The Principle of the Principal:

An Examination of Hotel-Management Agreements and the Laws of Agency

by Michael C. Shindler

Recent court decisions have affirmed a hotel owner's right to terminate its management firm. But it's not *carte blanche*.

Three court decisions rendered over the past six years appear to have changed the landscape regarding the relationships created by management agreements for hotels. As in most matters relating to the law, however, the exact nature of the new landscape is not entirely clear. The cases are (in abbreviated form) *Woolley v. Embassy Suites*,[1] *Pacific Landmark v. Marriott*,[2] and *Government Guarantee Fund of Finland v. Hyatt*.[3] Those three cases have been written about by the hotel trade press, victorious and not-so-victorious lawyers, and lawyers hoping to capitalize on their wisdom and prescience in matters of hotel-

[1] *Robert E. Woolley et al. v. Embassy Suites, Inc., et al.*, 227 Cal. App. 3d 1520, 278 Cal. Rptr. 719 (Cal. App. 1 Dist. 1991).

[2] *Pacific Landmark Hotel Ltd. et al. v. Marriott Hotels, Inc., et al.*, 19 Cal. App. 4th 615, 23 Cal. Rptr. 555 (Cal. App. 4 Dist. 1993).

[3] *Government Guarantee Fund of the Republic of Finland et al. v. Hyatt Corporation*, 95 F. 3d 291 (3rd Cir. 1996).

Michael C. Shindler, J.D., is executive vice president of The Plasencia Group (TPG), a Tampa-based hospitality-transactions and consulting-services firm. Prior to joining TPG, he served as senior vice president–development for Hyatt Hotels Corporation. During most of the pendency of the GGF v. Hyatt *case described in this article and throughout the period of Hyatt's management of the Hyatt Regency St. John, he was employed by Hyatt Hotels Corporation or its affiliates.*
The author gratefully wishes to acknowledge the editorial assistance of Margelia L. Jones, vice president, midwest region of TPG, and Donald A. Shindler, Esq., of Rudnick & Wolfe, Chicago, who critically reviewed his brother's efforts and made his firm's law library available for research.

© 1997, Cornell University

management agreements. After extensively reviewing this literature, though, I believe that no one yet has fully explained the rationale underlying the three decisions in a context useful for hotel investors.

Each of these cases arose in an appellate court, where review of findings of fact is circumscribed or non-existent and the question presented usually is whether the trial court correctly interpreted and applied the law. As these cases turned on relatively arcane points of law, it is little wonder that the parties settled in two cases (those involving Embassy Suites and Marriott). The Hyatt case, discussed in greater detail below, has been resolved in favor of the hotel owner, and the trial for determination of damages to be paid by Hyatt is pending.[4]

This article addresses these cases' potential effect on the relationships between owners and operators. It is not true that these cases stand for the proposition that the day has arrived when owners hold all the cards and that managers should be grateful merely for the opportunity to operate or brand an asset. The cases do, however, extend the swing of the pendulum of bargaining power in the direction of the owner.[5]

To begin by placing these cases within their legal context, virtually all hotel-management agreements create agency relationships, usually between the property's operating firm and its owner. An agent is, quite simply, anyone who undertakes to transact some business or manage some affair for another or by authority of another and to render an account of those transactions.[6] The chief characteristic of the agency is that one entity (the agent) represents another (the principal). Fundamental to all agency relationships is a series of duties, which one may not think of as legal obligations but which, like anything labeled a "duty," must have a basis in law. Among the agent's duties to the principal are the following, as found in the 1958 *Restatement of the Law, Second Agency.*[7]

- To be loyal, the precept that the agent acts for the good of the principal in all matters affecting the agency or the property which is the subject of the agency (¶387);
- To act strictly in accordance with the principal's manifestation of conduct (¶383);
- To obey the principal (¶385) (even where the terms of the agreement creating the agency proscribe the principal's giving directions! [¶385 (2)]); and
- To avoid dealing with the principal as an adverse party in a transaction connected with the agency (¶389).

None of those duties represents a new concept. Their purpose and derivation are clear. Since an agent acts for another regarding the other's property, the agent should do so only with the best interests of the principal in mind. If the agent and the principal disagree on how a matter should be handled, the principal should have the final say. Specific rights accrue to both parties regardless of the provisions of the agreements giving rise to the principal-agent relationship. As in most other areas of personal and commercial life, the law imposes its

A principal who employs an agent always retains the power to revoke the agency except in the case of an agency coupled with an interest...and defining what constitutes "an interest" is a complicated matter.

