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Terminating Hotel Management Agreements
Thunder over Woodley Road

by

Jim Butler and Jeff Riffer[1]

Woodley Road[2] may be the first indication of one of the most important legal developments in many years representing a dramatic sea-change for the hospitality industry. It could expose almost every operator to paying big damages to hotel owners. It could also give owners a free termination right for long-term management agreements[3] or powerful currency to renegotiate existing agreements.[4]

In *Woodley Road* a jury awarded $51.8 million in damages — almost $15 million in actual damages and over $35 million in punitive damages against Sheraton. The jury also concluded that the owner was entitled to terminate Sheraton's management contract (with more than 30 years remaining) without cost or penalty. The damages and free termination resulted from a finding that Sheraton breached its management agreement and its fiduciary duties to the Hotel's owner, a joint venture owned primarily by John Hancock and Sumitomo Life.

Woodley Road is the first jury verdict to focus on the consequences for a hotel operator failing to meet its "fiduciary" duties to the hotel's owner. As a result of this case, prudent operators will rewrite their management agreements on a going-forward basis (if they haven't already), and owners will scrutinize past behavior of their operators. Litigation is inevitable but reasonable business solutions should prevail.

Overview of Woodley Road

In 1979, the venture owned by John Hancock and Sumitomo Life entered into a management agreement with Sheraton that, with Sheraton's options to renew, ran through the year 2030. By the late 1990s the relationship between owner and operator had soured.

In *Woodley Road*, the owner (1) sued Sheraton for breach of contract and fiduciary duties, (2) terminated Sheraton as the operator and won a court order removing Sheraton from the hotel (under the *Woolley* line of cases), and then (3) won $58.1 million dollars in damages, and a verdict that it had no liability to Sheraton for terminating the management agreement that ran until 2030.

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The termination of Sheraton's management agreement was based on a line of cases going back almost 10 years.[5] These cases teach us that every hotel operator is an "agent" of the owner. In most situations, this means that the owner can terminate the hotel operator irrespective of the long term "no-cut" management contract's provisions, however, if the termination is wrongful, the owner may be liable for substantial damages.

The damage award and free termination of the management agreement resulted from Sheraton's conduct, which many experts believe reflects common industry-wide practices among hotel operators. The law says that every agent is a fiduciary. Sheraton's conduct did not measure up to this high standard.

Is Every Hotel Operator an "Agent" and a "Fiduciary"?

Under the line of cases starting with Woolley, it will be impossible for almost any hotel operator to avoid the legal status of an "agent" . . . and every agent is a "fiduciary." A fiduciary is like a trustee or a director of a corporation who owes the first duty of loyalty and care to the principal. A fiduciary cannot take rebates or kickbacks, cannot use or profit from its principal's property, and must prefer the principal's interest to its own.

The *Woodley Road* jury found that Sheraton received various discounts, rebates and other consideration from vendors and that these constituted "kickbacks" and "commercial bribes," which were a breach of contract and of Sheraton's fiduciary duty. The jury also awarded damages for breach of the Robinson-Patman claim (receiving a fee or commission in connection with a transaction for which no services were rendered) and workers' compensation insurance.

Other practices challenged (though not successful with this jury) included aspects of the frequent traveler program, the reservation system, "usable denials" practices, complimentary rooms practices and other such issues. These areas may prove problematic for operators in future litigation.

A broad spectrum of common management company practices will undoubtedly become the focus of future casts.

Why Is this Case Important?

This case affects virtually every management agreement in existence between owners and operators. It builds upon the prior body of law in the Woolley, Pacific Landmark, and Shopbank cases[6] but establishes or focuses on "the next step."

The prior cases established that:

- An operator is an agent of the owner.
- An owner can terminate an operator and remove him from a hotel no matter what the management contract says because a principal can always terminate the agent.
- The *power* to terminate an agency is not the same as the *right* to terminate the agency. An owner's wrongful termination of an operator by an owner can result in substantial damages for breach of contract, but that does not prevent termination of the relationship.
- Operators cannot be terminated if the agency relationship is found to be "an agency coupled with an interest." However, it is extremely difficult (if not impossible) to establish such an agency coupled with an interest in the context of hotel operators.[7]

The *Woodley Road* case focuses on an entirely different aspect of the agency relationship. It has been black-letter law for hundreds of years going back to old English common law that an agent is a fiduciary. Although this legal consequence attaches to all agency relationships, the prior cases in the hotel industry have not dealt with the *requirements*

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of a fiduciary relationship. The Woodley Road case does that.

