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Market Impact in the Information Age: Protecting Hotel Owners from Hotel Management Companies

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I. INTRODUCTION

The Dominion Post headline asked, “Can Morgantown support 41 movie screens?”¹ Quadrupling the number of movie screens in Morgantown may provide moviegoers with more options; however, the business viability of these theaters is questionable.² In any industry, each new entrant increases the

² Id.
risk of market saturation. While market saturation among competitors may be expected, owners taking from their own businesses’ market share is not. This is essentially the result forced upon franchisees when their franchisors encroach upon them. In franchising, encroachment occurs when a franchisor continues granting or opening new franchises within a particular geographic area to the point of taking sales from an existing franchise. Consider the situation of Laurence Geller, the owner of the California Ritz-Carlton Laguna Niguel, operated by Marriott International. After Mr. Geller complained about various Marriott practices, Marriott, who also owns the Ritz name, responded with a Ritz clone three miles up the coast. While this meant certain lost bookings for Geller’s Ritz, Marriott, which makes its money mostly from fee income, would only benefit. In fact, “[m]anaging two hotels on a prime stretch of Pacific coastline would increase Marriott’s bottom line even if neither property made money for the owners. That’s the beauty of being a hotel franchisor or operator, which Marriott is, rather than an owner of hotel buildings, which Geller is.” Hotel management companies, such as Marriott, enter into operating agreements with hotel owners, who use the management company trade name and operating standards to operate the hotel. The management companies then have access to sensitive, competitive information that may enable them to act to the detriment of, or even compete against, the hotel owner.

Geller and others in similar positions have argued that Marriott has a “fiduciary duty” to them, which would require Marriott to act in the best interest of its owners. The hotel industry is unique in its intertwined nature of franchise and management relationships; however, courts have frequently rejected the existence of a fiduciary relationship between franchisors and franchisees.

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3 Market saturation occurs when a product has been so widely distributed within a market that competitors can only achieve sales growth through population growth or taking market share at the expense of a competitor. Wikipedia, the Free Encyclopedia, Market Saturation, http://en.wikipedia.org/wiki/Market_saturation (last visited Oct. 30, 2005).

4 Market share is the proportion of industry sales of a good or service that is controlled by a company. The American Heritage Dictionary of the English Language 1072 (4th ed. 2000).


7 Id.

8 Id.

9 Id.

10 Online Interview with K.C. McDaniel, Partner, Katten Muchin, Zavis, Rosenman LLP (Jan. 5, 2005).

11 Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., ITT, 139 F.3d 1396, 1402 (11th Cir. 1998).

12 Fitch, supra note 6, at 72.
including in the encroachment context.\textsuperscript{13} In the hotel industry though, encroachment does not take place only within a single, geographic market. With large convention or resort hotels, encroachment, or “impact” as it is known in the industry, can take place on a national or even an international scale. Additionally, with management companies’ access to hotels’ billing rates, guest lists, reservation systems, and other proprietary information, the potential for abuse is staggering. As technologies which facilitate this abuse continue to progress, courts and legislatures must act to prevent hotel management companies from capitalizing on the conflicts of interest inherent in their relationships with hotel owners.

This Note seeks to briefly examine the history of the franchise relationship in the encroachment context, the nature and operation of hotel management agreements, and the need for a quasi-fiduciary duty between hotel brand management companies and hotel owners. Part II discusses generally the nature of the relationship, the problem of encroachment, and the various ways courts have protected franchisees. Part III looks at the hotel industry, both from a franchising and an operating agreement perspective. It then explores the inherent problems of the operating agreement system in greater depth. Part IV argues for the need for greater protection of hotel owners from abusive hotel management companies. Courts and legislatures should impose duties on management companies toward their hotel owners to disclose risks, protect the owners’ investments, and not engage in self-dealing detrimental to hotel owners through the use of the owners’ proprietary information. Part V summarizes the key points and arguments of the Note.

