Hotel Operators Open Pandora's Box: From "Agent" to "Fiduciary" & Beyond

by Jim Butler & Jeff Riffer

Once upon a time ... management agreements were invented

Once upon a time hotel operators owned the hotels they operated. Then, needing to lessen the intense capital requirements of ownership, hotel companies began to experiment with franchising and sale-leasebacks. But "paradise" was not reached until hotel management agreements were invented in the 1970s and 1980s. With this device hotel operators had almost all the benefits of ownership and almost none of the risks and capital costs.

What could be better? Operators could build national and international chains of hotels bearing their brand names. Operators no longer needed capital to buy, operate and maintain the hotels. These burdens of ownership were transferred to owners under the management agreements. But operators could earn fees for managing the hotels and exercise almost complete control over the hotel. Owners assumed most (if not all) obligations to provide working capital, make up operating deficits, and supply cash to maintain the standards established or aspired to by operators.

To effectuate the ideal relationship, operators drafted the management contracts with owners granting powerful agency authority to the operators to maximize the operator's ability to control the hotel asset and to minimize the need to go to the owner for approvals or action of any kind. While these long-term, "no cut" contracts were largely successful in banishing many owners from any active involvement with the hotel, they created another problem that most operators never fully appreciated until recently.

ABOUT THE AUTHORS

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, headquartered in Los Angeles, CA. With more than 50 of the Firm's 150 attorneys focused on virtually every legal aspect of hotels, restaurants, resorts, and sports facilities, JMBM's Global Hospitality Group has helped its clients in more than $20 billion of hospitality transactions around the*

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TROUBLE IN PARADISE: AGENCY PRINCIPLES RULE HOTEL OPERATORS

Just when things were going so nicely, Robert E. Woolley became involved in a lawsuit with Embassy Suites over termination of Embassy's long-term management agreement on nine of the 17 hotel properties his partnerships owned. Woolley claimed that the management agreement created an "agency relationship" and that certain common law rules therefore applied to the owner-operator relationship. He claimed that these rules trumped the express language of the contract and enabled Woolley to terminate the management agreement. The Court of Appeals agreed with Woolley! It held that the hotel operator is an agent and governed by agency principles that overruled any provisions of the management agreement itself to empower Woolley to terminate the management agreements.[1]

Woolley was the first in a steady line of relatively new cases to apply centuries-old principles of English agency common law to hotel management agreements.[2] Nothing was novel about the agency principles applied. Hotel owners and operators were just not used to thinking about the full implications of an operator being an agent. Under the legal tests, virtually every operator will be an agent of the owner for the hotel managed. And almost every agency (including the management contract) can be terminated by the principal (owner) at any time, however, the owner will be liable for damages to the operator if the termination is not justified.

Suddenly, operators began to worry about the agency implications of the long-term management agreements that had proliferated in the industry since the 1970s and 1980s. And when a $51.8 million jury verdict against ITT Sheraton was rendered in *2660 Woodley Road vs. ITT Sheraton* in December 1999, operators awoke with a start to find that the fairy tale had become a nightmare.

It should not have been a surprise once *Woolley* announced that hotel operators are agents, but many operators failed to appreciate all the implications of that decision. In summary, *Woolley* and its offspring establish the following principles for hotel operators:

- Virtually all hotel operators are agents.[3]
- Agents can be terminated by their principals (or owners) except in rare cases.[4]
- Agents are fiduciaries.[5]
- Fiduciaries owe special duties to owners and are not free to deal with them at arms length.

Under the legal tests, virtually every operator will be an agent of the owner for the hotel managed. And almost every agency (including the management contract) can be terminated by the principal (owner) at any time, however, the owner will be liable for damages to the operator if the termination is not justified.

- Remedies for breach of fiduciary duties include actual damages, punitive damages, and justifiable (free) termination of the management contract, despite provisions in the agreement to the contrary.

WHAT HAPPENED IN *WOODLEY ROAD*?

In 1979, the venture owned by John Hancock Mutual Life and Sumitomo Life Realty entered into a management agreement with ITT 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.

John Hancock and Sumitomo: 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[6]); and then 3). won $51.8 million dollars in damages, and a verdict that it had no liability to Sheraton for terminating the management agreement that ran until 2030.

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.

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 cases.

NEW INCENTIVE TO LEARN THE BASICS OF AGENCY PRINCIPLES

The $51.8 million jury verdict against Sheraton in *Woodley Road* has provided a wake up call for owners and operators alike to better understand the fiduciary duties that almost every operator owes to the hotel owner. *Woodley Road* has sent a similar urgent signal to all asset managers, pension advisors and other third party fiduciaries charged with overseeing effectiveness of hotel operators for their owners.