Hotel Operators Generally Cannot Deal At Arms Length.

Many hotel operators have thought of their business relationship with owners as a traditional business relationship where the parties are free to deal with one another at arms length. But that is not true for an agent. An agent cannot deal with his principal at arms length because he is a fiduciary.

These legal principals are not novel. Everyone expects that a bank trustee will act as a fiduciary. The trustee may not divert funds from the trust, invest them for his own benefit or make a secret profit. The trustee may not make secret and undisclosed charges to the trust through affiliated entities or other self-dealing. The trustee may not charge personal or undisclosed expenses to the trust.

Anybody would be outraged if the trustee of a family trust engaged in these violations of fiduciary duty. The only novel aspect of the *Woodley Road* case is applying these fiduciary principles to the agency relationship created between a hotel operator and a hotel owner. Once it is clear that an agency relationship exists, then the law attaches all of the fiduciary duties that any agent or trustee owes to its principal. This prevents the agent from operating at arms length and making undisclosed profits, self-dealing, preferring its interests over the principal, competing with the principal, using property of the owner and other such conduct.

Long-Accepted Hotel Industry Practices Put Operators at Risk.

For years, hotel operators have gotten rebate checks from telephone companies, vendors of food and beverage, insurance carriers and other parties they deal with. Maybe at year end an appliance vendor sends ten free televisions sets to corporate headquarters, the property and casualty insurer gives a dividend, or home office E&O is provided on a complimentary or lower-than-market basis.

Some operators may have kept the entire benefit of all of these kinds of rebates, discounts and other consideration. Others may have refunded substantial sums where they were clearly related to a property, such as telephone company rebates or beverage vendor rebates for a specific hotel, but may not have given credit for the television sets to each hotel property under management, or may not have reported the discount in home office insurance rates. A fiduciary cannot ignore any such benefits it receives. A fiduciary must account punctiliously to the principal for these benefits. There is no excuse because an accounting is difficult or the amounts involved as small.

It goes without saying that passing on inappropriate charges from the home office, whether parties, jets, minks, and escorts or corporate G&A expense are also inappropriate unless there is express authorization and the charges are appropriate.

What Are the Implications for Sheraton and Other Operators?

As noted above, there is nothing new or novel about he legal principles applied. The only thing new is that these centuries-old legal principles have finally been applied to hotel operators now that everyone recognizes they are "agents."

The implications for Sheraton and other management companies are serious. In one form or another, the practices giving rise to $51.8 million of damages are practices and approaches used widely throughout the hospitality industry in ignorance of the agency and fiduciary principles applicable. Thus, other juries may conclude that other operators, whether intentionally or "following the herd," have violated their fiduciary duties and may be liable for termination of their management agreements as well as substantial damages.

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How Far Back Can an Owner Go?

There are a number of legal principles designed to keep someone from recovering damages on an "old" claim. Statutes of limitation and equitable doctrines of laches and estoppel generally prevent plaintiffs from recovering unless the claims are timely brought. These statute of limitations and equitable doctrines are governed by the individual state laws of each jurisdiction involved and must be examined to see what limitations would apply.

However, there is a powerful exception to these limiting doctrines that will apply in many instances to enable plaintiffs to go back for potentially unlimited periods of time into the past to recover for damages for breach of fiduciary duty. There is a widely recognized doctrine that the statute of limitations is prevented from running (and the equitable doctrines of laches and estoppel will not apply) when the claims arise from a breach of fiduciary duty as long as fiduciary relationship stays in place and the victimized party did not know about the breach of duty. The time for raising these claims can be extended where there is fraud or constructive fraud and in the fiduciary context, it may be easier to establish constructive fraud where there is less than full disclosure.

This extension of the statute of limitations can have a significant impact on many hotels and operators.

What Options Do Owners and Operators Have?

Operators will have several options for dealing with existing management agreements which may continue to govern their relationship with owners for long periods of time under currently-existing long-term management contracts:

- Continue the status quo (very dangerous).
- "Clean up" procedures from now on and hope that owners will not raise questions concerning the past.
- Work out a business resolution with owners for the past and amend or clarity the contract as to what will be permitted in the future.
- Litigate.