[4] *Ibid.*

[5] As discussed more fully in: James J. Eyster, "Hotel Management Contracts in the U.S.: The Revolution Continues," *Cornell Hotel and Restaurant Administration Quarterly,* 38, No. 3 (June 1997), pp. 14–20; and James J. Eyster, "Hotel Management Contracts in the U.S.: Twelve Areas of Concern," *Cornell Hotel and Restaurant Administration Quarterly,* 38, No. 3 (June 1997), pp. 21–33.

[6] *Black's Law Dictionary* (6th ed., 1990, p. 63) defines an agent as follows: "[a] person authorized by another (principal) to act for or in place of him; one intrusted with another's business."

[7] American Law Institute, *Restatement of the Law of Agency,* 2nd ed. (St. Paul, MN: American Law Institute Publishers, 1958), ¶383–389.

own rules and restrictions even where sophisticated parties might believe they are free to reach their own accommodations.

Termination. One such area of imposition by the rules of law is the notion that the principal has the power to terminate an agent at will.[8] Somehow, this principle escaped the notice of hotel-operating companies, which commonly wrote no-termination clauses into their contracts. When the California Appellate Court handed down its decision in *Woolley v. Embassy Suites,* in February 1991, however, its holding rocked management firms, particularly those whose lifeblood was long-term, ostensibly "no-cut" management agreements. *Woolley* was the first case to deal with the basic proposition that the principal has the power to terminate its agent in the context of a hotel-management agreement. This agreement was typical of the genre; it ran for a long time and under its provisions the owner ceded a great deal of operating authority to the manager. Until the *Woolley* decision, most owners and most managers believed that once the management agreement was signed the owners lost their say over their own properties.

Woolley v. Embassy Suites. Through partnerships, Bob Woolley and Chuck Sweeney owned 22 franchised Embassy Suites hotels, 17 of which were also managed by Embassy pursuant to individual management agreements.[9] In a lawsuit containing many allegations of mismanagement, Woolley and Sweeney also asserted that under the common law of agency (and California statute) they had the power to terminate the management agreements, even though provisions of the agreements themselves said they were irrevocable (absent default) and set forth specific dispute-resolution mechanisms, which Woolley and Sweeney did not use. Thus, Woolley and Sweeney claimed the power to terminate the agreements although the act of termination itself may have been a breach of the agreements.

Disregarding the claims and counterclaims regarding mismanagement, the California trial court ruled in favor of Embassy and granted an injunction against the threatened termination of the management agreements on the rationale that Woolley's group was circumventing the agreements' plain provisions. On appeal, the California Appellate Court reversed the trial court, dissolved the injunction, and ruled simply:

> It is a cardinal principle of agency law that a principal who employs an agent *always* retains the power to revoke the agency...[except] in the case of an *agency coupled with an interest* [emphasis added]. ...Because an agency depends upon the mutual assent of the parties, it may be renounced by either the principal or the agent at any time.

An "agency coupled with an interest" is one where the agency is either created for the benefit of the agent (such as the power of attorney in a mortgage or deed of trust, where the lender is given the power to act for the borrower, but really to protect itself) or given as a security (such as a pawnshop owner's right to sell a pawned item after a lapse of time).[10]

Embassy argued that its incentive fees gave it sufficient interest in the hotel as to make its agency one "coupled with an interest." Analyzing prior case law, the court looked for a "specific, present, and coexisting" interest of Embassy in the hotels owned by Woolley, did not find any, and told Embassy that its compensation [and that of any agent], regardless of the form it may take, cannot create an agency coupled with an interest.

Pacific Landmark v. Marriott. Since the decision in *Woolley* six years ago, many lawyers have made a lot of money attempting to determine and define when an agency is coupled with an interest. None has yet succeeded, although Marriott's lawyers tried valiantly.

Douglas Manchester, through entities called Pacific Landmark Hotel and Pacific Gateway, owned the San Diego Marriott Hotel, a large, twin-tower, convention hotel adjacent to the San Diego Convention Center.[11] Marriott managed the hotel for the Manchester group through two separate entities (one for each tower), under management agreements calling for a basic fee and an incentive fee. Two other Marriott entities, SDHI and Host International, made loans to the owners and received ownership positions (and tax losses) in differing percentages on the two towers. At a certain point in the relationships, Manchester sued Marriott claiming breach of the management agreements and subsequently gave notice to Marriott of the termination of the agreements. Marriott refused to leave the hotel, pointing to the management agreements' provisions of non-revocation.

As with *Woolley,* the trial court in *Pacific Landmark* noted the agreements' language specifically addressing the irrevocability in a manner favorable to Marriott and found in favor of Marriott, based solely on points of law. On appeal, the appellate court focused on whether Marriott's agency was "coupled with an interest." Narrowing to the

[8] American Law Institute, ¶119 cmt. a.

