PROPERTY MANAGEMENT AGREEMENTS

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State Bar of Texas
16TH ANNUAL ADVANCED
REAL ESTATE DRAFTING COURSE
March 10-11, 2005
Houston

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I. INTRODUCTION

The purpose of this article is to examine selected issues which arise when drafting property management agreements. The contents of this article are meant to assist the practitioner in drafting the provisions discussed; no attempt is made to cover all aspects of drafting property management agreements or the relationship between an owner and a management company. Before the practitioner drafts any agreements, the particular circumstances of the parties and their respective negotiating positions should be considered and analyzed. Note that, for the most part, this paper pertains to agreements between an owner and an independent third party management company.

II. PARTIES

A. Who is the owner or principal?

Oftentimes, a property is owned by a single asset entity. Vendor contracts, including property management agreements, should be in the name of that single asset entity. Either the single asset entity should be named specifically or by assumed name. If the owner has an assumed name, the Assumed Business or Professional Name Act should be followed. *See* TEX. BUS. & COM. CODE ANN. §36.01, *et. seq.* This may affect a number of issues relating to the management of the property including signing vendor contracts, defending suits and proceeding with eviction actions.

B. Who is the agent?

Similarly, the correct legal name of the management company should be identified.

III. APPOINTMENT OF MANAGER

A. The agreement should appoint the manager. From an owner's standpoint, it is beneficial to have the manager be an independent contractor rather than an employee. The distinction between employee and independent contractor affects legal rights and obligations, including liability for social security taxes, the right to workers' compensation benefits, and the liability of an employer for the torts of a worker. *See Newspapers, Inc. v. Love,* 380 S.W.2d 582 (Tex. 1964). The agreement should establish the status of the manager as an independent contractor. This would not be an issue if the manager was a third party management company.

IV. TERM OF AGREEMENT

A. The term of the agreement can be a set term of a number of months or years or can be a month to month term which can be terminated by either party giving thirty days notice. Whatever is negotiated, the term and the manner and method by which the parties can give a notice of termination should be clearly stated.

B. Although the term can renew automatically for an established period of time, note that section 1101.652(b)(12) of The Real Estate License Act ("TRELA")[1] provides that the Texas Real Estate Commission may suspend or revoke a license issued under the TRELA or take other disciplinary action if the license holder, while acting as a broker or salesperson, as defined by the TRELA, *fails to specify* a definite termination date that is not subject to prior notice in a contract, other than a contract to perform property management services, in which the license holder agrees to perform services for which a license is required under the TRELA. If the agreement requires the manager to perform the acts of a broker or salesperson, there may be an argument that the contract must have a definite termination date not subject to being automatically renewed.

V. MANAGER'S DUTIES AND RESPONSIBILITIES

A. General Scope.

Generally, the manager is retained to manage, coordinate and supervise the ordinary and usual business and affairs pertaining to the operation, maintenance, leasing and management of the property. The agreement can state that the manager has those responsibilities customarily performed or taken by management agents of property of similar nature, location and character as that of the property in question. The owner will want the manager to ensure that the property will be maintained in accordance with the highest standards of property maintenance for the type of property subject to the agreement in the area in which the property is located. The manager will want to assure that all actions taken by the manager are on behalf of the owner at the owner's sole cost and expense.

B. Operating budget.

The agreement should outline how an operating budget will be established. Oftentimes, the manager is called upon to draft an initial budget within a set period of time after signing the agreement. Thereafter, the manager typically is responsible for proposing a budget on an annual basis. The agreement should set forth the procedure by which a "proposed budget" becomes an "approved budget". The proposed budget should be subject to the owner's review and approval within an established amount of time (i.e. thirty days). If the

[1] TEX. OCC. CODE ANN. § 1101.001, *et. seq.*

owner approves the budget or does not respond, the proposed budget becomes the approved budget. If the owner objects to the proposed budget, the owner should be required to suggest revisions so that the proposed budget can be revised accordingly and then be approved.