II. THE FRANCHISE RELATIONSHIP AND REGULATION

A. The Franchise Relationship and the Encroachment Problem

1. The Franchise Relationship

A franchise relationship is created when a franchisor, who owns a trademark or trade name, grants a franchisee the right to engage in the business of the franchisor, using the particular trademark in a certain area.\textsuperscript{14} The business may be selling goods or providing services.\textsuperscript{15} The Code of Federal Regulations (C.F.R.) describes a franchise as a “continuing commercial relationship . . . whereby” the franchisee sells goods or services which “are identified by a trademark [or] trade name,” where the franchisee is “required or advised to meet quality standards prescribed by” the franchisor, who “has authority to exert a significant degree of control over the franchisee’s method of operation, includ-


\textsuperscript{14} BLACK'S LAW DICTIONARY 683 (8th ed. 2004).

\textsuperscript{15} Id.
ing but not limited to the franchisee’s . . . management [and] marketing plan.”

This seemingly convoluted description of franchising is actually quite telling. First, the C.F.R. envisions a continuing relationship where the franchisee gets to use the trade name for a certain period of time. Franchise agreements, the contracts which create the franchise relationship and establish the terms and conditions, typically provide for a ten to twenty year business relationship. Second, the franchisor is able to exert a significant amount of control over the franchisee, requiring him or her to conform to established standards for quality, marketing, and other franchise norms.

The federal trademark law, the Lanham Act, requires licensors (franchisors) to exercise quality control over the licensee (franchisee) or risk the loss of the trademark. Protecting the quality of the brand is not just required, but mutually beneficial to the parties. For this reason, franchising has been described as “the perfect marriage between big business and the small businessman: the franchisor obtains new sources of expansion capital, new distribution markets, and self-motivated vendors of its products, while the franchisee acquires the products, expertise, stability, and marketing savvy usually reserved only for larger enterprises.”

Therefore, these standards ensure that each franchisee keeps the brand strong on a local level, so that the aggregate reputation of the brand remains strong and goodwill continues to grow. In turn, the franchisor uses its superior marketing resources to promote this strong brand, bringing customers to the local franchises to obtain the advertised brand’s good or service. This mutually beneficial “perfect marriage” works well, until the interests of the parties begin to diverge.

2. The Encroachment Problem

Franchisors typically want to continue market expansion to enhance brand recognition, yet at some point this market expansion has a negative impact on the sales of an existing franchise. The market becomes saturated with the franchise’s product and existing franchises begin to lose sales to other franchises of the same type. Because there are more of the franchises, the franchisor

17 Rust, supra note 5, at 527.
20 Rust, supra note 5, at 492 (quoting David J. Kaufmann, Business Strategies and Compliance Issues, FRANCHISING 1990, at 15, 17 (1990)).
21 Subway restaurant chain, which was recently named the number one franchise opportunity in Entrepreneur magazine’s 2005 Franchise 500 listing, is an example of a traditional fast food franchise. Entrepreneur.com, Entrepreneur’s 26th Annual Franchise 500, http://www.entrepreneur.com/franchise500 (last visited Oct. 25, 2005).
22 Rust, supra note 5, at 490.
23 Id.
continues to achieve the desired goal of enhanced brand recognition. Most importantly, because franchisors often make a large percentage of their royalties from a percentage of sales, rather than profits, this creates a direct conflict of interest between franchisors and their franchisees. Franchisors want to continue expansion as long as total sales among franchisees are increasing, or even remaining constant, although the sales of each individual franchisee may be decreasing. This conflict of interest is the essence of the encroachment problem. The common defense of the franchisors is freedom to contract. Franchise agreements can contain territorial provisions which indicate whether the franchisee has been granted an exclusive territory or not. Where the franchisee has not been granted an exclusive territory, franchisors feel that it is their contract right to expand into that market.