Basic Agency Principles

As noted above, virtually all hotel operators are agents and all agents are fiduciaries. As a result, the following basic rules of agency will apply to virtually every hotel operator:

1. In general, an agent has a duty to act solely for its principal.[7]
2. Agency contracts are special — fiduciary duties modify the contract.[8]
3. Agents owe a duty of special care and skill.[9]
4. Agents owe a duty of loyalty to act *solely* for the benefit of the owner.[10]
5. Agents owe a duty to account for profits.[11]
6. Agents must not use information acquired during the agency for their own account.[12]
7. Agents can modify those general duties only by making full disclosure.[13]
8. It is no excuse that the principal is not harmed.[14]

Remedies for an Agent's Breach of Duty

As demonstrated in *Woodley Road*, an operator's breach of its agency or fiduciary duties will justify a free termination of the management agreement by the owner.[15] Because the breach of duty is a breach of contract[16] it can give rise to all the normal contract damage remedies, but it may also constitute a tort[17] and therefore expose the defendant to punitive damages.

Furthermore, if the operator has profited from the breach of duty, the principal is entitled to all the profits, and the operator must account and disgorge them.[18] And even where the operator has not breached a duty to the owner, it may be liable for any unjust enrichment.[19]

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 principles 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 received 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 10 free television 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 considerations. 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 are small.

It goes without saying that passing on inappropriate corporate 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 DO YOU DO NOW?

The real importance of *Woodley Road* is that it dramatically shows what can happen if owners challenge common industry practices applying long-established legal principles. This case has implications for 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 but represents or focuses on "the next step."

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" for a *knowing and intelligent* waiver that will meet the legal test for validity.

If you are an owner, you should first 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 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[20] with counsel to determine whether there have been any breaches of contract or fiduciary duty, and

What is important here is whether those currently housed in office space will choose to communicate information electronically or continue to do so on a face-to-face basis. Their choice will be influenced by the kind of information they wish to communicate, insights into which flow out of a recognition of some important distinctions that can be made with respect to information.

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.[REI25]

NOTES

1. *Woolley v. Embassy Suites, Inc.*, 227 Cal. App. 3d 1520, 278 Cal. Rptr. 719 (1991) ("*Woolley*"). Note that the "power" to terminate an agency is not the same as the "right" to terminate the agency, and a principal can be liable for substantial damages to the agent if the termination was not justified.
2. See *Woolley*, supra. and also *Pacific Landmark Hotel, Ltd. v. Marriott Hotels, Inc.*, 19 Cal. App.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*"), and *2660 Woodley Road Joint Venture v. ITT Sheraton Corporation* (USDC Del., Civil Action No. 97-450) ("*Woodley Road*").
3. See *Woolley, Pacific Landmark, Shopbank* and *Woodley Road, supra.*
4. *Ibid.*
5. "An agent is a fiduciary with respect to matters within the scope of his agency." Restatement (Second) of Agency § 13 (1958) (hereinafter "Restatement Agency").
6. *Woolley, Pacific Landmark,* and *Shopbank, supra.*
7. "Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency." Restatement Agency § 387.

   The extensive citations to the Restatement (Second) of Agency (the "Restatement of Agency") are important to those who need to understand the critical nature of fiduciary duties. The Restatement is one of the most respected authorities and oft-cited distillations of generally accepted principles of agency law in the United States.
8. "[A]lthough the agency relation normally involves a contract between the parties, it is a special kind of contract, since an agent is not merely a promisor or a promisee but is also a fiduciary... Even specific agreements, however, must be interpreted in the light of the principles which are applicable to the relation of principal and agent. The existence of the fiduciary relation between the parties, and the duty of the

agent not to act for the principal contrary to orders, modify all agency agreements and create rules which are sui generis and which do not apply to contracts in which one party is not an agent for the other. Further, unlike most other contracting parties, the agent may be subject to tort liability to the principal for failing to perform his duties." Restatement Agency, Chapter 13, Introductory Note.

9. "Unless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has." Restatement Agency § 379(1).
10. "Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency." Restatement Agency § 387.

    "The agent's duty is not only to act solely for the benefit of the principal in matters entrusted to him ..., but also to take no unfair advantage of his position in the use of information or things acquired by him because of his position as agent or because of the opportunities which his position affords." Restatement Agency § 387, comment b.
11. "Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal." Restatement Agency § 388.

    "Ordinarily, the agent's primary function is to make profits for the principal, and his duty to account includes accounting for any unexpected and incidental accretions whether or not received in violation of duty. Thus, an agent who, without the knowledge of the principal, receives something in connection with, or because of, a transaction conducted for the principal, has a duty to pay this to the principal even though otherwise he has acted with perfect fairness to the principal and violates no duty of loyalty." Restatement Agency § 388, comment a.

