Any employee contracts which Owner declines to accept shall remain the obligations of Operator, even if the Owner offers employment to any one or more of Operator's employees. Nothing herein mandates or requires that Owner offer employment to any employee of Operator, or if employment is offered, that such employment will be under the same hours, wages and working conditions as existed prior to the termination. In addition, nothing herein mandates or requires that Owner recognize any labor organization that represented Operator's employees. Upon termination, all workers' compensation and unemployment costs as well as all unpaid salaries, vacation pay, sick leave benefits and other accrued benefits, including, without limitation, required payments to multi-employer pension plans or other pension liabilities, shall be payable by Operator as an operating expense of the Hotel unless otherwise mutually agreed to by Owner and Operator. Also, any accrued costs such as advances on salaries and bonus reserves established by Operator and accounted for as prior operating expenses of the Hotel shall be credited to Owner. Where permissible, at termination, at Owner's option, Operator shall transfer to Owner its workers' compensation and unemployment insurance ratings. By terminating this Agreement in accordance with this Article XI, neither party shall be deemed to have waived any action it might have, in law or in equity, by reason of a breach of or default under this Agreement.

(b) Upon the termination or expiration of this Agreement: (1) to the extent assignable, Operator shall cooperate to transfer to Owner all of Operator's right, title and interest, if any, in and to all restaurant, liquor, and other licenses and permits with respect to the Hotel; and (2) Operator

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As a practical matter, operators rarely seek to terminate early unless unusual circumstances exist.

shall peacefully deliver the Hotel and Operating Accounts to Owner. Operator and Employer acknowledge that they have no possessory, tenancy, security or lien rights in the Hotel and Owner shall have the rights of equitable enforcement in regard to the delivery of the Hotel and all related property to Owner.

(c) The provisions of this Section 11.4 shall survive the termination of this Agreement.

## ARTICLE XII

### OWNER'S PERFORMANCE OF OPERATOR'S OBLIGATIONS

Section 12.1 Owner's Performance of Operator's Obligations. In the event Operator fails to perform any of its obligations and undertakings hereunder, Owner may, after giving Operator 15 days' prior written notice thereof (unless such default creates an emergency in Owner's sole judgment, in which case no notice need be given by Owner) perform any of Operator's obligations (including payment of any monies due) and Owner shall be immediately reimbursed by Operator from the Operating Account for any monies so expended (to the extent there are funds in such Operating Account); provided, however, that any part of such monies expended by Owner which represent penalties, interest or Owner's expenses or costs (including reasonable attorneys' fees) incurred wholly or in part by reason of Operator's default under this Agreement shall not be charged to the Operating Account, but shall be paid by Operator to Owner together with interest at the lesser of (1) the rate of 18% per annum or (2) the highest rate of interest permitted by applicable law. Any performance by Owner of any obligation of Operator hereunder shall not be deemed a waiver by Owner of any other right or remedy Owner has under this Agreement or in law or equity by reason of such default or a waiver of any such rights or remedies Owner has by reason of a future default by Operator.

## ARTICLE XIII

### MISCELLANEOUS

#### Section 13.1 Notices.

(a) Any and all notices required or which either party herein may desire to give to the other (each, a "Notice") shall be made in writing and shall be given by certified or registered mail, postage prepaid, return receipt requested, or by recognized overnight courier, such as Federal Express or Airborne Express, and shall be deemed to be given on the third business day following the date of posting in a United States Post Office or branch post office or one day after delivery to the overnight courier, and shall be addressed to Operator's Notice Address or Owner's Notice Address, as appropriate. Copies of any Notices (a) terminating this Agreement, (b) asserting any default or claim hereunder or any claim for which Owner is indemnified pursuant to the terms hereof or (c) commencing or relating to any action, suit or proceeding whether against Owner or Operator relating in any way to Operator's or Owner's acts or omissions hereunder or any of Operator's or Owner's activities in respect of the Hotel shall also be sent to \_\_\_\_\_, Attention: General Counsel. Either party may, by notice as aforesaid actually received, designate a different address or addresses for communications intended for it.

(b) Notices given hereunder by any party may be given by counsel for such party. The foregoing Notice provisions shall in no way prohibit a Notice from being given as provided in the rules of civil procedure of the state in which the Hotel is located, as the same may be amended from time to time.

Section 13.2 Non-Competition. So long as this Agreement is in effect, neither the Operator nor any of its Affiliates shall either directly or indirectly operate or manage a hotel of

comparable average daily rate and quality within the Non-Competition Area without Owner's prior written approval.<sup>47</sup>

Section 13.3 Owner's Right to Inspect. Owner or its designated representative shall have access to the Hotel at any time for the purpose of inspecting the Hotel or any portion thereof, protecting same against fire or other casualty, prevention of damage to the Hotel or any portion thereof, or showing the Hotel to prospective purchasers or mortgagees.

