Senior Housing Facility Management Agreements

The number of people in the United States aged 65 and older is projected to surge to 86 million in 2050, up from 41 million in 2010. The projected rate of growth of this segment of the population (28 percent) is nearly quadruple that of the general population (111 percent) over the same period. These demographic shifts are likely to result in the significant expansion of a senior housing industry that is already quite active. According to a recent article in Senior Housing News, senior housing attracted more investment activity than any other property investment category in 2013 (for the first time), and nearly $2 billion in senior housing property sale transactions closed in the first quarter of 2014.

The ownership and operation of senior housing facilities are structured in various ways. Some operators of senior housing facilities primarily manage facilities that they own themselves or lease from third parties (often large health care real estate investment trusts (REITs)). By contrast, other operators primarily manage facilities as third-party managers for unaffiliated owners or lessees.

This latter third-party management model is widely expected to become more prevalent in the wake of the REIT Investment Diversification and Empowerment Act (RIDEA). Prior to the adoption of RIDEA in 2008, health care REITs were largely precluded from participating in the operation of the facilities that they owned. Typically, they leased their facilities to third-party tenants who made fixed rent payments under triple-net leases. RIDEA enabled health care REITs to use alternative structures (which were previously available only to REITs in the hospitality industry) in order to share in the potential profits (and the associated risks) of the operation of their facilities. In a typical RIDEA-compliant structure, the REIT leases a qualified facility to a taxable REIT subsidiary under a triple-net lease, and the subsidiary tenant then engages a third-party manager to operate the facility on a fee basis.

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Senior housing management agreements are employed in a wide variety of contexts and can take varying forms. The market position and negotiating power of managers vary appreciably, and a manager may operate facilities for owners in very different circumstances, ranging from small independent players to large public health care REITs with market capitalizations approaching $20 billion. Managers may be engaged by owners of the facilities or by tenants leasing the facilities from sister companies (for example, in the RIDEA structure described above) or from unaffiliated third parties (in a traditional triple-net lease structure). The management company may hold an interest in a joint venture that owns or leases the facility it manages or may hold no stake in such facility other than its role as manager. Finally, the management arrangement may cover a single asset or a large portfolio. Accordingly, there are significant variations in the types and substance of the provisions contained in these management agreements. This article outlines in brief a few of the key features that are negotiated as part of senior housing management agreements—specifically, fee structures, operational and physical standards, performance tests and territorial restrictions—and the manner in which they are sometimes addressed.

Management Fees

Managers of senior housing facilities are usually compensated with a combination of a base fee (intended to cover the cost of providing the services with a profit component) and an incentive fee (to reward performance). Base fees generally represent a fixed percentage of gross revenue—typically between three and six percent—with gross revenue defined as all revenue derived from operating the applicable facility other than certain excluded items that do not relate to operations or do not benefit the owner (for example, proceeds from insurance (other than business interruption insurance), condemnation awards, gratuities provided to employees, and sales tax collected from residents).

Incentive fees are usually calculated as a percentage of earnings in excess of a defined breakpoint (based on some baseline projection or expectation of earnings), with the breakpoint subject to annual escalations. Occasionally, incentive fees are capped at a fixed percentage of gross revenue. Less often, incentive fees are calculated as a percentage of earnings after the payment to the owner of a fixed return on its invested capital (i.e., the cost of acquiring the facility plus any owner-funded capital improvements).

Operational Standards

The manager is typically obligated to operate and maintain the facility—and, in many cases, the owner is obligated to make funds available for the facility’s operation and maintenance—in accordance with a specified standard. The standard is designed to give the owner comfort regarding the manner in which its facility will be operated and maintained, but also to give the manager comfort that the owner is committed to provide the resources necessary for the manager to operate the facility in a manner that maximizes the manager’s

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fees and preserves or enhances the manager’s reputation in the market. Particularly where the manager and its affiliates operate a sizable portfolio of senior housing facilities, the standard is often defined by reference to the standards prevailing at similar facilities operated by the manager and its affiliates. (The benchmark can be formulated more narrowly to include only standards that are consistently applied at a specified percentage of the facilities operated by the manager or more broadly to include standards that are “in the process” of being implemented at the manager’s other facilities.) Additionally or alternatively, the standard is sometimes defined by reference to market standards (e.g., those prevailing among “prudent” or “institutional” owners or operators of comparable facilities or those of a certain “class” of facility).

Performance Tests

Senior housing management agreements typically include performance tests that permit the owner to terminate the agreement if the manager does not meet certain metrics of performance. Performance tests are most commonly based on net operating income, EBITDAR or some other measure of earnings. Some agreements include a separate test that compares actual expenses to budgeted expenses. The specific mechanics of the tests (including frequency of application and rights to cure) vary widely. Performance tests based on operating profits or cash flow are generally applied on a monthly, annual or biennial basis. Following are three potential formulations that are sometimes used. One iteration compares actual earnings to a percentage (usually somewhere in the range of 75 to 95 percent) of the earnings that are projected during the annual budget process. Another iteration compares actual earnings to a fixed threshold, which is subject to annual escalations (often based on a consumer price index). A third iteration compares annual cash flow to a fixed rate of return (generally seven to nine percent) on the owner’s invested capital. In many cases, the owner can terminate the agreement only if the manager fails the performance test for two consecutive years, and in some of those cases the hurdle is higher in the second year (i.e., in the year after one in which the manager initially fails the test).