    "An agent can properly retain gratuities received on account of his principal's business if, because of custom or otherwise, an agreement to this effect is found. Except in such a case, the receipt and retention of a gratuity by an agent from a party with interests adverse to those of the principal is evidence that the agent is committing a breach of duty to the principal by not acting in his interests." Restatement Agency § 388, comment b.
12. "An agent who acquires confidential information in the course of his employment or in violation of his duties has a duty not to use it to the disadvantage of the principal... He also has a duty to account for any profits made by the use of such information, although this does not harm the principal... He is also liable for profits made by selling confidential information to third persons, even though the principal is not adversely affected." Restatement Agency § 388, comment c.

    "Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge." Restatement Agency § 395; see also Restatement Agency § 404, comment b ("The agent is subject to liability not only for the use of tangible things but also for the use of trade secrets, good-will, credit and other intangible assets of the principal.").

    "The rule stated in this Section applies not only to those communications which are stated to be confidential, but also to information which the agent should know his principal would not care to have revealed to others or used in competition with him. It applies to unique business methods of the employer, trade secrets, list of names, and all other matters which are peculiarly known in the employer's business. It does not apply to matters of common knowledge...." Restatement Agency § 395, comment b.

    Further, an agent is even restricted from using information obtained independently to compete with its principal. "The agent is entitled to use knowledge which he acquires independently for all purposes except that of competition with the principal in matters entrusted to him." Restatement Agency § 393, comment c.
13. "One employed as agent violates no duty to the principal by acting for his own benefit if he makes a full disclosure of the facts to an acquiescent principal and takes no unfair advantage of him. Before dealing with the principal on his own account, however, an agent has a duty, not only to make no misstatements of fact, but also to disclose to the principal all relevant facts fully and completely. A fact is relevant if it is one which the agent should realize would be likely to affect the judgment of the principal in giving his consent to the agent to enter into the particular transaction on the specified terms. Hence, the disclosure must include not only the fact that the agent is acting on his own account (see § 389), but also all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction from the viewpoint of the principal." Restatement Agency § 390, comment b.

    Thus, an agreement by the principal to allow the agent to modify its general duties is valid only if the agent made a prior full disclosure of all the relevant facts. "Unless the terms of such an agreement provide otherwise, an agent acting as an adverse party, even though with the knowledge of the principal that he is so doing, is subject to the duty stated in Section 390 to reveal to the principal all the material facts which he knows or which he should know, and to deal fairly with the principal." Restatement Agency § 389, comment b. "The burden of proof is upon the agent to show that he has satisfied the duties required by the rules stated in this Section." Restatement Agency § 389, comment e.
14. "Where no violation of duty or loss to the principal. Even though the agent properly acquires and uses confidential information concerning his principal's activities in the course of employment, he has a duty to account to the principal for any profits thereby made." Restatement Agency § 395, comment e; see also Restatement Agency § 388, comment c ("An agent who acquires confidential information in the course of his employment ... has a duty to account for any profits made by the use of such information, although this does not harm the principal.").

    "A failure of the agent to perform his duties which results in no loss to the principal may subject the agent to liability for ... any profits he has thereby made (see § 403), to discharge (see § 409)..." Restatement Agency § 401, comment b.

    "[A]n agent who, without the knowledge of the principal, receives something in connection with, or because of, a transaction conducted for the principal, has a duty to pay this to the principal even though otherwise he has acted with perfect fairness to the principal and violates no duty of loyalty in receiving the amount." Restatement Agency § 388, comment a.

    "The rule stated in this Section is not based upon the existence of harm to the principal in the particular case.... The rule applies, therefore, even though the transaction between the principal and the agent is beneficial to the principal." Restatement Agency § 389, comment c.
15. "A principal is privileged to discharge before the time fixed by the contract of employment an agent who has committed

such a violation of duty that his conduct constitutes a material breach of contract ..." Restatement Agency § 409.

16. "[A] serious violation of the duty of loyalty ... constitutes an entire breach of contract" Restatement Agency § 409, comment b.
17. See note 9 *supra*, Restatement Agency, Chapter 13, Introductory Note.
18. "Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profits to the principal." Restatement Agency § 388.

    "If an agent receives anything as a result of his violation of a duty of loyalty to the principal, he is subject to a liability to deliver it, its value, or its proceeds, to the principal." Restatement Agency § 402.
19. "Although the agent has committed no breach of duty to the principal, he is liable in an action for restitution for any enrichment which it is unjust for him to retain." Restatement Agency § 404A.
20. For a thorough discussion of the Management Agreement Audit, 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).

ABOUT THE AUTHORS

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globe. 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. [redacted]

Jeff Riffer *is both a senior member of the Global Hospitality Group for Jeffer, Mangels, Butler & Marmaro LLP, and a litigation partner with more than 20 years of experience.* [redacted]