Section 13.4 Partial Invalidity. In the event that any portion of this Agreement shall be declared invalid by order, decree or judgment of a court, or governmental agency having jurisdiction, this Agreement shall be construed as if such portion had not been inserted herein, except when such construction would operate as an undue hardship on Operator or Owner or constitute a substantial deviation from the general intent and purpose of such parties as reflected in this Agreement.

Section 13.5 Time of the Essence. It is expressly agreed that time is of the essence with respect to the obligations of Operator under this Agreement.

Section 13.6 Estoppel Certificate. Operator agrees that from time to time upon not less than ten (10) days' prior request by Owner, Operator will deliver to Owner a statement in recordable form certifying (a) that this Agreement is unmodified and in full force and effect (or if there have been modifications that the Agreement as modified is in full force and effect and stating the modifications); (b) the dates to which the Management Fees and other charges have been paid; (c) that Owner is not in default under any provision of this Agreement, or if in default, the nature thereof in detail; and (d) such other items as Owner may reasonably request.

Section 13.7 No Partnership, Tenancy, Etc. Nothing contained in this Agreement shall be construed to create a partnership or joint venture or relationship of landlord and tenant between Owner and Operator with respect to the Hotel. All rights and interests of Operator and Employer hereunder shall be subject and subordinate to the rights of any lender under a Permitted Mortgage. Notwithstanding anything to the contrary contained herein, Operator shall be solely an agent performing management functions for Owner within the scope of this Agreement. All books, plans, contracts, accounts, receipts, tapes, records and the like maintained by Operator with respect to the operation, leasing or maintenance of the Hotel shall, at all times, be and constitute the property of Owner subject only to the obligations of any Permitted Mortgage and shall be surrendered to Owner in accordance with the terms hereof, without charge or expense. Nothing herein shall create an agency coupled with an interest and Operator and Employer expressly waive any such interest.<sup>48</sup>

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<sup>47</sup> With the consolidation of ownership of multiple hands in a single company, and proliferation of hand sub-segments, cannibalization of territories is a realistic concern. These are becoming much more common topics of negotiation. Further, larger hotels competing in a national or regional market may have a "territory" that is not limited to the locality. How the management company allocates opportunity for, e.g., large convention business is also for negotiation.

<sup>48</sup> Some operators have recently advocated that they have protections against termination as agents based on the argument that they have agencies "coupled with an interest". Put briefly, such agencies would be analogous to the rights of a secured lender controlling the disposition of its collateral and protected against removal of the collateral until it is repaid. Courts have been in general unfriendly to this analogy in the hotel context. Most structures argued to give rise to such an agency were rejected in *Government Guarantee Fund of the Republic of Finland, et al v. Hyatt Corporation et al.*, 95 F3d 291 (3<sup>rd</sup> Cir. 1996). A further decision was that the express linking of an investment and a hotel management contract by separate entities did not result in an agency

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Section 13.8 Attorneys' Fees. In the event either party hereto institutes legal action against the other party to interpret or enforce this Agreement or to obtain damages for any alleged breach hereof, the prevailing party in such action shall be entitled to an award of reasonable attorneys' fees.

Section 13.9 Successors. Operator may not assign its interest under this Agreement or any rights or duties hereunder to any entity or person without the prior consent of Owner, which consent Owner may withhold in its sole discretion. The transfer of a majority in interest of the voting stock or general partnership interests in Operator or any material change in the individuals having operating responsibility for Operator shall be deemed an assignment of this Agreement. Subject to the foregoing, this Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective successors and assigns.

Section 13.10 No Third Party Beneficiaries. Owner, Operator and Employer acknowledge that this Agreement is solely for their own benefit and, subject to Section 13.9, that of their successors and assigns, and that no third party shall have any rights or claims arising hereunder, nor is it intended that any third party shall be a third party beneficiary of any provisions hereof.

Section 13.11 Waiver. Entire Agreement. No modification, amendment, discharge or change of this Agreement, except as otherwise provided herein, shall be valid unless the same is in writing and signed by the party against which the enforcement of such modification, amendment, discharge or change is sought. No waiver of any breach of any covenant, condition or agreement contained herein shall be construed to be a subsequent waiver of that covenant, condition or agreement or of any subsequent breach thereof or of this Agreement. This Agreement contains the entire agreement between the parties relating to the transactions contemplated hereby, and all prior or contemporaneous agreements, understandings, representations or statements, oral or written, are merged herein.

Section 13.12 Captions. Titles or captions contained in this Agreement are inserted only as a matter of convenience, and for reference only, and in no way limit, define or extend the provisions of this Agreement.

Section 13.13 Interpretation. In interpreting this Agreement, the provisions in this Agreement shall not be construed against or in favor of either party on the basis of which party drafted this Agreement.