[9] The facts and holding of the case are taken from 278 Cal. Rptr., as cited above.

[10] W. Edward Sell, *Agency* (Mineola, N.Y.: Foundation Press, 1975), ¶229.

[11] As cited above in 19 Cal. App. 4th 615, 23 Cal. Rptr. 555–563.

At the San Diego Marriott Hotel and Marina (pictured above), Marriott tried valiantly—but failed, in the eyes of an appeals court—to create an agency coupled with an interest.

concept of "specific, present, and coexisting" highlighted in *Woolley*, the court said that to create a "coupled" interest "the power [of agency] and the interest must be coupled in four ways: **(1)** in time, **(2)** in subject matter, **(3)** in the same person, and **(4)** in source."[12]

Without saying what would couple an agency to make it irrevocable, the appellate court elaborated why Marriott's agency was not such. First, the agency was created for the benefit of the owners, not the Marriott management entities (the management agreements' language on this point was quite clear). Second, Marriott chose to use different entities to take different positions in the transactions. Third, Marriott's management entity clearly had no interest directly benefiting it in the properties. Therefore, Marriott's agency was not irrevocable.

Government Guarantee Fund v. Hyatt. Observing the four elements of "coupling" as enunciated in *Pacific Landmark*, Hyatt attempted to argue in *Government Guarantee Fund of Finland v. Hyatt* that these elements were present in 1990 when the management agreement for the Hyatt Regency St. John Resort was executed.[13]

Upon foreclosing the owner's interest but immediately prior to taking title to the hotel in 1995, GGF (the Finnish equivalent of the RTC and successor to SKOPBANK, a failed Finnish bank) sent notice to Hyatt purportedly terminating the property's management agreement. Several days later, GGF sued Hyatt, claiming mismanagement and alleging termination of the management agreement on the basis of its power under the common law of agency enunciated in both *Woolley* and *Pacific Landmark*.

Hyatt argued, in effect, that it had taken a long-term contract, a below-market basic fee, and an interest in

[12]*Op. cit.*, at 561.

[13]As cited above, 95 F.3d 291 (3rd Cir. 1996), *affirming* 166 F.R.D. 321 (D. Virgin Islands 1996). Facts and holdings of the case are taken from both sources.

The abstract elements of an agency coupled with an interest are known, but no hotel-management firm has yet created such an arrangement in practice.

the profits of the resort to obtain a significant return on its investment. That is, its investment of brand name, expertise, training programs, chain services, and reputation constituted sufficient participation in the resort as an "investment" to create a joint enterprise with the owners of the resort.

Acknowledging that an agent in a joint enterprise with its principal (if created concurrently and in the same entity) might, indeed, have an agency coupled with an interest, the court looked at the Hyatt management agreement to determine whether Hyatt's joint-enterprise argument could bear scrutiny. Both trial and appellate courts decided that the argument failed.

The trial court, the decision of which was upheld on appeal, said:

> [To be coupled], it is necessary that the interest be in the subject matter of the power and not in the proceeds which will arise from the exercise of the power. ...The person clothed with the authority must derive a present or future interest in the subject itself. ...In short, the test is: Does the agent have an interest...in the subject matter [the resort] independent of the power conferred, or does the interest...accrue by...the exercise of the power?[14]

The court concluded that the agency itself cannot create the interest necessary for a "coupling," there was no joint enterprise, and "Hyatt's only asserted interest is in the compensation due it as manager, the benefit to its reputation, and an enhanced presence in the Caribbean." As in *Woolley,* these factors were determined to be elements of compensation that did not support Hyatt's claim "that the agreements were entered into for the benefit of Hyatt as opposed to the benefit of the owners."

[14]95 F.3d at 301.

What the Cases Mean

Against the backdrop of the case holdings set forth, five points arise:

(1) Most management agreements, regardless of the terms of the contracts themselves, are revocable by the owner as a matter of long-settled holdings of law.[15]

(2) Management agreements are also subject to being renounced by the manager, so termination is not a one-way street.[16]

(3) If the termination is in breach of the written agreement, the breaching party (that is, the terminating party) may be liable for damages.[17]

(4) None of the cases resolves the issue of the calculation or measure of damages. *Woolley* and *Pacific Landmark* both settled before trial; *Hyatt* is in pre-trial on the damages issue, with the trial date uncertain at this writing. Because courts and juries historically have been able to fix damages for breach of contract, they should be able to do likewise for damages relating to breach of a management agreement.

(5) Invariably, the terminating party will claim a default by the other party, although that claim is not essential for terminating an agreement. So far as I know, no management firm has availed itself of the common-law right of terminating an agency established by a management agreement against the owner's wishes.