C. Leasing.

The extent to which a manager will have leasing responsibilities may depend upon the type of property that is subject to the agreement and the particular qualifications of the manager.

The TRELA provides that unless a person holds a license issued under the TRELA, the person may not act as or represent that the person is a broker or salesperson. *See* TEX. OCC. CODE ANN. § 1101.351. A "broker" includes a person who, in exchange for commission, or other valuable consideration or with the expectation of receiving a commission or other valuable consideration, performs for another person certain acts including the following acts: (i) leases real estate; (ii) offers to lease real estate; (iii) negotiates or attempts to negotiate the lease of real estate; (iv) lists or offers or attempts or agrees to list real estate for lease; (v) aids or offers or attempts to aid in locating or obtaining real estate for lease; (vi) procures or assists in procuring a prospect to effect the lease of real estate; or (vii) procures or assists in procuring property to effect the lease of real estate. *See* TEX. OCC. CODE ANN. § 1101.002 (1)(A). There are several exemptions to the TRELA. Most notably, with respect to leasing issues, the TRELA does not apply to an on-site manager of an apartment complex. TEX. OCC. CODE ANN. § 1101.002(6).

To the extent that an apartment manager is exempt from the TRELA, the manager can perform leasing functions in a management agreement. However, to the extent that the manager is not exempt (such as a manager of commercial properties), the manager should be properly licensed in order to lease. Under certain circumstances, there may be separate agreements for management and leasing.

D. Security Deposit.

The manager should be authorized to establish security deposits in accordance with the approved budget and collect and refund security deposits in accordance with the terms of each tenant's lease. The owner's lender may have particular requirements with respect to escrowing security deposits which the manager should meet.

E. Collection of rents and enforcement of leases.

The manager should be held to some standard ("reasonable efforts" or "best efforts") to collect rents and enforce leases. Monies collected should be deposited into the appropriate operating account depending on how on-hands the owner wants to be, the agreement should discuss the extent to which the manager is responsible for pursuing legal actions against defaulting tenants. Oftentimes, initiating and prosecuting eviction actions would be the responsibility of the manager. The pursuit of non-eviction matters or defending suits may require the authorization and approval from the owner.

F. Approved operating expenditures.

The approved budget should outline the approved expenditures. Generally, the manager should be given responsibility to incur expenses in connection with or arising from the ownership, operation, management, repair, replacement, maintenance or use or occupancy of the property including:

1) License and permit fees;
2) Management fees and other approved expenses of the manager;
3) Advertising and marketing expenses;
4) Legal, accounting and other professional fees;
5) Payments to vendors or suppliers;
6) Insurance premiums;
7) Property improvements or replacements;
8) Maintenance and repair items;
9) Security deposit refunds;
10) Real estate taxes; and
11) Certain payroll costs.

The approved budget should constitute authorization for the manager to expend funds as long as the expenses are incurred in connection with the operation or management of the property. In the event that the manager is required to exceed expenses outlined in the approved budget, the manager should be given some limited authority, which can be identified by a dollar amount. If the manager requires the expenditure of funds, in emergency cases, in excess of the manager's authority, the manager should be responsible for notifying the owner after the expenditure occurs.

G. Vendor contracts.

The manager may have responsibility to negotiate and execute, as the agent for the disclosed principal, vendor contracts necessary for the operation of the property. If the owner has particular requirements for vendor contracts, the agreement should state what those requirements are. For example, owners might allow manager's to sign vendor contracts as long as the contract can be terminated by giving no more than 30 days notice. Long terms contracts or contracts that encumber the property might need special authorization and approval from the owner.

