HOTEL MANAGEMENT AGREEMENTS
Industry Trends and Today's Issues

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I. SCOPE OF THE ARTICLE

This article presents a general overview of management agreements in the hotel industry with specific focus on the background of management agreements, as we know them today; the issues that should be addressed in such agreements; and recent developments which impact the negotiation, drafting, implementation and enforcement of such agreements. Throughout this article, the terms "management agreements", "operating agreements", and "management contracts" may be used interchangeably. Although there are more similarities than differences, this article does not attempt to address the issues arising out of management agreements for restaurants, recreational resorts, cruise ships or other types of hospitality properties. Neither will the article attempt to address the concept of a master lease, even though it can be a vehicle through which the owner and operator structure their relationship. Finally, this article will not address franchise agreements in any detail.

II. HISTORICAL BACKGROUND

Today we have become accustomed to the tri-furcation of the hotel industry, but that has not always been the case. The separation of ownership, operations and franchises is a relatively new phenomenon, which has occurred, for the most part, during the lifetimes of the participants in this conference.

A. Parties.

1. Owners.

Prior to the Second World War, most hotels in the United States were owned by individuals or families and operated by family members or a general manager who was hired to oversee operations. Conrad Hilton was one such owner who owned his first hotel in Cisco, Texas, in the oil boom of the thirties. The first hotel he built still stands in Dallas and is currently operated as the "Aristocrat". Mr. Hilton was one of the first hoteliers to envision a "chain" of hotels, which would be owned and operated by the same person or group.

During the Great Depression, many hotels and their owners became insolvent and closed. The hospitality industry, such as it was, was on the verge of extinction when World War II created a high volume traveling public who needed to be housed overnight and fed enroute. Because the war consumed most construction materials, few new hotels were built during this time. Many hotels were, however, reopened in buildings that were previously hotels, office buildings and warehouses.

The 1950s brought a whole new concept of prosperity and mobility to the United States. The explosive growth of the suburbs created the need for every family to own an automobile. Those automobiles became the driving force of the leisure traveler who filled the tourist courts, roadside inns and hotels of the country. Tourist courts became "motor hotels" which, in keeping with America's love affair with nicknames and slang, became "motels."

While Mr. Hilton was expanding his holdings and operations, Keenon Wilson, a Memphis salesman, figured out that the newly mobile citizenry of the U.S. would flock to clean, modern, convenient motels. Out of that concept, Holiday Inn was born in the early fifties. Within a decade, Holiday Inns and their imitators replaced most of the pre-war tourist courts.

During the 1960s, hotel chains discovered that they could expand much more quickly through two vehicles which, although not new, had not been used significantly in the hotel industry: public ownership and franchising. Another driving force for change in the sixties was the entry of life insurance companies as owners of hospitality properties. Since the life insurance companies were not set up to operate assets, they

initially teamed up with Hilton and other franchisors to run the hotels. In the late sixties and early seventies, the owner/operators realized that they could free up a large amount of cash by selling their properties to the life insurance companies and leasing them back. These factors, combined, accelerated the move to segment the functions in the industry into owners, operators and brands. This phenomenon pushed the hotel management contract into a much more sophisticated document than it had been previously.

Today hotel owners are typically publicly held in the form of REITs, limited partnerships and corporations. There are still family-owned hotel chains, such as Hyatt and a large number of properties with owner/operators. Most of the latter are older, limited service facilities that operate as independents or as one of the many lower cost franchises now available.

2. Operators.

Historically, the manager, if he was not a family member, was generally an at-will employee who was hired, supervised and fired without the formality of a written agreement. Hotel workers were employed by the hotel, which was often merely a trade name for the owner. With the changes in ownership came radical changes in the way hotels were operated. Currently few hotels, relatively speaking, are owned and operated by the flag owner. The number of properties, however, operated by affiliates and strategic partners of the owners are increasing.

Operators today are typically companies that operate hotels as their core business, if not their only business. Because these operators are third parties, not affiliated with owners, the management agreement has become the defining instrument in governing the relationship between owners and operators.

3. Franchisees.

Historically, hotel branding, positioning, marketing, appearance and level of service provided by a particular hotel were decided by the owner with little or no input from third party operators, industry consultants or reservation providers. Success of a property was, more often than not, dictated by location. Only when competing hotels were in the same location, did issues such as amenities, price, facilities, operational quality, and referral arrangements become predictors of success. As the industry became more competitive, the ability to provide consistency to travelers across numerous locations became paramount. Since no one owner had the ability to do this, branding through franchises became the vehicle of choice for meeting expectations of hotel guests on a consistent basis with a single product. Once chains were created, centralized reservations systems, operating systems and national advertising became the infrastructure of the franchise against which an independent hotel could rarely compete.

A franchise, as understood today, is a relationship whereby the franchisee offers the franchisor's products and/or services to consumers using the branding, intellectual property, operational systems and marketing plan of the franchisor in return for a fee. Theoretically, this creates a community of interest in the success of the franchised business. Much like other industries, hospitality franchises have become channels of distribution. Instead of automobiles, hamburgers, or other products, hospitality franchises offer a complete system through which hotel guests are directed to the properties operating under their flag. To implement this system, their franchisees are required to maintain facilities, levels of services and amenities consistent with the reputation and positioning of the flag and the other franchisees. In return for their fee and franchisee compliance, the franchisors provide their well-developed reservation systems, national advertising and affinity programs to gain and maintain market share.

The relationship between the owner and the franchisor is governed by a franchise agreement or license agreement, which is sometimes combined with a management or operating agreement where the brand owner also operates the property. The issues arising out of franchise or license agreements are, however, beyond the scope of this paper and are mentioned here only for context.

4. Branded Managers.

The evolution of the industry has continued with the revival of the concept of the branded manager. A branded manager is an entity that blends the functions of the operator and the flag. In a branded management agreement, there is not a franchise because the owner is not using the marks, systems, names and other assets of the hotel operating company. The company is using its own systems and intellectual property to operate the hotel for the owner. The typical branded management agreement, in fact, prohibits the owner from ever using the names and marks of the operator, except as specifically set forth in the agreement. Interestingly, the majority of recent litigation between owners and operators involve branded management agreements.

B. Issues.

The management agreements of the twenty-first century have become fine-tuned to the point that the issues are well developed and even the formats seem more and more similar. The sophistication of owners and operators has risen to the point that most contracts are heavily negotiated documents, covering a multitude of issues. As disputes have arisen between the parties to these contracts, certain issues have become more important and new issues continually need to be addressed from both sides. Management agreements have also become a significant due diligence item when purchasing a hotel property. In this section, some of the more important issues in hotel management agreements will be summarized.

1. Revenue Sharing.

The basic economic issue in a hotel management agreement is the compensation to be paid to the operator, which is typically a revenue sharing arrangement.

a. Base Management Fees.

Virtually every management agreement in place today starts with a base management fee (usually so-called) equal to some percentage of gross revenue. The Base Fee is usually in the one to four percent range. Fees in the top end of the range are generally paid to operators that have some form of equity invested in the property in some fashion. One major independent manager currently has a large number of properties under contract with an average base management fee equal to 2.2% of Gross Revenues from their managed properties. Branded managers, on the other hand typically receive gross management fees of 3% of gross revenue.

b. Incentive Management Fees.

