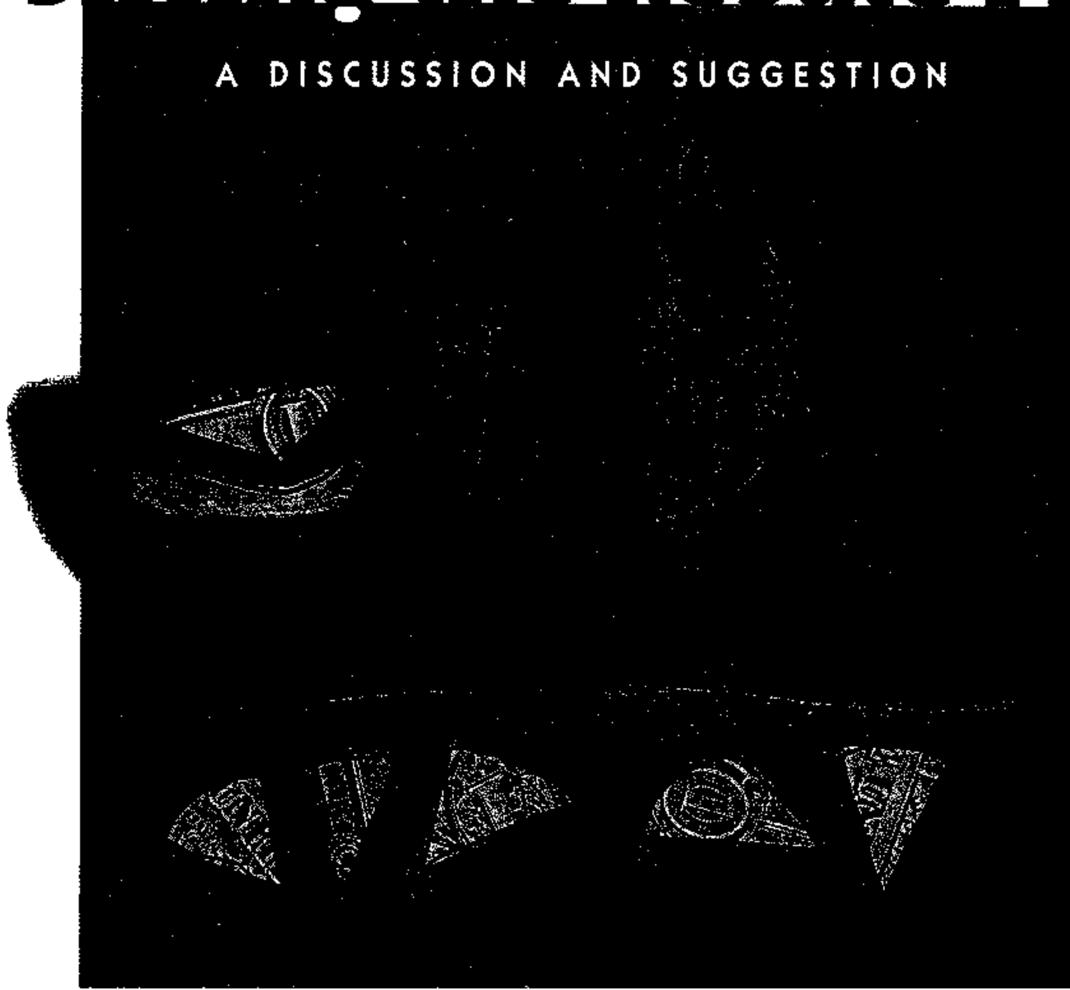
Slicing the Rebate Pie

A DISCUSSION AND SUGGESTION



JAMES YANG/SIS

BY MICHAEL C. SHINDLER & DONALD A. SHINDLER

The hospitality industry is reeling from recent legal rulings concerning entitlement to vendor rebates, fees, discounts, and credits. As courts rule that common practices within the industry are illegal, hotel management companies may face claims for huge damages and the possibility of cancelled contracts. The issue is simple: To whom do the benefits of volume purchasing discounts or vendor rebates and credits belong?

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Over the past few decades, many hotel management companies have established affiliated purchasing companies or divisions as profit centers to serve the operation of the companies' managed hotels. Chain management companies particularly engage in this practice, for they exercise control over the purchase of furnishings, fixtures, and equipment; operating equipment; and food and beverage. A management company's control over these items helps to maintain consistency in quality and appearance throughout the chain. Moreover, if the hotel purchased these materials through an unrelated, third-party purchasing firm, that firm would certainly assess a fee against the hotel. The management firms conclude, therefore, that using their own purchasing companies and charging competitive fees for the purchasing service should be acceptable.