B. **Fiduciary Duty, Agency, and the Franchise Relationship**

1. **Fiduciary Duty and Franchises**

A fiduciary relationship arises when one party, the fiduciary, is under a duty to act for the benefit of another party, the beneficiary. A fiduciary duty is "a duty of utmost good faith, trust, confidence, and candor...a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person." Some examples of fiduciary relationships are trustee-beneficiary, guardian-ward, principal-agent, and attorney-client, and these relationships require "an unusually high degree of care." The Restatement of Agency states that "an agent is a fiduciary with respect to matters within the scope of his agency," meaning the principal is the beneficiary of the relationship. Among the specific duties of an agent to the principal are the duties to act "solely for the benefit of the principal in all matters connected with

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24 *Id.* See also Fitch, *supra* note 6.
25 *Rust, supra* note 5, at 490.
26 *Id.* at 490-91. *See also RESTATEMENT (SECOND) OF CONTRACTS*, Chapter 8, Unenforceability on Grounds of Public Policy, Introductory Note (1981) ("The principle of freedom of contract is itself rooted in the notion that it is in the public interest to recognize that individuals have broad powers to order their own affairs by making legally enforceable promises.").
27 An exclusive territory is "a geographical area specifically designated as the exclusive territory" of a particular franchisee. *Rust, supra* note 5, at 510. Within the exclusive territory, franchisors are prohibited from establishing any new franchises or similar businesses. *Id.*
29 *BLACK’S LAW DICTIONARY* 1315 (8th ed. 2004).
30 *Id.* at 545.
31 *Id.* at 1315.
32 *RESTATEMENT (SECOND) OF AGENCY § 13 (1958).*
the agency [and to] not act secretly in the same transaction on the agent’s own account or act for an adverse party without the principal’s consent. 33

Franchisees have long tried to argue that, because of the mutually dependent nature of the relationship, franchises should constitute a fiduciary relationship. 34 For example, in Arnott v. American Oil Co., which concerned a major oil company franchisor and a service station dealer franchisee, the court found that because both parties have a common interest in the profitability and goodwill of the venture, a fiduciary duty is inherent in a franchise relationship as a matter of law. 35 However, Arnott was a wrongful termination case, and except in that context, courts have nearly universally found that there is no general fiduciary relationship in the franchise setting, even in the encroachment context. 36

In Domed Stadium Hotel, Inc. v. Holiday Inns, Inc., 37 the franchise agreement stated that it was not an exclusive license, that is, there was no territorial protection for the franchisee, and that Holiday Inns, the franchisor, “may construct and operate one or more Holiday Inns at any place other than on the site licensed [to franchisee].” Then, when Holiday Inns purchased a competing hotel and converted it into a rival Holiday Inn, thus competing with the plaintiff-franchisee, the franchisee alleged that this was a violation of the franchise agreement. 38 The court found however, that there was no general fiduciary obligation imposed upon franchisors, and therefore no breach of that duty. 39 The general argument against finding a fiduciary duty is the same argument against inferring any territorial protection: potential impairment of the parties’ freedom to contract. 40

2. The Agency Relationship and Franchises as Agencies

An agency is a fiduciary relationship that results when a principal gives an agent permission to act on his behalf and subject to the principal’s control, and the agent agrees to act as such. 41 A principal is liable for any torts an agent commits while acting in the scope of their employment. 42 Courts have typically

33 HARRY G. HENN, AGENCY, PARTNERSHIP AND OTHER UNINCORPORATED BUSINESS ENTERPRISES 186 (2d ed. 1985).
35 609 F.2d 873, 881-82 (8th Cir. 1979).
36 See, e.g., Broussard, 155 F.3d at 348; Domed Stadium Hotel, 732 F.2d at 485.
37 Domed Stadium Hotel, 732 F.2d at 483.
38 Id. at 484.
39 Id. at 485.
40 Rust, supra note 5, at 491. See also Fitch, supra note 6.
41 RESTATEMENT (SECOND) OF AGENCY § 1 (1958).
42 See id. § 219.
found franchises to not be agency relationships, unless the franchisor exerts too much control over the franchisee.\textsuperscript{43} This creates a dilemma for franchisors, who have to exert enough control to adequately protect their trademark under the Lanham Act, yet not exert too much control so as to be found a principal, and thus become liable for the torts of their franchisees. It is important to note that, even if franchisors try to disclaim an agency relationship in the franchise agreement, the courts may still find an agency relationship exists.\textsuperscript{44}