Note: Vendor contracts should require that the vendor perform certain criminal history checks on any

employees or officers that will enter an occupied apartment unit. Section 145.004 of the Texas Civil Practice and Remedies Code provides that a person who contracts with a residential delivery company to deliver an item or who contracts with an in-home service company to place, assemble, repair, or install an item referred to in Section 145.001(1), is rebuttably presumed to have not acted negligently in doing so if: (1) the residential delivery company or in-home service company is in compliance with Section 145.003(b); or (2) the person who contracts with the residential delivery company or in-home service company requests that the company obtain a criminal history background check described by Section 145.002 on any employee of the company being sent to deliver, place, assemble, repair, or install an item and the person's request is in writing and is delivered to the company prior to the company's employee being sent. A copy of any such request is required to be maintained for at least two years. TEX. CIV. & PRAC. REM. CODE ANN. §145.001, *et. seq.*

H. Manager's Employees.

The agreement should set forth whether employees of the property are the manager's employees or the owner's employees. From the owner's standpoint, the employees of the property should be the manager's employees and the manager should have the responsibility for interviewing, hiring, supervising, discharging and paying all property personnel. The manager would then be responsible for compliance with all labor laws involving the manager's employees. The approved budget should specify employee expenses. To the extent that an employee of the manager does not exclusively work at the owner's property, the salary might be deemed to be part of the manager's overhead or might be prorated to the property.

I. Debt service and tax payments.

The agreement should specify the degree to which the manager is responsible for paying debt service and taxes on the property. This requirement should contain a caveat that the manager's responsibilities are only to the extent that funds are available.

J. Disclaimer of certain liabilities.

From the manager's standpoint, it may be beneficial to clearly state that the manager assumes no liability for any acts or omissions of the owner, or any previous owners or managers of the property. Additionally, a manager may want to disclaim liability for violations of environmental or other building regulations other than to properly notify the owner of violations or hazards that are discovered.

In apartment management agreements, it may be beneficial for the manager to state that it assumes no liability for compliance with the state security devices law. TEX. PROP. CODE ANN. §§ 92.151 to 92.170.

K. Property reports.

The manager should be obligated to provide certain regular reports relating to the operation of the property. The content of the reports is negotiable and should contain whatever information the parties agree the owner should review on a regular basis. These reports might contain information regarding rental rates, leasing activity, concessions, expenses and noteworthy incidents at the property.

VI. FINANCIAL RECORDS

A. Financial record keeping.

The manager should be responsible for maintaining, in a manner customary and consistent with generally accepted accounting principals, accounting records based on the owner's fiscal year. Any details with respect to the standards the manager will be held to should be outlined.

B. Financial reports.

The manager should make regular reports to the owner with respect to such items as collections, disbursements and other accounting matters. To support the regular financial reports, the manager should make available for inspection any statements, ledgers, etc. that support the numbers contained in the financial reports.

C. Owner's right to audit.

The owner should be given the right to audit the books and records maintained by the manager pertaining to the property. The owner should have an unlimited right to audit; however, the agreement may specify that the owner must give a certain reasonable notice to the manager so that the manager can be sure that the books and records are organized in a fashion that would make the owner's audit easier. The agreement should state who pays for the audit. Typically, the owner should be the one paying for the audit; however, there may be exceptions if the manager has made mistakes revealed by the audit.

D. Disbursement of deposits.

The agreement should specify when and to what extent, the manager is to disburse funds to the owner. Disbursements will have to be in accordance with any other funding requirements for the property. If the manager is responsible for paying such things as debt service, insurance premiums, etc. those funds should be paid before disbursements to the owner.

VII. OWNER'S DUTIES AND RESPONSIBILITIES

A. Initial deposit and contingency reserves.

Depending upon the circumstances of the property, from the manager's standpoint, there should be sufficient funds in the operating account to pay the expenses of the property from the outset of the agreement. If there is no money in the operating account upon takeover, the manager may require the owner to deposit an initial amount so that operating expenses can be paid. With each future budget, there should always be a minimum level of funds required to be kept in the account. if the operating expenses drain the account below the minimum level, the owner should be required to deposit funds into the account.

B. Insufficient operating funds.

If a cash flow deficit occurs, what happens? The owner should be responsible for depositing sufficient funds into the account. From the manager's standpoint, the agreement should state that, under no circumstances, should the manager be responsible for funding operating deficits or advancing funds to the owner.