Management firms have long employed this practice to obtain FF&E, and most management contracts expressly provide for it. These contracts usually have two limitations. First, the fee must be lower than the fee charged by third-party purchasing companies and lower than the fee the management company's purchasing affiliate charges to other operated hotels. Second, the aggregate price of the goods, including the fee, must not exceed the charges the hotel would have incurred had the hotel used an independent third-party purchaser.

For purchases of OE, however, the practice varies. Many suppliers have negotiated rebates for volume purchasing rather than discounts on a per-order basis. These suppliers base the rebate on the aggregate dollar volume of goods the management firm bought for all of its hotels. Management companies have come to treat the rebate as belonging to them in lieu of charging the hotel a purchasing fee.

Those management firms that operate F&B facilities in their hotels also may have similar arrangements with vendors of F&B items, which benefits both the hotel owners and the management company. The hotel benefits from a volume purchasing arrangement made at the management company level, almost certainly paying less for potatoes than if the executive chef purchased the potatoes from a local purveyor. The management company keeps the rebate as a fee for arranging the transaction and for assuring the potato purveyor a steady source of vending opportunities for its potatoes.

This rebate arrangement is less longstanding in the hotel industry than purchasing fee arrangements, and recently has caused owners to inquire into and examine the practices of management firms. In response to increasing scrutiny from owners, several chain management firms have begun to disclose expressly the existence of the rebate practice in their proposed management term sheets for new hotel transactions and annual plan reports to investors and owners of existing properties. This disclosure typically describes the practice of the management company in general, but does not include any estimates of amounts allocable to individual hotel properties, although such an allocation is certainly possible.

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Owners have begun to assert that mere disclosure of these practices, without more information, is insufficient, because management companies typically do not disclose the amount they receive from individual hotels. Even if the management companies disclose the rebates, owners argue, the management contracts do not permit the management companies to keep the rebates. In addition, owners allege that arranging volume purchasing contracts is among the reasons the management company was hired in the first place, and that the rebates are nothing more than disguised management fees, taken without consent, in excess of those negotiatied in the management agreement.

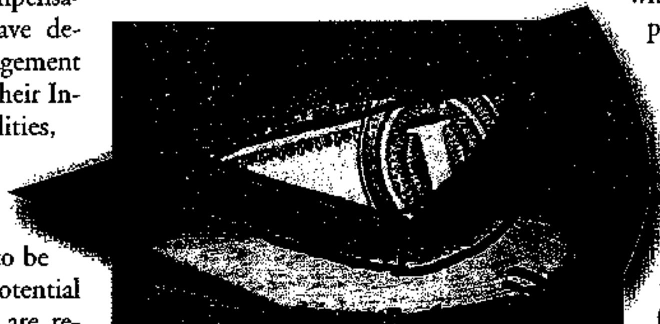
Management firms counter that these arrangements are not a component of operating hotels and that they have incurred expense in negotiating these arrangements. Moreover, they provide the service of overseeing the volume purchasing contracts and administering quality controls necessary to maintain them. Management firms reason that the rebate structure simply eliminates the purchasing fee arrangements otherwise permitted in the governing management agreements. From a practical standpoint, management companies point out, they do not maintain records indicating how much of the aggregate rebate is attributable to an individual hotel. Finally, the materials need to be purchased in

any event, and the total cost to the hotel is less under the existing practice even when the management companies retain the rebate.

Faced with increasing challenges to these practices and the possibility of losing the rebates and compensation upon which they have depended for so long, management companies are expanding their Internet purchasing capabilities, which may increase savings and make their value-added compensation systems appear to be reasonable. Among the potential benefits of online buying are reduced prices, streamlined processes, and improved service. Traditional purchasing arrangements are not the only means to use the Internet to increase savings. Forrester Research predicts that trade via real-time models like auctions and exchanges will grow 25-fold over the next five years—reaching $746 billion in 2004. Management companies capable of purchasing effectively on the Internet can increase savings to their managed hotels at the same time as they lay claim to increasing pieces of the larger rebate pie.

State of the Law

A quartet of cases has led to the questioning of traditional management contracts. First, in 1991, a California court of appeals ruled that the relationship between a management company and a hotel owner is "one of agency and the principal always retains the unrestricted power to revoke the agent's authority." Two years later, another California court of appeals granted a preliminary injunction to the owners of a hotel managed by Marriott, reaffirming the 1991 holding that hotel management contracts create a revocable agency relationship. In 1996, the Third Circuit followed the lead of the California courts in ruling that a hotel owner unilaterally may terminate a hotel management contract. Finally, in 1999, the Delaware jury in the Woodley Road case returned a $51.8 million verdict against Sheraton for breach of the fiduciary duty owed a hotel owner as the owner's agent.