Most hotel management agreements provide for the operator to earn an incentive fee (usually so-called). Often this is a percentage of Net Operating Income, but may also be expressed as a percentage of Gross Operating Profit, Adjusted House Profit or other line items from the operating budget of the hotel or totally separate formulas.

Incentive Fees often have carve-outs to provide that ownership costs, such as debt service, real estate taxes, ground lease payments, etc., are covered before incentive fees are calculated. Such carve-outs are often couched in terms of subordination to such expenses. Incentive Fees are often stated in terms of a percentage of NOI (or other standard) above a certain threshold, which may be a formula or a fixed amount or percentage.

c. Data Processing Fees.

In the 1970s the industry saw a seismic shift in hotel accounting. At the beginning of that decade every hotel had a comptroller supervising a staff of folks in green eyeshades and arm garters, using pencils, paper, ten-key calculators, manual register tapes, restaurant checks, front desk folios, and index cards to

account for the operations at the hotel. By the end of the decade, virtually all operations were on a computer, either in the hotel, at a service bureau or in the central office of the chain or its management company.

One of the benefits that management companies bring to a hotel owner is the ability to account for the operations of the hotel. Like many other service providers, they have discovered they can lay off a part of their overhead by passing through costs to their clients. One major cost the market has allowed operators to pass through is their management information systems.

Data Processing Fees are usually a monthly fixed dollar amount or treated as other shared services and priced on a per room basis.

d. Fee Caps, Guarantees, Subordination, Deferral and Disgorgement.

Owners have responded to diminished returns on their investments by seeking to cut their management costs in various ways. One resulting trend is the appearance of caps on total fees. This, of course, limits the owner's overall cost of management. Another trend is for fees to be dependent on achieving some standard on a <u>cumulative</u> basis. Cumulative calculations can require forfeiture or deferral of current fees, as well as disgorgement of fees previously earned. This does not change the amount of fees paid over the long term, but can certainly change the amounts paid in a given period of time.

2. Expense Treatment.

A critical issue in a management agreement is the treatment of expenses. Which items are treated as expenses are generally non-controversial when incurred only for the hotel. Issues often arise where there are operating costs that are shared with other hotels. These are typically shared on the basis of gross revenue, number of rooms or number of properties basis.

Expenses are a major economic issue for both parties involved. Expenses reduce NOI, which is used in the calculation of incentive fees earned by the Operator in most contracts. Additionally, the profit passed on to the owner is, obviously, reduced by every penny spent in operations.

Another expense issue arises when vendors of goods or services are affiliated with the operator. This is discussed in more detail below.

3. Risk Allocation and Management.

The third major issue addressed in a hotel management agreement is the allocation and management of risk.

a. Financial Risk.

The financial risk is typically assumed by the owner who has the obligation to pay the taxes and debt service, cover operating shortfalls and to keep funds in the operating account.

b. Operational Risk.

The allocation of certain operating liabilities has been heavily negotiated with increasing intensity over the last few decades. Both the owner and the operator want to identify and quantify the risks they undertake and to eliminate or limit all that they can. To the extent that certain risks are predictable, quantifiable and insurable, the management agreement will simply list which risks are to be insured by each party. To the extent that they are not insurable, the agreement will allocate the responsibility for such risk. To the extent that applicable law will not allow a party to avoid liability for certain risks, the parties often use indemnities to provide protection from these risks.

c. Indemnification.

As risk management increased as a concern, hotel operators began seeking and receiving indemnification for operating liability from the owners. The theory was that of agency. If the operator is managing the hotel for the owner's account, the owner should accept the costs of doing business. During the seventies and eighties, full indemnity for the operator (except for fraud and gross negligence) was the standard. Since then, owners have increasingly negotiated additional carve-outs for their indemnification.

C. Relationships.

Historically, not much consideration was given to the legal relationship between the owner and the operator of a hotel. As mentioned earlier, most hotel managers, who were not the owner or a member of his family, were simply at-will employees. Even as the relationships became more formal and structured there remained ambiguity as to the legal nature of the relationship. When owners became insolvent, from time to time, operators would often be left with exposure for trade debt and other liabilities. Operators defended these actions by claiming that they were merely agents of the owner, with no direct liability for goods and services ordered for the hotel or its operations. As they entered into new agreements, operators insisted on language making them agents of the owner to limit their liability.

Operators soon learned that there were two sides to this coin since one of the characteristics of an agency is the agent's duty of fidelity to the principal. This made for some interesting disputes where the operator found that this higher duty meant it could not treat the owner as a true third party with whom it could deal aggressively.

The agency relationship became a much more prominent issue in the 1990s with a series of cases in which hotel owners took the position that they possessed the power to terminate their agent at any time, regardless of the stated term of the management agreement. This issue will be more fully discussed below in the Current Legal Issues section of this article.

D. Terms.

As professional management companies replaced owners and their at-will managers, the term or duration of management contracts became an important item. Operators always want the longest term possible. Owners, understandably, want the ability to terminate the relationship when it is to their advantage to do so. The compromise that became fairly uniform was a long-term contract (10 years or more), which could not be terminated by the owner except for cause. As that became the industry standard, most of the negotiation on this point was over what constituted "cause" for termination. In addition to the obvious "lyin', cheatin' and stealin'" performance thresholds, exclusive territories and buy-outs came to be used regularly to give the owner an "out", if things did not go well. As will be discussed in more detail below, however, the agency cases decided in the last fifteen years gave the owner the power to terminate the contract prior to the expiration of the term of the agreement.

E. Accounting Systems and Terminology.

The terms of art, or defined terms, relating to accounting in hotel management agreements are usually derived from the *Uniform System of Accounts for Hotels*, which is prepared by the International Association of Hospitality Accountants and adopted by the Hotel Association of New York City and the American Hotel & Motel Association. It is the industry standard, currently in its ninth edition. It is a very helpful reference for anyone involved in the negotiation and documentation of hotel management agreements, particularly for those who have not spent their careers on the financial side of the business.

III. CHANGING ENVIRONMENT

While the historical discussion above helps provide some context, the environment has radically changed in many ways. An illustrative list, although not exhaustive, would include the elements discussed in this section.

A. Public Ownership.

Public ownership of hotels has resulted in many of the same changes experienced in other industries that have gone from mom-and-pop businesses to being publicly held. These changes include:

1. Cash.

Public companies raise, earn and maintain large amounts of money to buy, build, staff, own and operate hotels. This provides them with significant resources and options not available to independent owners or small closely-held chains.

2. Perspective.

Public companies do not have the luxury of long-range vision. Wall Street is always interested in this month, this quarter and this year. As a result, many decisions are short-term, which creates problems with long-term relationships.

3. Sophistication.

The resources of the public company are such that they can acquire professional hospitality executives, sophisticated advisors and state-of-the-art management information systems.

Because of the increased specialization, money available, investor demands and competitive pressures, the people who run hospitality companies, and those who advise them, have increased exponentially their levels of preparation and performance. There are now schools that prepare students specifically for the hospitality industry. With or without specialized college training, successful leaders in the industry tend to spend a lot of time learning the business through on-the-job training. Perhaps the largest distinctions of the modern hotelier are financial expertise, which was rarely seen in earlier times, and the availability of data, which is unparalleled in history.