Although they are perhaps less common than earnings-based tests, tests based on expenses are sometimes used in senior housing management agreements. Typically these tests compare “controllable” or “discretionary” costs at a facility to a percentage of budgeted costs on an annual basis. Controllable or discretionary costs generally exclude, for example, taxes, insurance premiums and management fees. The existence of this test—and the prospect that an owner will terminate the agreement upon its failure—places even greater importance on the accuracy of the annual budget process.

Performance tests can be applied on a facility-by-facility basis or, in the case of agreements governing the management of multiple properties, on a portfolio-wide basis. Some management agreements provide for both facility-specific and portfolio-wide performance tests, with the owner having the right to terminate the manager with respect to the particular facility or the entire portfolio, as the case may be, if the manager fails the applicable test.

Most performance tests permit the manager to cure a failure by making a payment to the owner. The availability of cure rights is sometimes contingent upon the severity of the failure. (For example, an agreement may preclude the exercise of a cure right if cash flow falls below 75 percent of projected cash flow, but permit the exercise of a cure right if cash flow falls between 75 and 85 percent of projected cash flow.) The number of times that a manager may exercise a cure right is often limited (e.g., a three-strike rule) on a facility-specific or portfolio-wide basis.

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The amount that a manager must pay in order to cure its failure of a performance test typically represents the amount by which the actual earnings fell short of, or the actual expenses exceeded, the required threshold. Some agreements permit the manager to cure by paying only a percentage (e.g., one-half) of that amount, provided that the manager does not fail the test again within a specified period of time (e.g., six months). In agreements that provide for both earnings- and expense-based tests, cure amounts paid in respect of one test are often credited against cure amounts for the other test. The agreements generally provide for equitable adjustments to account for force majeure events, defaults by the owner, approved major renovations or other similar factors.

Territorial Restrictions

Although often imposed on tenants in triple-net leases of senior housing facilities and on operators in management agreements for certain other types of assets (e.g., hotel management agreements), territorial or radius restrictions are less common in senior housing management agreements. Where they do exist, they are often formulated using relatively soft language—for example, language requiring the manager to act in good faith and with honesty and impartiality regarding conflicts between the facility and competing facilities operated by the manager.

More onerous provisions impose a blanket prohibition on the manager’s operation of any competing facility within a defined radius, but exceptions are typically made for facilities already operated by the manager and (in some cases) for facilities that are acquired as part of a large portfolio. Agreements with small or fledgling operators sometimes prohibit the manager from operating a new senior housing facility (for itself or a third party) until the existing facility or portfolio reaches a certain level of profitability.

Conclusion

As owners of senior housing facilities begin to rely less on the traditional structure of triple-net leases and more on management agreements with third-party managers, those management agreements will take on increasing importance in the structuring of transactions in this industry. They should be carefully negotiated by owners and the managers they hire in order to lay the groundwork for relationships that are mutually beneficial.

2. Ibid.
3. Senior Housing News, Senior Housing (Occupancy Rises as Investor Interest Hits Record) (http://seniorhousingnews.com/2013/10/10/senior-housing-occupancy-rises-as-investor-interest-hits-record/).
5. For example, Holiday Retirement Corporation, the fifth largest owner of senior housing in the United States, generally owns and operates its properties. See Wikipedia: Holiday Retirement (http://en.wikipedia.org/wiki/Holiday_Retirement).
6. For example, Emeritus Corporation, the second largest provider of senior housing in the United States (as of Jan. 1, 2012), leases a majority of its properties from public health care REITs. See Anya Martin, Largest Providers 2012, Senior Living Executive, March/April 2012; Emeritus Corporation, 2013 10-K.
9. REITs must satisfy two gross income tests each year. See IRC §856(c)(3), 856(c)(5). While “rents from real property” may qualify as good income for purposes of these tests, it will generally not qualify if the REIT owns 10 percent or more of the stock or voting power (in the case of a corporation) or assets or net profit (in the case of other entities) of the tenant. See IRC §856(d)(2)(B). However, rents received from a “taxable REIT subsidiary” with respect to a facility or a facility-related service will not qualify as “revenue from real property” if one of two provisions applies. Those rents will qualify under the first provision if (i) at least 50 percent of the leased space at the property is leased to third parties and (ii) the consolidated entity is”not” a taxable REIT subsidiary” to tenants paid by other tenants for comparable space. See IRC §856(d)(2)(A). Prior to the enactment of RIDEA, rents received from a taxable REIT subsidiary would only qualify as good income under the second provision if those rents were paid under leases of qualified lodging facilities. RIDEA expanded the second provision to apply to qualified health care properties (as well as lodging facilities). See IRC §865(d)(8)(B); Housing and Economic Recovery Act of 2008, P.L. 110-289, §3061.
10. For simplicity’s sake, we will refer to the manager’s counterparty (whether it has a fee or a leasehold interest in the facility) as an “owner.”