C. \textit{The Implied Covenant of Good Faith and Fair Dealing}

With no relief from the courts for franchisor encroachment under a fiduciary duty theory, franchisees have sought relief under a duty of good faith and fair dealing. Courts commonly state that “in every contract there exists an implied covenant of good faith and fair dealing.”\textsuperscript{45} This implied covenant has been explained as meaning that neither party will act to injure the rights of the other party to receive the fruits of the contract.\textsuperscript{46} Particularly in contracts which confer on one party a discretionary power affecting the rights of the other, “a duty is imposed to exercise the discretion in good faith and in accordance with fair dealing.”\textsuperscript{47} The Uniform Commercial Code (U.C.C.) defines good faith as “honesty in fact and the observance of reasonable commercial standards of fair dealing.”\textsuperscript{48} However, most courts allow parties to elaborate the scope of the duty, or to even effectively write the good faith requirement out of the contract.\textsuperscript{49} In \textit{Domed Stadium Hotel}, for example, the court found that because the franchise agreement was not an exclusive agreement, and because it granted Holiday Inns the right to operate other Holiday Inns, this was not a breach of the implied obligation of good faith.\textsuperscript{50} With regard to the implied covenant of good faith, the court stated, “[t]he implied obligation to execute a contract in good faith usually modifies the express terms of the contract and should not be used to override or contradict them.”\textsuperscript{51}


\textsuperscript{44} \textit{Brown, supra} note 19, at 667. \textit{See also infra} notes 97 and 98 and accompanying text.

\textsuperscript{45} \textit{Kirke La Shelle Co. v. Paul Armstrong Co.}, 188 N.E. 163, 167 (N.Y. 1933); \textit{Restatement (Second) of Contracts} \textsection 205 (1981).

\textsuperscript{46} \textit{Kirke La Shelle}, 188 N.E. at 167.


\textsuperscript{48} \textit{U.C.C.} \textsection 1-201(20) (2004).


\textsuperscript{50} \textit{Domed Stadium Hotels, Inc. v. Holiday Inns, Inc.}, 732 F.2d 480, 485 (5th Cir. 1984).

\textsuperscript{51} \textit{Id.}
Two years after Domed Stadium Hotel, Inc., in the Illinois case of Patel v. Dunkin' Donuts of America, Inc., the franchisee brought suit alleging breach of the implied covenant of good faith and fair dealing based on another non-exclusive franchise agreement when Dunkin’ Donuts planned to construct a competing franchise within one mile of plaintiff's existing franchise. The franchise agreement in Patel, like the one in Domed Stadium Hotel, Inc., also granted the franchisor the sole discretion to operate or franchise other Dunkin’ Donuts shops. The plaintiffs urged that they were not claiming entitlement to territorial exclusivity, but rather that the defendants' conduct denied plaintiffs the fruits of their franchise agreement, a breach of the implied covenant of good faith and fair dealing. The court found that the implied covenant of good faith and fair dealing is generally implied in every contract, however, it can essentially be written out by express terms. Therefore, here, where the contract permitted defendants' "unrestricted competition," the court found no breach of the implied covenant of good faith, even where significant encroachment was expected.

After these rather narrow constructions of the implied covenant of good faith, some courts showed their willingness to "back in" to an implied covenant breach where the franchise agreement does not explicitly state the franchisor's right to establish competing franchises. In Scheck v. Burger King Corp., for example, the franchise agreement specifically stated that the franchisee had no exclusive territorial protection, yet did not expressly state that Burger King could establish other franchises at any desired location. Therefore, because the agreement did not affirmatively grant Burger King the right to encroach upon the franchisee, the court found an opportunity to apply the implied covenant of good faith and fair dealing as a gap filler, to prevent Burger King from encroaching upon its franchise. Although the Scheck opinion has been criticized and distinguished, it has been followed where franchise agreements are silent as to the rights of franchisors.