Hotel advisors have also grown with the industry. Law, accounting, architectural, consulting, appraisal and insurance firms now have hospitality departments committed exclusively to advising hotel owners, operators, investors, lenders, asset managers, franchisors and other interested parties. Additionally, the large hospitality companies have their own cadre of in-house lawyers, tax, financial and accounting specialists, risk managers and experts in every segment of the industry.

B. Consolidation.

The hotel industry has seen extensive consolidation in the last few years as a result of public ownership, the global economy, competitive pressures and other factors. There are now more hotels than ever, but not a proportionate increase in the number of hotel owners. With consolidation came economies of scale, diversity of properties whether owned or managed, and increased sophistication of the companies. The results of consolidation mirror, to a large degree, the results of public ownership. In reality, they both support the other although more on parallel tracks than true cause and effect. In the final analysis, both are driven more by economics than each other.

C. Tax Law Changes.

Changes in tax laws have significantly altered the economics of buying and selling hotels during the last twenty years. Operations have also changed, but not to the extent that tax law changes have impacted

ownership issues. Tax treatment of REITs, leases, the elimination of Investment Tax Credit, the changes in capital gains treatment of assets sold and the changes effected by the Tax Reform Act of 1986 completely altered the landscape for owners of hotels.

D. Litigious Society.

Hotels are not immune from the "suit happy" world in which we live. Everyone with whom hotels now deal is a potential plaintiff. This includes their employees, operators, owners, franchisors, guests, contractors, suppliers, competitors and other third parties. These risks have become a substantial part of what hospitality companies must now manage in order to survive, much less succeed.

E. Terrorism.

If hotel owners, operators, franchisors and others were not aware of the threat that terrorism presented before September 11, 2001, they are certainly focused on it now. Not only are some signature hotels terrorist targets, but hotel properties at every level have been adversely impacted by the upheaval in the travel industry precipitated by the attack on the World Trade Center and the Pentagon. Several of the largest air carriers are now in bankruptcy and some of the others are losing significant amounts of money. The inability of the airlines to fill their seats with passengers translates very quickly into empty hotel rooms, reduced sales of food and beverage and red ink. Additionally, the PATRIOT Act and other governmental mandates have increased the cost of regulatory compliance, with no corresponding increase in revenue to offset the expense.

F. Environmental Considerations.

Hopefully, we are past the initial problems the industry encountered when numerous environmental laws became effective in the seventies and eighties. Since many properties have come on line since then, the percentage of problem properties has been greatly reduced. Additionally, many of the earlier problems have been remediated or abated. The fear remains, however, and continues to impact hotel transactions and the dollars involved.

G. Employment Law.

Since the mid-sixties, numerous laws have been enacted governing the relationship between businesses and their employees by both the federal government and various states. Not only has this created significant management challenges at the hotel level, but also companies which operate in numerous states have to comply with different requirements in each and train their corporate and individual property managers on the intricacies involved.

H. Regulatory Compliance.

Although not a regulated industry as such, government regulation has come to consume significant resources from hotels and those involved with them. The alphabet soup of ADA, ADEA, DOD, DOL, DOT, EEOC, EPA, ERISA, FTC, IRS, OSHA, SEC, and other state, local and federal agencies and legislation have created additional challenges for hoteliers, nationwide.

I. Niche Marketing.

The development of niche marketing is closely related, but not identical, the consolidation in the industry. With the advanced ability to determine consumer preferences, demographic distinctions and price sensitivity, hotel chains have created new brands which are positioned for a niche market that may have existed for some time but had not been identified until recently. In the not too distant past, hotels could generally be classified as luxury hotels, convention hotels, full service hotels/motels or limited service products. Now, each of those categories is divided into several sub-markets, the distinctives of which are rarely readily apparent to the casual observer.

IV. CURRENT LEGAL ISSUES

A. Agency.

As mentioned earlier, management agreements historically dealt ambiguously and inconsistently with the relationship between owners and operators, if at all. By the 1980s most management agreements recited that the operator was the agent of the owner, but few in the industry recognized the significance of this appointment. Beginning in the early nineties, cases were decided that revolutionized the relationship of owners and operators by fleshing out what it meant to be an agent of the owner. The law of agency has not significantly changed for centuries, but the application of that body of law to the hospitality industry created a whole new world of management contracts. The elements of agency that have served as the basis for many disputes arising in the last few years are summarized as follows:

1. Fiduciary Duties.

An agent is a fiduciary to the principal as a matter of law. A fiduciary is one who acts primarily for the benefit of another. A fiduciary owes the duty of utmost loyalty to its principal, which includes both negative and positive components. An agent is, for example, prohibited from self-dealing in transactions with the principal, making undisclosed profits in transactions with the principal, appropriating the property of the principal for the benefit of the agent and competing with the principal. Affirmative obligations of the agent to the principal include good faith, fair dealing and full disclosure. These duties are in addition to the duty of care based on contractual standards contained in any contract between the two. There are several cases, in various stages of development winding their way through the courts, which are substantially based on the operators' breach of various fiduciary duties owed to the owners/plaintiffs.

a. *2660 Woodley Road Joint Venture v. ITT Sheraton Corp.*, *369F2d*, *732, U.S. Court of Appeals, Third Circuit (2004)*

In a memorandum opinion filed in January of 2002, the court ruled on post-trial motions filed by Sheraton after it suffered a significant loss at the hands of a jury. Sheraton was seeking to set aside the verdict or, at least, mitigate the substantial damages awarded in the case. The jury had returned a verdict of over 11 million dollars in actual damages and $37,500,000 in punitive damages, resulting from its decision that Sheraton breached its fiduciary duties to the owner. The court reduced the award of punitive damages to one and one-half times actual damages, but its analysis of the claims is more instructive for current purposes. Interestingly, the court includes the following acts under the global headings of "Failing to act as owner's agent" and "Putting their interest above that of their principal":

(1) Improper receipt of purchasing kickbacks;

(2) Failure to disclose the receipt of the kickbacks and the cost to the owner;

(3) Intentional and negligent misrepresentation in providing false and misleading information to the owner;

(4) Charging the owner higher prices for goods and services than were charged to Sheraton-owned hotels; and

(5) Violating antitrust laws (by virtue of being in the same business as the owner) to the detriment of the owner.

The Third Circuit in May of last year reversed in part and remanded in part. Competing Motions for rehearing en banc were denied on September 15, 2004. The case is now on remand to the D.C. trial court, but appeals are expected from the judgment entered by that court. The Third Circuit focused almost entirely on the antitrust standing of John Hancock. Most of the damages vacated by that court were based on their holding that John Hancock, the hotel owner, had no such standing. The antitrust allegations of the complaint were based on the commercial bribery prohibition of §2(c) of the Robinson-Patman Act. Interestingly, the Supreme Court has never decided a §2(c) commercial bribery case. Many observers are expecting they may get an opportunity to do so with this case.

The precedential value of the pure hotel agency issues in this case may be somewhat questionable (the extent to which you think so is probably driven by your perspective). While the case was on appeal, Sheraton asserted a malpractice claim against their litigation counsel for mishandling the trial. That dispute was settled on terms which have not been made public.

b. The Marriott/Avendra Purchasing Cases.