Looking Ahead

The full effect of these cases on management agreements has yet to be realized. Eventually a case may go

[15]Warren A. Seavey, *Handbook of the Law of Agency* (St. Paul, MN: West Publishing Co., 1964), ¶46.
[16]American Law Institute, ¶118.
[17]Reuschlein and Gregory, ¶43, 44.

to trial and a judge or jury may find that the terminated party did not default and that the termination of the agreement by the other was a breach of contract. Only then will there be an indication of the effect of these cases on the owners and management firms. If court-determined damages in such a hypothetical instance prove to be substantial, owners' hands will once again be effectively tied—especially if the owner has the deep pockets that invite large damage settlements. If damages prove to be relatively mild in such a case, on the other hand, owners might feel new-found flexibility with regard to their managers.

Individual circumstances would be critical to the determination of any damages. Damages would probably be modest in the case of an owner's termination of a short-term manager or one that is certain to fail a performance standard (and offers no cure of that shortfall). On the other hand, if the owner terminates an agreement that still has a long term remaining, damages could be considerable—particularly if the manager is meeting performance goals. Whether the owner is prepared to risk a large damage claim depends on the owner's appetite for that risk and its ability to fulfill the damage award.

These decisions have altered the current climate of management-agreement negotiations, adding to the effects of competition among management firms for properties to manage. The case holdings represent one more weight in the negotiating balance. On existing deals, the owner and the manager may need to reassess the weight of damages (in the case of termination without cause) against other contract provisions. An owner might attempt to negotiate reduced base and incentive fees in exchange for granting an extended contract term. A management firm seeking an extended term might, nevertheless, trade off some years on the contract for a large termination payment (in lieu of leaving the issue to a trial).

Agency with interest. For a new management agreement, a manager might seek to structure an agency coupled with an interest. The abstract elements of an agency coupled with an interest are known, but no hotel-management firm has yet created such an arrangement in practice. The following are the elements that almost certainly must be in place.

- The manager must make an investment in the property, through an interest in the owning entity.[18]
- The investment in the owning entity and the execution and delivery of the management agreement should be concurrent.[19]
- The agreement must state the parties' true intention that the agency is protecting some right of the agent and is for the benefit of the agent. (Merely extending a brand has not constituted a sufficient benefit.)[20]
- The manager and its investor must be the same entity. An affiliate or subsidiary for investment or tax purposes will not do, as Marriott discovered.[21]
- The owning entity (that is, the entity in which the manager is an investor) must grant the agency authority to the manager.

It is by no means certain, however, that even following these steps will accomplish the manager's goal of creating an agency coupled with an interest.

The most conceptually difficult of the stated tests is the one requiring the agency to be created for the benefit of the agent. Interestingly, the very thing that many property owners have been requesting of management firms, namely, a substantial investment by the operator (to put the operator and the owner on the same side of the table), may ironically eliminate the owner's power to terminate the manager, even if that termination is in violation of the agreement. If an investment by the operator is a critical step to attaining an agency coupled with an interest, which is thus an irrevocable agency, why then would the owner expose itself to that risk? When an owner asks its manager to become its partner, that owner may be eliminating the power the law otherwise gives it and removing an important negotiating weight. At the same time, a tiny equity investment by the operator (say, 5 or 10 percent) may be determined to be insufficient for agency with interest.

It is most likely that *Woolley, Pacific Landmark,* and *Hyatt* are not a collective invitation to owners to rush to terminate management agreements.[22] They represent leverage, another tool in the toolbox of management-agreement negotiations. Like any tool, they need to be used carefully and wisely. They can, however, be used to bludgeon rather than to excise. Hotel investors should know the difference. **CQ**

[18]Although *Pacific Landmark* did not state categorically that Marriott would have had a coupled agency had it used its management entity as its ownership entity, it is clear that its failure to do so was fatal to its case. See: *Pacific Landmark Hotel Ltd. et al. v. Marriott Hotels, Inc., et al.*, supra. In its agreement with Pacific Landmark, Marriott stated that the agency was "coupled with interest" and thus not revocable. Marriott's foresight in 1987 is notable although its execution of agency with interest was not perfect.

[19]23 Cal. Rptr. at 561.

[20]"[E]ven if the parties intended to create an irrevocable agency, one coupled with an interest, unless they do so and such an interest does in fact exist, the...power to revoke may be exercised." *Ibid.*

[21]23 Cal. Rptr. at 563.

[22]The appellate court's findings in *Hyatt* that Hyatt Corporation *breached* the management agreement do not contradict this point. Had the court not determined that a breach by Hyatt had occurred, the GGF parties may well have been found to have breached the agreement and thereby exposed themselves to a large damage claim.