C. Compensation.

1. Management fee.

The agreement should clearly set forth the manager's compensation. Typically, a management fee is based upon a certain percentage of fees generated from the operation of the property. If the fee is based on a percentage, the agreement should clarify how the percentage is calculated. For example, in a residential agreement, the percentage might be based upon all rents and other cash income and charges from the operation of the property including rental income from units, insurance payments for loss of rental income, laundry, cable, telephone and other service provider income, parking and storage income, interest income and forfeited security and other deposits. The calculation may exclude security deposits and other deposits which have not been forfeited, insurance proceeds other than rental loss insurance proceeds, condemnation awards, sale or refinancing proceeds, reimbursement of any overpaid expenses and utility charges. If the property is new construction, the manager may want to negotiate a minimum base fee which would be paid if the percentage fee was calculated to be less than the minimum base. This will assure that the manager gets paid even when the income generated from the property would generate a relatively insignificant percentage management fee.

2. Other compensation.

Depending upon the circumstances of the property and the manager's qualifications, other fees can be worked into the agreement such as leasing fees (for commercial properties), fees for supervising capital improvements, fees for assisting with due diligence when the property is sold or refinanced, and brokerage fees for the sale of the property.

D. Manager's costs to be reimbursed.

The agreement should specify any of the manager's costs that will be reimbursed, which would be in addition to whatever fee the manager receives. Reimbursable costs would be such things as: (i) direct payroll costs of employees assigned to the property, including regular, overtime and holiday pay, incentive bonuses, leasing commissions and associated leave time; (ii) payroll taxes and related personnel costs of employees assigned to the property such as insurance costs, social security and unemployment taxes; (iii) on-site personnel administrative costs such as personnel file maintenance, preparation of quarterly and annual IRS reports, payroll service data processing costs, and any other costs of dealing with employment personnel; and (iii) direct costs of the manager such as photocopying and mailing costs and long distance phone charges.

E. Representations.

The owner should be willing to make certain minimal representations and warranties. The owner should represent that it has full power and authority to enter into the agreement and certain issues relating to the condition of the property. The manager would want to know whether there are easements, restrictions or reservations which would adversely affect the use of the property for the purposes intended, whether the property is zoned for the intended use, whether all the certificates of occupancy have been properly issued and whether the construction on the property has been in accordance with applicable laws. Also, if the owner has a specified authorized representative that will be acting for the owner with respect to the asset management of the property, it may be beneficial to have that authorized agent named either in the agreement or by separate letter signed by the owner.

VIII. INSURANCE AND INDEMNIFICATION

A. Insurance.

1. Owner's insurance.

The owner should be required to obtain and keep in force at all times adequate insurance against physical damage and against liability for loss, damage or injury to property or persons which might arise out of the occupancy, management, operation or maintenance of the property. The owner's insurance should include a commercial general liability policy with coverage for bodily injury and property damage of a sufficient amount.

2. Manager's insurance.

Although the manager may be required to obtain a certain level of insurance, in most cases, the liability insurance of the owner should be primary over any liability insurance obtained by the manager for anything related to the occupancy, management, operation or maintenance of the property. The manager should be named as an additional insured on the owner's policies and the owner's policies should provide for the cost of defense of any claims. The manager will be responsible for maintaining, at the owner's expense, workers compensation insurance covering the employees that provide services to the property. The manager may also be required to obtain, at the manager's expense, a fidelity bond covering all employees of the manager who handle or are responsible for the safekeeping the monies of the owner. This would be designed to cover the owner in the event of employee theft.

3. Insurance by others.

The owner may require that the manager only retain subcontractors or vendors that have a certain minimum level of insurance coverage. The insurance policies of subcontractors and vendors should identify both the owner and the manager as additional insureds.

4. Waiver of subrogation.

To the extent that the parties desire, each party can waive any right that either party may have against the other on account of any loss or damage arising in any manner, that is covered by insurance. The insurance carrier should be consulted with respect to how a waiver of subrogation clause affects coverage.