When Marriott spun off its airport concessions and its institutional cafeteria operations, it became concerned that the discounts it received from suppliers would decrease because of its reduced volume of purchasing. To remedy this, Marriott spun off its purchasing department to a new joint venture called Avendra. Avendra is owned by Hyatt (18%), Six Continents (15%), Club Corp (10%), and Fairmount (9%); Marriott owns the remaining 48% of the company.

Avendra appears to be patterned after Covisant, a similar venture formed to supply parts and components to various automobile manufacturers. Both rely heavily on internet transactions in the development of their business plans. While Covisant has encountered profitability problems, it has not faced irate franchisees who are contractually obligated to buy from the venture. Covisant deals only with the manufacturer, not directly with the franchisees. Automobile franchisees purchase only automobiles, parts and accessories from their franchisor. Hotel franchisees, on the other hand, may acquire a significant portion of their hardware, software, operating supplies, furniture, fixtures and equipment from, or through, their franchisors and operators, and more so from branded managers.

Several hotel owners have sued Avendra and Marriott alleging breaches of fiduciary duty, conspiracy to defraud and a laundry list of other activities, which the plaintiffs contend unjustly enrich Marriott and Avendra at the expense of the owners. Their list of grievances include:

(1) Marriott/Avendra's retention of rebates received from suppliers;
(2) Marriott/Avendra's failure to disclose the amounts they make from the purchasing transactions;

(3) Marriott's acquiescence in Avendra's upcharges because it receives almost half of the benefit; and

(4) Although not yet raised as a claim, observers are closely watching the software company that designed and maintains Avendra's internet site and MIS systems, some of which Avendra licenses to hotels operated by Marriott. Avendra owns 20% of that entity which expects to receive rebates from Avendra based on volume. If these rebates are not passed on to hotel owners, it is expected that the plaintiffs will amend their pleadings to include this perceived conflict as well.

Avendra's "close to the vest" operation and "trust me" disclosures mirror the Marriott corporate culture, but stand in contrast to the relative openness of some of their competitors. This may be why Marriott was named as a co-defendant with Avendra while the other owners of the new venture have not been. It has been suggested that the other owners either own most of their properties or do not utilize Avendra as aggressively and extensively as does Marriott.

In any event, neither Marriott, Avendra, its other owners nor their vendors have disclosed any of their arrangements publicly. One can only assume that the plaintiffs will get access to the information through the discovery process. What they do with it remains to be seen.

One such claim brought by the Flatley Co., the owner of the Boston Marriott Quincy Hotel, was settled in 2002. The terms of the settlement have not been disclosed publicly.

Another recent case of interest is ***In Town Hotels Limited Partnership v. Marriott International, Inc.***, 246 F.Supp. 469 (S.D. W. Va. Feb. 25, 2003). In that case, two affiliates of In Town brought suit against Marriott and Avendra alleging breach of contract, breach of fiduciary duty, negligence, and fraud arising out of Marriott's management of the plaintiffs' hotel known as the Charleston Town Center Marriott. Additionally, the hotel's owners alleged that Marriott violated Section 2(c) of the Robinson-Patman Act, 15 U.S.C. 13 (c), and an analogous West Virginia unfair trade practices statute. As described by the court:

For approximately twenty years, the plaintiffs have contracted with Marriott to manage the plaintiffs' Hotel. Under the terms of the contract, Marriott is granted unfettered authority to manage and control the Hotel. The contract purports to create an agency relationship between Marriott and In Town Hotels whereby Marriott has a fiduciary duty to operate the Hotel solely for the benefit of plaintiffs. The contract provides that Marriott's compensation for its services would consist solely of management fees as set forth in the agreement. For the purpose of their antitrust claim, the plaintiffs allege that Marriott, acting in conjunction with Avendra, entered into exclusive or preferred contracts with vendors to provide goods to the Hotel. In so doing, Marriott and Avendra solicited and received "sponsorship funds", which were payments and rebates by vendors made in the course of selling, or in exchange for the opportunity to sell, goods to the Hotel. Marriott and Avendra retained these payments and rebates for themselves and did not disclose them to the plaintiffs. As a consequence, the plaintiffs allege, the Hotel has been restricted in its choice of vendors, has paid a higher price for goods than it would otherwise have paid, and has suffered vis-a vis rival hotels (some of which are owned or managed by Marriott) that are not paying these higher prices.

Marriott moved to dismiss these Robinson-Patman Act and West Virginia statutory claims. The court denied the motion by noting that Section 2(c) sought to avoid "corruption of the agency relationship", which occurs when a supplier like Marriott secretly receives a commission on purchases of goods for a hotel it manages and the hotel incurs a higher cost as a result. The court also held that it was not necessary to allege an injury to competition to establish a claim under Section 2(c). In any event, plaintiff suffered here because it was denied the rebates and payments to which they were entitled and they lost business to their competitors, including other Marriott hotels. The Plaintiff was also damaged because of the higher costs they had to incur for needed supplies. Additionally, the court denied Avendra's dismissal motion that asserted that no breach of contract or breach of fiduciary duty occurred through these secret commissions. As the court stressed, the applicable management contract provided that Marriott's only compensation was to be derived through the management fee, which made no mention of kickbacks or rebates. The court thus refused to dismiss these "secret commission" claims.

This case was settled in 2003 on terms not publicly disclosed.

c. Employee Churning Claims.

When an operator owns its own portfolio of hotels and also manages other hotels for third party managers, conflicts of interest can arise from the assignment of management personnel. Some owners have complained that the operator uses the hotels it manages for others as training grounds for executive level managers. As a result, the owners claim, they never have experienced staff at their hotels. The higher performers continually get transferred to a hotel owned by the operator. Such a situation would be a clear

violation of the operator's fiduciary duty to pursue the owner's interest, even above its own. Not only are the owners not getting a return on their investment in new employees, the role is being reversed and they are providing staff for their operator's benefit. It is only a matter of time until this claim is raised in litigation.

d. Territorial Violations and Non-Competition.

Many management agreements provide for a territory in which the operator will not manage any other competing hotel. Even in the absence of a specific geographic area, an agent cannot compete with its principal. Whether hotels managed by the same operator for separate owners are treated differently is always fact intensive. When given an opportunity to manage a hotel in proximity to an existing operated hotel, the chain companies will always take the position that the two properties are not competitors. Three factors have complicated analysis of this issue:

(1) Consolidation.

If the operator of a hotel merges with another hotel company, which just happens to operate a competing property across the street, is the covenant violated?

(2) Positioning.

The second factor complicating the territorial restrictions is positioning. If Marriott is operating a Marriott hotel pursuant to an agreement with (or without) a territorial restriction, is the covenant duty violated if Marriott opens a Ritz-Carlton, J.W. Marriott or Marriott Suites in the territory?

The case can certainly be made that operating an owned hotel that competes with a hotel owned by a third party is a conflict of interest. This is true whether territorial restrictions appear in the contract or not. The issue becomes, is it truly a competitor.

(3) Market Saturation.

As a result of the positioning discussed above, the major chains are able to saturate a given market with lodging for the smallest budget transient traveler, the most discriminating consumer of hospitality facilities and services, and everyone in between. The inevitable question arises when the chain operator owns some, but not all, of the hotels in a given market. How close is too close, with regard to geography, services, facilities, rates, etc.?