Section 13.14 Governing Law. This Agreement shall be governed and construed in accordance with the laws of the state in which the Hotel is located.<sup>49</sup>

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(continued from previous page . . .)

coupled with an interest. *2660 Woodley Road Joint Venture et al v. ITT Sheraton Corporation et al.*, 97-450 JJF (U.S. Dist. Ct. Del. 2/4/98).

<sup>49</sup> Owners should be particularly careful NOT to specify the law of the state of Maryland, and should specify the law and jurisdiction of courts of a different jurisdiction. Maryland has enacted a law which purports to deny owners the right of termination as a remedy for a breach of a hotel management contract.

There is no legal necessity that the law of the situs of the hotel should govern. Under normal common law principles, the parties may contract to apply a different law. Such a contract will not, however, govern whether the interest of the management company is an interest in real property

(continued)

Section 13.15 Further Assurances. The parties hereto agree to execute, acknowledge, deliver and record such certificates, amendments, instruments, and documents, and to take such other action, as may be necessary to carry out the intent and purposes of this Agreement.

Section 13.16 Owner's Limited Liability. No general or limited partner in or of Owner, whether direct or indirect, or any direct or indirect partners in such partners or any disclosed or undisclosed officers, shareholders, principals, directors, employees, partners, servants or agents of the Owner or any of the foregoing or any investment adviser of Owner (including any assignee or successor of Owner) or other holder of any equity interest in Owner, shall be personally liable for the performance, of Owner's obligations under this Agreement. The liability of Owner (including any assignee or successor of Owner) for Owner's obligations hereunder shall be limited to Owner's interest in the Hotel and the proceeds of insurance coverage described in Article IX.

Section 13.17 Compliance with Equal Opportunity Law and Regulations. During the term of this Agreement, Operator and Employer and anyone authorized to act for Operator or Employer shall comply with the provisions of Title VIII of the Civil Rights Act of 1968, as amended, and Executive Order 11063; Titles VI and VIII of the Civil Rights Act of 1964 and where applicable, Executive Order 11246, as amended, and all applicable state and local laws. Neither Owner, Operator nor anyone authorized to act for such parties shall, in the rental, lease or sale, in the provision of services or any other manner, discriminate against any person on the grounds of race, color, creed, religion, sex national origin, or any other basis prohibited by law.

Section 13.18 Jury Trial Waiver. Owner and Operator hereby waive trial by jury in any action, proceeding or counterclaim brought by either of the parties hereto against the other in respect of any matter arising out of or in connection with this Agreement.

Section 13.19 Liens. This Agreement shall not create an interest in real property and it shall not be recorded in the public records of any jurisdiction. Notwithstanding anything to the contrary contained herein, neither Operator nor any officer, partner, representative or agent thereof shall be entitled to place, file or record a lien against the Hotel on account of any sums alleged to be due and payable to Operator hereunder.

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(continued from previous page . . .)

for lien and foreclosure purposes. That will normally be decided by the law of the jurisdiction in which the real estate interest is claimed to exist..

Section 13.20 Joinder of Employer. Employer joins in the execution and delivery of this Agreement for the purpose of agreeing to perform all of its obligations with respect to the employees and personnel of the Hotel as set forth in the provisions of this Agreement. Employer acknowledges that it is not entitled to any payments or reimbursements from Owner in addition to those to be made by Owner to Operator hereunder.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the date first above written.

OWNER:

\_\_\_\_\_  
a \_\_\_\_\_ corporation

By: \_\_\_\_\_  
Name:  
Title:

OPERATOR:

\_\_\_\_\_  
a \_\_\_\_\_ corporation

By: \_\_\_\_\_  
Name:  
Title:  
EMPLOYER:

By: \_\_\_\_\_  
Name:  
Title

## EXHIBIT D

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### MONTHLY REPORTING PACKAGE TRANSMITTAL FORM

- A. LETTER TO OWNER (GENERAL MANAGER'S REPORT)
- B. PROFIT AND LOSS STATEMENT
- C. GENERAL LEDGER TRIAL BALANCE
- D. CHECK REGISTER
- E. BANK ACCOUNT RECONCILIATION FORMS
- F. BANK STATEMENT COPIES
- G. CAPITAL EXPENDITURES REPORT/SUMMARY OF FF&E RESERVE
- H. AGED RECEIVABLES REPORT
- I. MGMT. CO. CHARGEBACKS PER MONTH AND YTD VS. BUDGET
- J. SMITH TRAVEL RESEARCH REPORT<sup>1</sup>
- K. SALES & MARKETING PRODUCTIVITY REPORT
- L. MONTHLY REFORECAST FOR CALENDAR YEAR
- M. MARKET SEGMENT REPORT
- N. MONTH-END DAILY REVENUE REPORT

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<sup>1</sup>

This is a widely used report customized for individual hotels and generated monthly from a database maintained by Smith Travel Research ("STR"). It compares the basic elements of hotel performance for the individual hotel with the blended performance of a defined competitive set of hotels.