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52 496 N.E.2d at 1159-60.
53 Id. at 1159.
54 Id. at 1160.
55 Id.
56 Id. at 1161.
57 Id.
59 Scheck, 798 F. Supp. at 694.
60 Id.
61 See, e.g., Camp Creek Hospitality Inns, 139 F.3d at 1403 n.6; In re Vylene Enters., Inc., 90 F.3d 1472, 1477 (9th Cir. 1996).
D. Other Means of Franchise Regulation

Besides judicially created remedies, states legislatures have also taken steps to regulate the franchise relationship and prevent franchisor abuses. Many states have adopted industry-specific legislation to regulate franchise relationships, such as in the automobile industry. Several states have also enacted franchise relationship laws to monitor the ongoing relationship between franchisees and franchisors, primarily to prevent arbitrary termination, but also encroachment. One of the most potent regulations affecting franchisors however, has been franchise disclosure laws. These laws require franchisors to disclose detailed information to potential franchisees concerning practically every aspect of the franchise system, including territorial restrictions to protect against encroachment. The most effective part of the disclosure laws are the requirements that franchisors disclose information regarding the history of criminal and civil litigation within the franchise system, alerting potential franchisees that a franchise system has been plagued with complaints of abusive practices. The threat of disclosure to potential franchisees serves as a strong deterrent to franchisors when considering whether to engage in questionable practices toward its franchisees.

E. Summary of Franchise Regulation and Encroachment

Courts have recognized a fiduciary relationship for wrongful termination of a franchise agreement, yet have most often relied on the implied cove-

62 Rust, supra note 5, at 503.
63 Id.
64 Id. at 509.
65 Id. at 506-08.
67 Rust, supra note 5, at 506-08.
68 Id.
69 See Cahn, supra note 66. All states have now adopted the Uniform Franchise Offering Circular (UFOC), but that these disclosure requirements are much more effective when applied in conjunction with state laws that ensure proper compliance. Id. Thirteen states, including Maryland, have adopted these stricter state laws. Id.
70 Arnott v. Am. Oil Co., 609 F.2d 873 (8th Cir. 1979).
nants of good faith and fair dealing to protect franchisees in the encroachment context.\textsuperscript{71} These cases have not been well received,\textsuperscript{72} and have required the courts to use a "backing in" type analysis to achieve the desired result.\textsuperscript{73} This gap-filler approach works when contracts are silent about exclusive territory protection. Unfortunately, most franchise agreements do not leave many holes for franchisees to attack, and courts have found that the covenant of good faith may not be used to rewrite or override the express terms of a contract.\textsuperscript{74} There are now franchise regulations in many states, such as franchise disclosure laws, that protect against many franchisor abuses.\textsuperscript{75}

III. THE HOTEL FRANCHISE SYSTEM/OPERATION MANAGEMENT ARRANGEMENT

The hotel franchise industry began with two distinct types of franchisors. There were traditional franchisors, known as brand companies, and there were management companies.\textsuperscript{76}

A. Brand Companies

Brand companies' operations, for example, Howard Johnson and Holiday Inn, were very similar to traditional franchisors, such as fast food restaurants.\textsuperscript{77} The companies provided owners with the franchise name, trademarks, etc. and established certain guidelines for hotel owners to follow in accordance with the franchise system.\textsuperscript{78} Owners were responsible for managing the hotel themselves, in accordance to the franchise standards, like most franchisees.\textsuperscript{79} As with most franchises, these arrangements were found not to amount to a fiduciary relationship, or an agency relationship.\textsuperscript{80} Therefore, these brand companies have traditionally been subject to ordinary franchise regulation such as disclosure laws.\textsuperscript{81} Most encroachment issues are determined in the franchise

\textsuperscript{71} See, e.g., Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., ITT, 139 F.3d 1396 (11th Cir. 1998); Scheck v. Burger King Corp., 798 F. Supp. 692 (S.D. Fla. 1992).


\textsuperscript{73} See Camp Creek Hospitality Inns, Inc., 139 F.3d 1396, Scheck, 798 F. Supp. 692 (relying on silence of agreement as to franchisors' explicit right to create competing franchises within a certain proximity of franchisees).


\textsuperscript{75} Rust, supra note 5, at 506-08.

\textsuperscript{76} Online Interview with K.C. McDaniel, supra note 10.

\textsuperscript{77} Id.

\textsuperscript{78} Id.

\textsuperscript{79} Id.

\textsuperscript{80} See, e.g., Domed Stadium Hotels, Inc. v. Holiday Inns, Inc., 732 F.2d 480 (5th Cir. 1984).