This issue was raised in a case filed in state district court in New Orleans styled, ***WH Holdings, LLC, et al. v. The Ritz-Carlton Hotel Company, L.L.C. and Marriott International, Inc.*** In that case, Ritz, a Marriott subsidiary, operated the Ritz-Carlton Hotel and Spa in New Orleans, a suite hotel and a boutique hotel for a third party owner. Marriott operated both a Marriott and several down market hotels in the same area.

The Marriott and the Ritz are four blocks apart on a main commercial street, with several hotels in between them. One of the hotels between them has been operated as the Le Meridien which was neither owned nor operated by Marriott or the owner of the Ritz-Carlton Hotel.

Marriott gave notice to the owners of the New Orleans Ritz that CNL was in the process of acquiring the Le Meridien hotel and that Marriott would then operate it under a J.W. Marriott flag.

The hotel owner objected to its manager operating a competing hotel three blocks away. Marriott took the position that the J.W. Marriott would not compete with the Ritz.

After failing to persuade each other of their positions, the owner filed suit alleging numerous breaches of fiduciary duty and other causes of action against Marriott and Ritz, seeking damages and

injunctive relief. The court denied the TRO and set the case for a Preliminary Injunction hearing. The case was settled on terms not made publicly available. The JW and the Ritz continue to operate in the same locations, but the consideration for doing so is subject to a confidentiality agreement.

e. Use of Proprietary Information.

The use of operating, marketing and guest data is discussed more fully in the section on Intellectual Property below. A couple of recent cases on this issue are of interest.

(i) The New Orleans Ritz case, discussed above, also included allegations that Marriott and Ritz used the owner's confidential information in underwriting its decision to operate a new hotel close to the owners.

(ii) The Laguna Niguel Ritz case, discussed on page 28 of this paper, made similar allegations but was also settled short of a definitive analysis on the issue from the court.

2. Termination of an Agent.

An agency is terminable by either party at will. Even if a stated term exists in their contract, either party has the power to terminate an agency at any time. This power has to be distinguished from the right to terminate the agency. Exercising the power to terminate may give rise to damages, unless the contract also gives the terminating party the right to terminate the contract.

An exception to the rule that a principal retains the power to terminate an agency is when the agency is "coupled with an interest," which is discussed further below.

The elements of agency, in the context of hotel management agreements, have been the basis of significant litigation during the last fifteen years. The reported cases involving these issues are:

a. *Olympia Hotels Corp. v. Johnson Wax Development Corp.,* 908 F. 2d 1363 (7th Cir. 1990).

Olympia, the manager of a hotel in Racine, Wisconsin, sued the owner for breach of contract. The owner counterclaimed against Olympia raising numerous issues, including the managing agent's breach of its fiduciary duty to the owner. The appellate decision, written by Judge Roger Posner, focused almost entirely on federal procedural issues. His discussion of the agency claim consumes only one paragraph and appears to almost be an afterthought. Judge Posner stated, "We decline the invitation to recast hotel contract managers as trustees or guardians of the hotel owners . . . other than in the performance of financial functions in which the manager is exercising a traditional fiduciary role such as the management of bank accounts." This decision did not cause a ripple in the industry, because it followed what had been traditional thinking among both owners and operators.

b. *Woolley v. Embassy Suites, Inc.*, 227 Cal. App. 3d 1520, 278 Cal.Rptr. 719 (Cal.Ct.App. 1991).

This case was brought by Robert Woolley, who was the managing partner of 22 partnerships, owning 22 hotels in various locations. Five of the hotels were franchised by Embassy Suites, and the remaining 17 were operated by Embassy, pursuant to branded management agreements. The contracts allowed the owner to terminate for cause, after notice, with any dispute being referred to arbitration. Based on this provision, Woolley served notice of default on Embassy and sued for a declaratory judgment that the owner could terminate the management agreements. There were actually several lawsuits running on parallel tracks in

different jurisdictions with many other competing claims. For the purpose of this discussion, however, the focus will be on the agency issues only.

When the case was referred to arbitration, Woolley announced its intention to terminate the contract. Embassy then sought injunctive relief to bar Woolley from terminating the contract, prior to the conclusion of the arbitration. The trial court granted the injunction and Woolley appealed that decision to the California Court of Appeals.

(1) Termination.

For our purposes, the appellate court reached three important holdings. First, as an agent, a hotel operator can be terminated at any time by the owner/principal. This is the case regardless of the term of the management agreement or the fact that the agreement recites that it is non-terminable. The court discussed the exception for agencies coupled with an interest, but held that the interest in receiving compensation for services was not an interest that could be coupled with an agency to make it non-terminable. The court opined that for an agency to be coupled with an interest, the interest must be a "specific, present and co-existing beneficial interest in the subject matter of the agency." That is, the agent must have an interest in the hotel, not just the contract. The court rejected Embassy's argument that its interest in seeing its hotels succeed, so as to enhance their reputation and prestige, was such an interest.

(2) Equitable Relief.

The second relevant holding of the *Woolley* case was that personal service contracts (which include management agreements) cannot be specifically enforced. Since the agent cannot be forced to continue providing services, mutuality requires that neither can the owner be enjoined from terminating the agreement which calls for provision of those services.

(3) Damages.

The *Woolley* court was very clear, however, that when an owner exercises its power to terminate the agreement, but has no right to do so under the contract, the terminated operator is entitled to damages.

c. *Pacific Landmark Hotel, Ltd. v. Marriott Hotels, Inc., 23 Cal.Rptr. 2d 555 (Cal.Ct.App. 1993).*

Another California appellate court considered the application of agency principles to a hotel management agreement in a case arising out of a dispute between the owner of the San Diego Marriott Hotel and Marina and its operator, Marriott Hotels, Inc. In this case, the court followed the reasoning of its sister court in *Embassy Suites* instead of the Seventh Circuit decision in *Johnson Wax*. Like *Embassy Suites*, the *Landmark* contract contained specific language characterizing the relationship as an agency agreement.

The issue was whether the agreement between the parties was an agency coupled with an interest. The agreement stated that the agency was, "coupled with an interest and may not be terminated by Owner until the expiration of the term of the [Management] Agreement[s] . . ." The contract provided for a term of sixty years.

Affiliates of Marriott, San Diego Hotels, Inc. and Host International, Inc., had made a loan of fifteen million dollars and a capital contribution of eight million dollars, respectively, in return for ownership positions in limited partnerships which were the owners of the hotels.

The plaintiff filed suit against Marriott for breach of the management agreement and terminated the contract. Marriott refused to vacate the hotel on the ground that the contract was non-terminable and sought

injunctive relief to prevent its eviction from the premises. The trial court granted the injunction and the owner appealed.

The appellate court held that the contract was terminable because it was not coupled with an interest, in spite of recitations to the contrary. In refusing to follow form over substance, the court analyzed the relationship and rejected the clear language of the contract. It noted that the investment and the loan were from separate entities, not from Marriott. Citing the "traditional" rule, as opposed to the "modern" rule argued by Marriott, the court held that the agency failed to have an identity of parties, time, source and subject matter. Since there was no identity of parties, they declined to analyze the other elements in any great detail.

Without diminishing the impact of either *Woolley* or *Landmark*, it should be noted that both were decided under California law. The *Landmark* court, in fact, specifically declined to consider cases from other jurisdictions in its opinion. Additionally, the *Restatement (Second) of Agency* does not require an identity of parties for an interest to be coupled to an agency. Following that reasoning would allow another court to find that an affiliate's investment or loan does create an interest to be coupled with the agency of the management company.

