

# Hotel Franchise Agreements: What Should Owners Focus On?

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Whether you are considering developing a hotel or acquiring a hotel, in order to maximize your revenue per available room (and obtain capital investors and financing), you are likely to turn to one of the major hotel brands to "flag" your hotel with an appropriate hotel brand. The document that formalizes your rights and obligations is known as the hotel "license agreement" or "franchise agreement." For many owners, their understanding of this important agreement does not extend beyond the basic economic terms of royalty fees, "areas of protection," length of term, and possibly "key money."

This article will demystify this critical document by: (1) generally describing what franchise agreements are; (2) summarizing some of the most material terms within the hotel franchise agreements; and (3) suggesting which terms may be open to negotiation with the franchisor/hotel brand.

## What Is the Franchise Agreement and What Does It Do?

The franchise agreement is a license agreement between the hotel owner and the hotel brand that sets forth the rights and obligations of the owner to operate the hotel under the brand or "flag" in exchange for fees. Franchise agreements are essentially licenses, which means that they are personal and cannot be assigned by the current owner. These agreements are drafted by the hotel brand companies and are very one-sided.

Even though franchise agreements are drafted in favor of the brands, most owners are more than happy to sign them since the right flag (and its reservation system) is enormously beneficial to the owner's business. The right flag can significantly increase hotel occupancy and the room rate and add upwards of 20%-40% to the value of a hotel when compared to "unflagged" or weaker brand options.

## What Are the Material Terms in a Franchise Agreement?

As you would expect, franchise agreements contain hundreds of material terms. However, some of the more important terms address:

1. Fee Structure. There are lots of different types of fees, including royalty fees, application fees, "brand services"/marketing fees, technology fees, and "rewards club" fees.
2. Term. A standard term is typically between 20 and 25 years.
3. Owner Responsibilities. These include very specific obligations to operate and maintain the hotel in accordance with standards established by the brand, identify and market the hotel as a brand hotel, participate in the brand's reservation system, and pay the applicable fees. It also includes more vaguely drafted obligations such as operating the hotel in a "first class" and "high moral and ethical standard" that "maximizes the gross revenue" of the hotel.
4. Brand Responsibilities. These include the brand's responsibilities to train hotel personnel, provide access to the brand's reservation system, maintain the brand's standards consistently across all system hotels, and market the brand in a manner deemed appropriate by the brand.
5. Brand Standards. Brand standards are designed and continually updated by the brand in order to assure that the guest experience is similar across the brand's system of hotels. They are nonnegotiable and are subject to change in the sole determination of the brand.
6. Brand Marks and IP Rights. If you do not comply with all brand requirements, you do not get to use the brands marks (including the big sign on top of your hotel).
7. Indemnification. Owners indemnify the brand, not the other way around.
8. Restrictions on Transfers and Changes in Ownership. The brands have to know who they are doing business with "down to a warm body." The entire ownership structure must be approved by the brand in advance and anytime it changes. Some transfers (such as transfers of non-controlling interests) can be obtained fairly quickly while others (such as the transfer of a controlling interest) can be extremely complicated and time-consuming.
9. Net Worth Requirements/Personal Guaranty. All major hotel brands require a personal guaranty. The brands know that nothing ensures compliance like personal liability and therefore insist on getting the sponsor to sign a guaranty.
10. Renovation Requirements. Owners should expect to replace "soft goods" every five to six years, "case goods" every 10 to 12 years, and periodic major renovations (also called property improvement plans, or PIPs) whenever the hotel is sold and as required by the brand to ensure the furniture, fixtures, and equipment; décor; and trade dress conform to current brand standards.
11. Events Requiring Brand Approval.

12. Brand Inspection Rights and Quality Assurance Programs.

13. Rights of First Refusal. Usually if/when the owner sells the hotel.

## What Terms Are Open to Negotiation?

Very few of the "legal" terms in the franchise agreement are open to negotiation, but if raised while negotiating the term sheet before "committee approval" by the brand, there are several "business terms" that owners have some ability to negotiate. Owners will have more negotiating leverage on the economic terms if they are developing the hotel instead of buying a stabilized asset. The terms that are considered business terms and are potentially subject to negotiation are:

1. Key money (in development deals)
2. Areas of protection (in development deals)
3. Royalty fee "ramp-ups" (in development deals)
4. Special termination rights for failing to obtain financing (in development deals)
5. Deleting the brand's rights of first refusal
6. Brand "preapproval" of the management company and/or the ownership structure
7. The construction commencement date and the opening date (in development deals)
8. Brand preapproval of the guarantor

An owner's ability to obtain concessions from the brand is largely dependent on (1) the owner's leverage (i.e., is the owner developing a new hotel or agreeing to perform a major renovation; does the owner own several other hotels within the brand family); and (2) the owner's knowledge of the issues. If an owner does not have deep experience in franchise agreement negotiations, the owner should hire an experienced hospitality attorney and/or hotel consultant to guide the owner through the negotiations.

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