\textsuperscript{81} Online Interview with K.C. McDaniel, supra note 10.
agreement, with the franchisee either being granted an exclusive territory or not.\textsuperscript{82} As in the Sch\textsuperscript{e}ck case, where the contract is silent as to the franchisor’s rights to encroach upon the franchisee, courts have sometimes inferred a duty of good faith and fair dealing.\textsuperscript{83} However, the most effective deterrent against abuse for these hotels have been the disclosure laws which require the hotels to disclose any potential conflicts of interest, past claims of misconduct, or litigation to potential franchisees in the franchise offering circular.\textsuperscript{84}

\section*{B. Management Companies}

Hotel management companies have a more complicated history than brand companies. The management companies began by leasing the hotels from the owners.\textsuperscript{85} The hotels were largely owned by insurance companies, pension funds and other institutional investors, and were disallowed by their industries’ regulators to participate in the risk of operating hotels.\textsuperscript{86} By leasing and operating the hotels for a rental fee, the management companies made money based on the actual profitability of the hotel, and therefore bore the risk of loss.\textsuperscript{87} That is, the hotel company would lease the hotel, then operate it and be responsible for whether the business survived, just as if they actually owned it. The actual hotel owner received rental income and basically just owned the building. This meant that management companies had no incentive to encroach on the hotels they were operating, and had all the incentive to see that business flourished.\textsuperscript{88}

Later, hotel owners’ regulators began to relax some of the restrictions against the companies’ investments.\textsuperscript{89} This allowed the hotel owners to begin operating hotels as well as owning them. However, the hotel companies that had been leasing the hotels still had all of the experience and expertise necessary to run the hotels. Therefore, owners retained these same companies, except under a different type of operating agreement. The hotel management companies stopped leasing the hotels.\textsuperscript{90} Instead, the management companies entered agency management agreements, where the management agreements explicitly stated that the management companies were the agents of the hotel owners.\textsuperscript{91}

\textsuperscript{82} Id.

\textsuperscript{83} See, e.g., Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., ITT, 139 F.3d 1396 (11th Cir. 1998).

\textsuperscript{84} Online Interview with K.C. McDaniel, supra note 10. See also Rust, supra note 5, at 506-08.

\textsuperscript{85} Online Interview with K.C. McDaniel, supra note 10.

\textsuperscript{86} Id.

\textsuperscript{87} Id.

\textsuperscript{88} Id.

\textsuperscript{89} Id.

\textsuperscript{90} Id.

\textsuperscript{91} See, e.g., Woolley v. Embassy Suites, Inc., 278 Cal. Rptr. 719, 725 (Cal. Ct. App. 1991) ("The sole relationship between Owner and [manager] is that of principal and agent.").
The key difference was that instead of the management companies paying a rental fee and then being responsible for the bottom line, the hotel owners paid the management companies a management fee, often a percentage of revenues, and then received the bottom line profit amount.92

Management companies originally liked the agency management relationship because the companies were able to operate for this percentage of revenues without bearing the risk of loss.93 But, this shift of the risk of loss created the conflict of interest between hotel owners and hotel management companies. That is, because the management companies were now operating for a flat management fee, or a percentage of revenues, the situation was the same as for regular franchisors and franchisees: the management companies would want to manage as many properties as possible, spreading the name and reputation of their company as widely as possible, without regard for the bottom line profitability of the hotel owners. However, owners still found some protection from abuse because agents are fiduciaries of their principals.94 Then, because management companies were being held to the high standard required of fiduciaries, the hotel companies no longer wanted to be agents of the hotel owners.95 The companies began disclaiming any agency relationship.96 The companies would enter the exact same operating agreement, but insert the language that no agency relationship exists.97 However, the management companies' roles remained the same and some courts found that an agency relationship remained, even in light of the attempted disclaimer.98 This is because the Restatement of Agency suggests that courts should look to the substance and performance of the agreement rather than the express provisions.99 However, some courts do honor the no-agency disclaimer, which leads to the counterintuitive result of management

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92 For purposes of this discussion, revenues are a company's cash inflows from sales before any expenses or taxes are taken out. Profits, or net income, are the revenues minus expenses and taxes.