It should also be noted that both contracts in question stated on their face that the relationship between the parties was one of principal and agent. Would the courts have reached a different conclusion if the contract disclaimed agency? Probably not, unless the elements of agency are clearly not present in the terms of the agreement. Eliminating, however, the delegation of authority, reporting requirements, management responsibilities, accounting and payment of profits, all of which constitute an agency, would create a very different relationship than that found in typical hotel management agreements today.

d. *Government Guarantee Fund v. Hyatt Corp.,* 95 F.3d 291 (3rd Cir. 1996).

Five years after the two California cases, the issue of a non-terminable agency agreement arose with regard to the Hyatt Regency in St. John, Virgin Islands, a/k/a the Virgin Grand Hotel. This case involved a failed resort, financed by a failed bank. Hence, the Government Guarantee Fund appears as the successor-in-interest of SkopBank, a failed Finnish financial institution, which was the successor-in-interest of the original owner through foreclosure. GGF is the Finnish counterpart of the FDIC in the U.S. Like the earlier cases, this was an appeal of a trial court's ruling on injunctive relief to terminate an operator's right to continue operating a hotel. Unlike the earlier cases, however, the district court from which this appeal was taken had ruled in favor of the owner and allowed the termination to become effective. This may be the best-written opinion on the subject. Since this was basically a one-issue appeal, the court very methodically and cogently discusses each argument raised by Hyatt, the appellant.

The holding in the case paralleled those of the California cases, ruling that a management contract is an agency agreement which leaves the owner with the power to terminate the agency at any time, for any reason or for no reason. It states that the only purpose of providing a term during which the contract cannot be terminated is to determine whether the termination is wrongful. A wrongful termination entitles the operator to damages but, while the damages are being determined, the operator must vacate the property and relinquish control to the owner or its successor agent. The Hyatt St. Johns case is the first in which a federal court followed the California cases. The court specifically applied the law of the Virgin Islands, which states that its common law is that of the *Restatement,* unless there is specific local law to the contrary. The case was decided, in large part, on reliance on the *Restatement (Second) of Agency*. It did cite the California cases with approval. Interestingly, the management agreement provided that Ohio law would govern, while the mortgage was governed by New York law. The court affirmed the choice of Virgin Island law, but

mentioned in dicta that the result would have been no different if decided under the law of Ohio or New York.

The *Hyatt* court does a good job also of addressing the ways in which an agency agreement cannot be coupled with an interest to make it non-terminable. Management fees, intellectual property, management expertise and sweat equity will not suffice. It is not clear what the *Hyatt* court would have done with a fact situation where Hyatt, or even an affiliate, had made a significant monetary investment and received an ownership interest in the hotel. They made it clear, however, that an indirect profits interest to be derived through management fees is not sufficient.

e. ***2660 Woodley Road Joint Venture v. ITT Sheraton Corp.,*** Civil Action No. 97-450JJF, 1998 U.S. Dist. LEXIS 22825, *1, 1998 WL 1469541 (D. Del. Feb. 4, 1998).

The *Woodley Road* case is more often cited for the discussion of the breach of fiduciary duties found in the second opinion in 2002, as discussed above. The first *Woodley Road* opinion from 1998, however, was a federal district court decision, granting a preliminary injunction mandating that Sheraton quit the premises of the Washington Sheraton Hotel, since their agency had been terminated by notice from the owner. The court followed the same discussion of the *Restatement* and cited, with approval, the *Embassy, Hyatt* and *Marriott* cases, discussed above.

f. ***Senior Housing Properties Trust, et al v. Marriott Senior Living Services, Inc.,*** Civil Action No. 02-5020-J (Mass. Super. Court, March 4, 2003)

These facts were originally litigated as an injunction suit in Maryland. The Injunction was denied and the plaintiffs filed this case in Massachusetts. Among other remedies, they asked for a declaration from the Massachusetts court that the Marriott operating agreement created an agency relationship. The court denied this request on two grounds. (i) First, they noted the language of the contract, which provided that Marriott was an independent contractor which served as an agent only in specifically designated activities. Thus, the court opined, the parties never intended for it to be a general agency; and (ii) that an agency is created, notwithstanding the terms of the contract when three elements are present:

(a) The agent is subject to the control of the principal;

(b) The agent has a duty to act primarily for the benefit of the agent; and

(c) The agent holds the power to alter the legal relations of the principal.

Finding that these elements were not present in the operating agreement, the court held that no agency relationship existed.

3. Independent Contractors as Agents.

Some operators have removed the agency language in their contracts and state that they are independent contractors. The flaw in doing this, without other substantive changes, is that an independent contractor can also be an agent. There are two types of independent contractors: those who meet the criteria set forth in §2, above, are agents; those who do not meet that criteria are not.

4. Disclaimers of Agency.

Similarly, some operators have begun including language in their contracts that disclaims agency. The problem with this approach is found in the cases discussed above. Each has made it clear that courts are going to disregard recitations in the agreement and look to the essential nature or substance of the relationship. That being the case, merely saying that the operator is not an agent will not be dispositive if the essential elements of an agency exist.

5. Options for Owners and Operators.

How do parties to a hotel management agreement address these issues with any hope of knowing what rights exist under the contract? Unfortunately, there may still be no clear answer. This is often the result when courts attempt to overlay contracts with theories that run counter to the clear intention of the parties. While the technical analysis may be defensible, it ignores the parties' freedom to contract and makes their "meeting of the minds" a non-event. Will other courts follow the reasoning of the *Embassy*, *Hyatt* and *Sheraton* cases? Probably. Some may not, choosing to follow basic contract law over the agency analysis presented in these cases. Others may, like Judge Posner, find that the operator is an agent for some purposes and not for others. Only time will tell. In any event the only practical approach at this point is to structure agreements in ways that give a party the greatest confidence that it will get the benefit of the bargain it reached.

a. Owners.

Owners were initially excited by the opportunity to discard management companies that were performing poorly. The other side of the coin, however, is the damages that will lie for a wrongful termination. From an owner's perspective, the following prophylactic approaches may be considered:

(1) Liquidated Damages.

In order to eliminate the uncertainty of the cost of termination, the owner may want to provide for liquidated damages for a wrongful termination. This simplifies the cost/benefit analysis if an operator is underperforming the market or the owner's reasonable expectations. At that point, the owner compares the cost of keeping the inept or overpriced manager with the perceived benefit to be derived by replacing the existing manager. This may be particularly beneficial in marketing a property for sale. A buyer is willing to pay less for a property burdened with a long-term contract, unless the buyer is convinced that the property cannot be better positioned, managed and maintained. Buyers rarely come to that conclusion.

(2) Termination for Cause.

Another provision that could be revised to benefit the owner is to put more thought into the events giving rise to termination for cause. If courts continue to follow the reasoning of the cases discussed above, the next level of protection for an owner would be to provide for events of default, which would allow an early termination of the agreement without subjecting the owner to damages for such termination. One such event may be the failure to achieve certain performance standards.

(3) Performance Standards.

A trend seems to be developing to require management companies to perform as advertised. If a management company receives the contract by providing rosy projections, those projections may be treated as performance standards.