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Agency law provides the basis for these recent decisions holding management companies liable for retaining rebates, as the relationship of a manager to an owner is that of an agent to its principal. The duty of loyalty is one of the overriding obligations of an agent to its principal: "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."

Owners who claim that their managers have violated their fiduciary duties invoke two corollary principles of agency law. First, an agent has a duty not to deal with his principal as an adverse party in a transaction connected with his agency without the principal's knowledge. Second, an agent acting on his own account has a dual duty to deal fairly with the principal and to disclose all facts that might affect the principal's judgment in giving its consent. Taken together, these fundamentals of agency law require that an agent in a potential conflict of interest with its principal must disclose fully all the relevant facts and treat its principal fairly, and that the principal must manifest its consent to the agent's dealing in the conflicted situation. Complete disclosure leading to informed consent in the hotel management context would include a statement of the value of rebates attributable to operation of a given hotel, if not an item-by-item explanation of the derivation and magnitude of the various rebates. In the case of a new transaction, which may require an owner's consent in advance, perhaps the terms and an estimate of the anticipated amount of the rebate would suffice when followed by appropriate reporting.

Regardless of whether current management contracts explicitly require disclosure or consent, agency law likely imposes a duty on management companies to make disclosure and obtain consent to these practices.

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A case pending in the Delaware District Court alleges that Hyatt employed many of the same practices that formed the basis of the Sheraton

award. The complaint seeks $8.9 million in retained rebates and actual damages, as well as punitive damages and the termination of Hyatt's management contract. The Hyatt action appears to substantiate the speculation of industry experts, who predicted that Sheraton would lead to many similar cases against management companies.

Perhaps even more importantly, in accord with agency law (but not with industry practice), owners can terminate management contracts unilaterally without paying any penalties if they can demonstrate that the management company was in default. If, however, a management company can demonstrate that its agency is coupled with an interest, the management contract may not be terminable solely upon the owner's whim.

Courts have struck down most of the defenses management companies attempt to use against suits filed by hotel owners. Most management agreements call for "notice and cure" periods—if the owner believes the manager is in default he must give the manager notice and time to cure the alleged default. One court recently ruled, however, that if an agent engages in self-dealing he is not entitled to a notice and cure period because such actions are a fundamental breach of the duty of loyalty. In other very similar cases, however, courts have ruled that a notice and cure period is required even where an agent engaged in self-dealing. This disagreement between courts may be resolved in the pending Hyatt action, as, in its motion to dismiss the complaint, Hyatt claims that it is entitled to a notice and cure period.

Deaggregation: A Recommendation

If full disclosure is made and the parties desire to reach an agreement, the following recommendation is offered for consideration. Since the additional purchasing fees and rebates obtained by hotel management companies provide compensation in addition to the negotiated management fees, an owner may choose to permit the manager to receive a certain level of additional compensation. The manager should be required to disclose fully all fees and rebates including credits or discounts as they occur and as related to the hotel property in question. Anything that can be aggregated can also be deaggregated; if the owner requires that the management company attribute fees to individual hotels, the management company should be able to comply. The owner and the manager can agree on a cap on the amount of additional compensation that the management company can earn from these miscellaneous fees and rebates (or upon a total compensation including management fees). Fees and rebates above the limit can be allocated between the owner and manager in agreed proportions or entirely to the owner. The amount of the limit, calculated by dollars or by a percentage of revenues (analagous to the basic management fee), would vary from transaction to transaction and from owner to owner. Purchases of FF&E, particularly in conjunction with a major renovation or refurbishment, can be dealt with separately, and the management agreement should so provide.

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Rather than argue over the legal rights and obligations inherent in a complex management agreement, slicing the pie as suggested in this article may remove the legal underpinnings of a dispute before litigation is necessary. Since these self-dealing claims arise from the confluence of the owners' hotels in conjunction with the management companies' purchasing power and administrative and organizational contribution, it seems equitable that both parties share in the rewards. Thus, neither the industry nor its participants need to resort to unseemly allegations and finger-pointing in circumstances where equitable solutions, along the lines suggested in this article, might provide just desserts to all. ■

Donald A. Shindler is a partner in the real estate department of Piper Marbury Rudnick & Wolfe in Chicago. Michael C. Shindler is vice president of development, Americas, for Mandarin Oriental Hotel Group. Previously, he served as executive vice president of the Plasencia Group and as senior vice president of development for Hyatt Hotels Corporation.
The authors wish to thank Amy J. Collins (J.D. candidate, 2001, University of Virginia), summer associate at Piper Marbury Rudnick & Wolfe, for her research and writing contributions in this article.

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