B. Indemnification.

1. Owner's indemnification.

The owner should indemnify, defend and hold harmless the manager and the manager's agents and employees from and against all claims, liabilities, losses, damages and expenses arising out of: (i) the manager's performance under the agreement; and (ii) facts, occurrences or matters first arising prior to the date of the agreement. An exception to the owner's indemnification might be if damages or expenses are the result of the manager's negligence, willful misconduct or fraud. From the manager's standpoint, the manager would prefer to make an exception only for "finally adjudicated" negligence, willful misconduct or fraud.

2. Manager's indemnification.

The manager might indemnify, defend and hold harmless the owner for claims arising out of the manager's "finally adjudicated" negligence, willful misconduct or fraud or cases where the manager has been finally adjudicated to be in breach of the agreement.

Note: The Texas Supreme Court has stated that because indemnifying a party for its own negligence is an extraordinary shifting of the risk, a fair notice requirement will be applied to indemnity arguments. This requirement, also called the "express negligence rule", requires:

(a) A party seeking indemnity from consequences of its own negligence must express that intent in specific terms within the four corners of the contract. *See Dresser Indus., Inc. v. Page Petroleum*, 853 S.W.2d 505, 508-09 (Tex. 1993); *Ethyl Corp. v. Daniel Constr. Co*., 725 S.W.2d 705, 708 (Tex. 1987); and

(b) The indemnity clause must be "conspicuous" under the objective standard defined in the Uniform Commercial Code. *See* TEX. BUS. & COM. CODE ANN. § 1.201(1) *Littlefield v. Schaefer*, 955 S.W.2d 272, 273 (Tex. 1997).

The indemnity clause must meet both prongs of the express negligence rule to be enforceable. *Griffin Indus., Inc. v. Food maker, Inc.*, 22 S.W.3d 33, 37 (Tex. App.? Houston [14th Dist.] 2000, pet. denied). Unless the indemnification clearly states that the indemnitee is being indemnified from the indemnitee's own negligence, the indemnification of the indemnitee's own negligence will not be enforceable under current Texas case law. For example, if the owner indemnifies the manager from any acts or omissions, the indemnification will not be interpreted by the Texas Courts as an indemnification against the manager's own negligence. If the manager is deemed to be negligent, the indemnification will not be enforceable with respect to the claim arising out of the manger's negligence.

IX. TERMINATION

A. Right to terminate

The agreement should clearly specify when and under what circumstances the agreement can be terminated. Typically, an agreement can be terminated under the following circumstances:

1) By giving appropriate written notice after the expiration of the term of the agreement or as otherwise provided in the term paragraph of the agreement.

2) Automatically in the event the owner sells or otherwise disposes of the property.

3) By either party in the event that the other party is in default. With this type of notice, the parties may negotiate a written notice and

opportunity to cure before a notice of termination can be given after a default.

B. Actions upon termination.

The agreement should specify who is responsible for receiving income and paying expenses after a notice of termination is given. The agreement should also state that the manager is to provide a final accounting and return all records, reports and contracts pertaining to the property upon termination.

X. MISCELLANEOUS

A. Personal liability.

The owner's liability could be limited to the greater of the owner's interest in the property or the extent of insurance coverage, if applicable. The manager's liability can be limited to the greater of the management fee or the extent of insurance coverage, if applicable.

B. Notices.

Each party should identify appropriate notice addresses and addresses to which any copies of notices should be sent. The parties should decide how notices should be delivered (i.e. hand delivery, facsimile, electronic mail, overnight mail or certified mail).

C. Assignments.

The agreement should probably not be assignable by the manager without the prior written consent of the owner. However, the owner may be able to assign the agreement to any successor in title to the property.

D. Applicable law.

The agreement should specify the applicable law. Also, to the extent desired, the agreement can state that the agreement is performable in a certain county.

XI. CONCLUSION

The contents of a property management agreement are negotiable; however, these are the types of issues that should be considered. Hopefully, this article will provide some food for though when drafting property management agreements.