Historically, management agreements have included disclaimers like, "The budget (or projections) prepared by the Operator are estimates only and not guarantees that the projected profit, or any profit, will be realized." It is appropriate, however, to add, "except as provided herein" to such language. Performance standards can provide a vehicle for early termination without exposing the owner to damages.

The balancing act at this point is to come up with meaningful performance standards that are not so low as to be no challenge (which the operator likes) but are not so high as to become a self-fulfilling prophecy of failure (which would give the owner an unfair benefit). Additionally, whatever standards are chosen need to make allowances for unforeseen circumstances, which will be discussed more fully below.

One type of performance standard, which appears fair to both parties, is to create a competitive set of hotels and establish a standard at some percentage of the mean performance of one or more categories available. More often than not, RevPAR is the item compared. Independent third parties can provide the data on a blind and blended basis so no antitrust violations occur. Two challenges to this type of standard is agreeing to a competitive set which is truly competitive and providing a mechanism for determining how to move competing properties in and out of the set when appropriate.

For new hotels, the performance standards need to take into effect the ramp-up time for getting the property to a point of normal operations.

(4) Exclusive Territories.

Another protective device to be considered by the owner is territorial exclusivity. To be meaningful in today's world the exclusivity should protect the owner not just from the operator competing in the restricted area, but also any affiliate of the operator. Specifically, if an operator, or one of its affiliates, operates a competing hotel in the restricted area, as a result of merger, acquisition or otherwise, the owner should have the option to terminate the contract. The fairness issue here is restricting the termination right to truly competing properties where a true conflict of interest exists.

Unless the territory is sufficient in size to prohibit competition, it may be counterproductive. A creative operator will argue that by creating the territory, there is the implicit acknowledgement that properties located outside of the territory are, by definition, not in competition with the owner.

b. Operators.

(1) Coupling with an Interest.

Although mere recitals will not create an irrevocable contract, there are ways to couple the agency with a bona fide interest to make sure that the contractual term is more than illusory. It is not uncommon today to find operators buying their way into the contract. Sometimes this is to facilitate the buyout of a previous operator or franchisor. At other times, it is to provide capital for deferred maintenance or FF&E replacement. Sometimes it is sweat equity whereby the new operator defers fees for some period to provide the economic benefit the owner needs, for whatever reason. If the operator does make an investment in a management agreement, it can reasonably ask for an interest in the property from the owner, as consideration for its investment. If the upfront payment is characterized as a loan, the mortgage or deed of trust securing the loan can appoint the operator as the owner's agent, <u>to protect its interest in the property</u>. If the loan is a participating mortgage, the contingent interest in a portion of the proceeds upon sale of the hotel can also be characterized as an interest which is coupled to the agency.

In such a structure, the economics of the relationship have not changed, but the agency is now characterized as, "being held for the benefit, of the agent, not the principal." This is the first of four elements recited by the *Restatement* for the creation of an agency coupled with an interest. Such circumstances would, likewise, fulfill the *Restatement's* second element, because the agency will have been "created to secure the performance of a duty to the agent (or to protect title in the agent)". The last two elements, simultaneous creation and consideration, should be no challenge to the parties, at this point.

Such a scenario is tailor-made for those situations where the operator is also the technical consultant for construction and pre-commencement activities at a new hotel.

One caveat to becoming a lender is the exposure to lender liability claims. Another risk to be considered is that a reviewing court could characterize the investment as *de minimus*, and conclude that no real interest had been coupled to the agency.

(2) Avoiding Boilerplate Disclaimers.

Review your "miscellaneous provisions" very carefully. Make sure that the boilerplate provisions do not inadvertently destroy what you have worked so hard to create elsewhere in the document.

(3) Liquidated Damages.

Liquidated damages can also serve as a safety net for an operator, if no legitimate way exists to create an irrevocable agency. Liquidated damages are generally stated in terms of a formula to be applied to the financial performance of the hotel at the time that the damages are calculated. The concept is usually to establish a present value of the net income stream that the operator would have realized had it managed the hotel for the full term of the agreement. The devil, however, is always in the details and parties can often disagree about test periods, discount rates, contingency considerations and treatment of renewal options in the process. Because NPV calculations can be contentious, if all of the variables are not fully negotiated in advance. Liquidated damages are also seen expressed as a multiple of annual fees. The multiples may be different where the termination results from a sale of the property as opposed to simply changing operators. Liquidated damages are often waived if the new owner engages the operator to manage the property, and significantly reduced if the new owner becomes a franchisee of the operator or its affiliate.

A significant problem with liquidated damages, regardless of the amount, is their generally unsecured nature. When a lender forecloses on a hotel or the property goes into bankruptcy, the best laid (and documented) plans of the operator can be frustrated. Without a non-disturbance and attornment agreement, a mortgagee in possession or foreclosure buyer will have no privity with the operator and have no obligation to operate under the terms of the management agreement. If the owner is a single asset entity, the operator will have little recourse.

Similarly, if the owner is in bankruptcy, the management agreement may be treated as an executory contract, which may be rejected by the debtor/owner. Any liquidated damages may then be treated as an unsecured claim, leaving the operator with scant comfort in the process. The treatment of hotels in bankruptcy is beyond the scope of this article, but this comment is included to raise the issue for consideration. For further reading on this point you may want to look at the combined decision in *In Re Prime Motor Inns, et al., Debtors and In Re Servico, Inc., et al., Debtors* (124 B.R. 378), 1991, which affirmed the Debtor's decision to reject the hotel management agreement. For a case reaching a contrary result, see *Dunes Hotel Assocs. v. Hyatt Corporation* (*In Re Dunes Hotel Associates*), 194 B.R. 967 (Bankr. D.S.C. 1995).

In negotiating liquidated damage provisions, both parties must be cognizant of the fact that the damages to which the parties agree must bear a rational relationship to the loss to be incurred and cannot be a penalty. Otherwise, the provision will not be enforced. When the owner is a single asset entity owned by a solvent parent, the operator will often request a guarantee of the liquidated damages from the parent company.

(4) Subordination, Non-disturbance and Attornment Agreements.

Operators should always seek to have a non-disturbance and attornment agreement recorded between themselves and the lenders to insure that the lender or its transferee will step into the shoes of the owner in

the event of a foreclosure. Even with an SNDA in place, the secured lender(s) claims may be greater than the value of the hotel. This generally renders the claims of the operator worthless.

(5) Recordation.

Any interest of the operator should be filed of record for notice and priority purposes. At a minimum, a memorandum of the primary document should be considered. If an interest has been taken in the property it will generally be documented by a deed of trust or mortgage securing the interest.

6. Remedies of the Operator.

As mentioned in several of the decisions cited, where an owner exercises its power to terminate a contract without the right to do so, the operator will be entitled to damages. The measure of such damages is the lost profit to be experienced by the operator as a result of the termination.

7. Remedies of the Owner.

a. Contract.

If the operator defaults on its obligations to the owner, the owner can recover its provable damages that are reasonably foreseeable as a result of the breach. For the operator, for example, this may take the form of lost profits in the form of the stream of income (base, incentive and other fees) expected to be earned over the remaining years of the contract, discounted to present value. Punitive damages are not available for a breach of an agreement, but attorneys' fees, costs and interest are recoverable in most situations. It is important to note that the parties can expressly incorporate in their agreement limits on the types of damages that can be awarded for breach of the agreement or, as explained above, substitute liquidated damages as the exclusive remedy. The owner’s damages are less formulaic but will still be based on damages actually resulting from a breach by the operator.

b. Tort.