Operators should know that owners generally can make a *knowing and intelligent* waiver of the operator's fiduciary duties, such as the duty not to complete. Thus, many management agreements require the owner to acknowledge that the operator is free to compete at any location other than the managed hotel or at any location outside the specified territory.[8] Similarly, an owner could make an informed written waiver and agreement authorizing an operator to receive certain rebates, discounts and other consideration which it is entitled to receive and keep for its own account as part of the compensation for providing certain management services.

What Do You Do Now?

If you are an operator, you need to make sure that you understand the consequences of "agency" and "fiduciary" duties. You should hire counsel knowledgeable in this area to help you understand the critical issues. Counsel should also hire or coordinate your experts to perform a self audit on all your third party management situations, so that the attorney-client privilege may apply to important communications with staff and experts. Obviously, your team will need to address past practices and issues of liability. Your new management agreements need to fully respond to these issues, including any waivers of fiduciary obligations. Make sure your waivers are based upon sufficiently detailed disclosures to be enforceable. In the future, we will find out how much detail in disclosure is "enough."

If you are an owner, you should hire counsel knowledgeable in hotel management practices and agreements as well as fiduciary duties. Just as operators want to be able to claim the attorney-client privilege for the broadest range of

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communications with their employees and experts, you want your counsel to hire and coordinate your staff and experts for an operational or forensic audit. You should evaluate the findings of your management audit with counsel to determine whether there have been any breaches of contract or fiduciary duty, and what course of action may be appropriate — staying the course, seeking payment of damages, termination of the management agreement, or renegotiation of the management agreement. Remember, although an owner will almost always have the power to terminate an operator under the Woolley case, wrongful termination can be devastatingly expensive and dangerous.

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[1] Headquartered in Los Angeles, California, Jim Butler chairs the Global Hospitality Group® for Jeffer, Mangels, Butler & Marmaro LLP — the internationally acclaimed premier hospitality practice in a full-service law firm. With more than 50 of the firm's 160 attorneys focused on virtually every aspect of hotels, restaurants, resorts and sports facilities, JMBM's Global Hospitality Group has helped its clients in almost $50 billion of hospitality transactions — hundreds of transactions — around the globe. Jim Butler has worked on complex issues of fiduciary duty, such as those raised in the *Woodley Road* case, in many contexts for more than 25 years. Jeff Riffer is both a Senior Member of the Group and a litigation partner with more than 20 years of experience.

[2] *2660 Woodley Road Joint Venture v. ITT Sheraton Corporation (USDC Delaware, Civil Action No. 97-450)*.

[3] Termination of a long-term management agreement prior to the end of the contract term usually requires payment of either some termination fee upon the occurrence of a specified event (reaching a certain anniversary event, sale of the hotel, etc.) or payment of damages upon the wrongful termination of the contract. A "free termination" is one where the management agreement can be terminated by the owner without the payment of any termination fee, liquidated damages, damages or other costs, whether by the express terms of contract, or by operation of law, such as in the *Woodley Road* case.

[4] The right to a free termination of a management agreement is powerful currency to renegotiate the terms of the management agreement.

[5] Woolley v. Embassy Suites, Inc., 227 Cal.App. 3d 1520, 289 Cal. Rptr. 719 (1991) ("Woolley"); Pacific Landmark Hotel, Ltd. v. Marriott Hotels, Inc., 19 Cal. Ap.4th 615, 23 Cal.Rptr.2d 555, modified, 19 Cal.App.4th 1552i (1993) ("Pacific Landmark"); Government Guar. Fund of the Republic of Finland v. Hyatt Corp., 95 F.3d 291 (3d Cir. 1996) ("Shopbank").

[6] See en 4, *supra*.

[7] For a thorough discussion of a hotel operator as an agent, what constitutes an "agency coupled with an interest" and an agent's fiduciary duties, see "The Marriott Decision: Increasing a Hotel's Value with a Management Agreement Audit," James R. Butler, Jr. and P. Peter Benudiz, Real Estate Finance Journal (Spring 1994).

[8] Note this is not the same as a mere prohibition on the operator competing within the specified territory, which still does not give the operator the privilege of breaching its fiduciary duty not to compete whether inside or outside the non-competition radius clause.

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