Many cases being filed against operators include claims that sound in Tort. That is, they are based on the breach of a common law or statutory legal duty as opposed to a duty or obligation arising purely under a contract.

(1) Actual Damages.

The owner who prevails in a tort claim against an operator is entitled to its provable actual damages proximately arising out of the breach of the legal duty. Any breach of an agent's duty to its principal will allow the principal to recover tort damages, even if the same act was also a violation of the contract. These tort damages can take the form of non-pecuniary losses.

(2) Punitive Damages.

The plaintiff in a tort case is also entitled to punitive damages to punish the wrongdoer and to dissuade others from engaging in similarly egregious conduct. Tests for the award of punitive damages vary among jurisdictions, but typically the defendant's wrongful conduct must shock the conscience, pose an extreme risk of substantial harm to the victim, and be done maliciously, recklessly, or intentionally by the wrongdoer.

(3) Attorneys' Fees, Costs & Interest.

Attorneys' fees, costs and interest are generally non-recoverable in a common law tort action, but the jury may consider such items in arriving at the amount of punitive damages. Often the contract will provide for attorneys’ fees for a prevailing party. The language of some such provisions are broad enough to cover tort claims.

(4) Disgorgement.

One measure of damages available when an agent engages in an impermissible conflict of interest is forfeiture of fees owed and disgorgement of fees paid to the agent. This remedy is in addition to the damages resulting from the breach of either the contract or a legal duty. In some cases, disgorgement of an agent's compensation may be ordered even if no actual loss or damage was suffered.

8. Legislation.

In 2004 Marriott sponsored legislation in Maryland which provides that nothwithstanding the law of agency, the terms of a management agreement will strictly govern the relationship between the parties. The effect of this statute is to give the operator a no cut contract which is specifically enforceable, and which is subject to no fiduciary duty or other implied duty. It even disclaims a duty of good faith and fair dealing to the extent that the contract allows the operator to make a decision in its sole discretion. This legislation became effective last year and is now codified as MD COML §23-102.

It is expected that Marriott (and maybe others) will now require that its contracts disclaim agency (which they have been trying to do for years) and be governed by the substantive law of Maryland. In the past, the governing law provision has been non-controversial with Marriott and most other operators. Management Agreements have generally provided that the substantive law of the jurisdiction where the hotel is located controls.

B. Force Majeure.

This is one of those boilerplate provisions that need to be rethought, given the world in which we live. The events of September 11, 2001, created numerous disputes about what contractual obligations should be excused and on what terms. The sub-categories of force majeure may get more attention and analysis in new agreements. They are (i) Impossibility; (ii) Frustration of Purpose; and (iii) Inadvisability or Impracticability.

C. Risk Allocation & Management.

A significant development in the management of risk in hotels is the upheaval in the insurance market that followed 9/11. Both owners and operators covenant to carry certain types of insurance in their management agreements. In spite of those covenants, some coverage is now unavailable, or unavailable to a certain property, or available only at a prohibitive cost. This new reality needs to be addressed in future contracts and may justify amending existing agreements with lenders, franchisors, owners and operators. Many existing agreements make the failure to provide specified insurance coverage an event of default.

The Terrorism Risk Insurance Act of 2002, among other purposes, voids any exclusions from coverage in property and casualty insurance policies for terrorist acts. Coverage will now be available, but the premium for such coverage will be passed on to the insureds. The amount of this premium is determined by the Secretary of the Treasury.

D. Alternate Dispute Resolution.

The frequency, cost, delay, lack of predictability, publicity and risk of litigation has created a trend toward alternate dispute resolution in the hospitality industry. The primary ADR vehicle in management agreements is arbitration. The problems with arbitration include the quality, legal training and impartiality of the arbitrators; the lack of precedential value (although this can also be a benefit); the loss of technical legal claims and defenses; privacy of the proceedings; the fact that the perceived reductions in cost and delay can be illusory; the lack of (or limitations upon) discovery; and the finality of the arbitrator's decision and the limits on appeal. Each party should weigh these issues carefully and negotiate procedures to protect it to the extent possible in the event that a dispute is referred to arbitration.

E. Intellectual Property.

Most issues involving intellectual property are a result of the speed at which technology has developed, relative to our ability to understand and manage it. The disputes in this area are driven by technology that was not contemplated, or at least understood, when many current management agreements were signed. Most hotels are operated on the management information systems of their operators. In fact, many of these operators charge a separate fee for providing proprietary computer systems to manage the owner's hotel.

1. Guest Information.

These systems have become so sophisticated that they harvest every piece of data on each guest. The question then arises, whose information is this? The arguments are predictable, and for the most part valid. The industry has not, however, established a template of who owns this data and how the other party should compensate the owner of the data for using it for other purposes. This area is in its infancy and currently provokes more questions than answers.

2. Access.

The question of ownership may really be the wrong inquiry. Some have suggested that the real issue is access. Who can use the information, for what purposes, and how the costs of, and revenues from, such use, are the principal issues in this debate.

3. Compensation.

If the operator sells a mailing list to someone who wants to target the people who stay in the brand's hotels, should the owners benefit from that sale? On what basis?

4. Disclosure.

Is there a duty on the part of the operator to disclose how it will use the owner's data, particularly in those circumstances where the data itself becomes a profit center? Is an accounting required?

5. Competition.

Is it a conflict of interest for the operator to use the owner's group data to benefit a competing hotel or even a hotel in another city? What if that information is used to underwrite the construction of another hotel in the same market by the operator? That issue was raised in the case of *SHC Laguna Niguel I, LLC v. Marriott International, Inc*., Civil Action Number BC 280028 (Los Angeles County Ct. dismissed July 12, 2004). Strategic Hotels owned a hotel in Laguna Niguel which was operated as a Ritz-Carlton, pursuant to a branded management agreement. A hotel in the same market was opened by Ritz as the Montage. Strategic alleged that Ritz-Carlton and its parent, Marriott, used operating information, customer lists and other proprietary data to underwrite the new hotel. Ritz ultimately gave up the management of the hotel, but the lawsuit based on their use of the information continued. The case gives the observer little meaningful guidance, however, because it was settled last year on terms not made publicly available.

6. Privacy and Confidentiality.

Can the misuse, or even legitimate use, of personal data about a guest be a violation of confidentiality rights of the owner and/or the guest? Can it violate privacy statutes in one or more jurisdictions? If liability arises from the use, who bears that risk? Additionally, can such use violate confidentiality and non-disclosure provisions in the management agreement? How does the privacy policy of the property required by the Gramm Rudman Act impact these issues?

V. CONCLUSION

Management agreements will continue to be the vehicle used to govern relationships between hotel owners and operators for the foreseeable future. Some brave souls may venture into uncharted territory or long-discarded forms, but most owners and operators will not be willing to be the test case for a new type of arrangement as long as their current form works. In spite of the wailing and gnashing of teeth over developments in the area, the concept still works. In fact, it works pretty well. The relative scarcity of reported cases indicates that most owners and operators agree with this analysis.

The industry will continue to monitor the cases as they are decided, as well as attempt to structure new methods of dealing with new technologies and challenges. These will precipitate incremental changes, but not a wholesale revamping of the industry.

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