93 Online Interview with K.C. McDaniel, supra note 10.

94 See RESTATEMENT (SECOND) OF AGENCY § 1. See also supra text accompanying note 32.

95 Online Interview with K.C. McDaniel, supra note 10.

96 Id.

97 Id.

98 See, e.g., Sklar v. Princess Properties, 194 Cal. App. 3d 1202, 1205-1206 (Cal. Ct. App. 1987), Franksen v. Crossroads Joint Venture, 515 N.W.2d 794, 801 (Neb. 1994) ("Whether an agency exists depends on the facts underlying the relationship of the parties irrespective of the words or terminology used by the parties to characterize or describe their relationship.").

99 RESTATEMENT (SECOND) OF AGENCY § 1 cmt. b (1958).

The relation which the law calls agency does not depend upon the intent of the parties to create it, nor their belief that they have done so. To constitute the relation, there must be an agreement . . . between the parties; if the agreement results in the factual relation between them to which are attached the legal consequences of agency, an agency exists although the parties did not call it agency and did not intend the legal consequences of the relation to follow.

Id.
agreements that are arguably fiduciary in nature (given that the relationship used to be considered fiduciary and has changed in name only) receiving less protection from abuse than simple franchise agreements, with their disclosure laws, that are decidedly not fiduciary. 100

1. Hotel Management Agreements – Potential for Abuse

Aside from the inherent conflict of interest with hotel management companies’ fee structures and the inducement to encroach upon their owners, there are numerous other potentials for abuse that hotel management companies use to profit at the expense of their owners and to facilitate encroachment, or impact. For example, there have been many cases where management companies would purchase supplies and then overcharge the hotel owners for reimbursement. 101 Courts have found this to amount to a “[management company] put[ting] [its] interests ahead of [hotel owners’] interests, thereby violating the Agency Provision of the Management Contract” where the management companies were improperly receiving kickbacks without disclosing them to hotel owners, consistent with their role as an agent. 102 This is an example of self-dealing that may be harder to remedy without an agency relationship between the parties, because less disclosure is required when no agency relationship exists.

The most dangerous situation is the management companies’ access to private information about each hotel and the ability to manipulate technologies such as chain-wide reservation systems to avert potential business from hotel owners. For example, in 2660 Woodley Road v. ITT Sheraton Corp., 103 in addition to the management company receiving kickbacks on supply purchases, the hotel owners, including the John Hancock Mutual Life Insurance Company, alleged that the management company was abusing the frequent travelers program, failing to limit usable denials, 104 improperly profiting from providing Workers’ Compensation insurance, permitting excessive numbers of complimentary rooms, and breaching other unspecified contractual duties. 105 In Camp Creek Hospitality v. Sheraton Franchise Corp., plaintiffs argued that a competitor was able to obtain “information concerning the Inn’s occupancy levels, average daily rates, discounting policies, rate levels, long term contracts, marketing plans, and operating expenses . . . and that he may have used it to compete

100 Online Interview with K.C. McDaniel, supra note 10.
103 2660 Woodley Road, 369 F.3d 732.
104 Id. at 736, n.1 (“According to Sheraton, a usable denial occurs when a potential guest is denied a reservation when a room is actually available.”).
105 Id. at 736.
against the Inn." Camp Creek also provided evidence that Sheraton Reservations agents systematically favored a competitor's hotel over the plaintiff's hotel when fielding calls. The abuses that Camp Creek asserted occurred before the Internet and related technologies became prevalent. This type of favoritism and access to sensitive information is even easier with today's technology. For example, brand managers can control the order in which hotels appear on their website and reservation system and choose to favor one hotel over another.

Finally, what makes hotel "impact" different from typical franchise encroachment is the potential scope of the infringement. Recall that franchise encroachment deals with a limited geographic area and the existence of exclusive or non-exclusive territorial licenses. However, with hotels, the relevant market can be a single city, for example a website that lists all of a given brands' Atlanta hotels in a particular order, or national or even international. For example, a brand manager can use its national sales office to divert a large group meeting from one major convention hotel to another one a thousand miles away. This is especially abusive because some management companies, such as Marriott, own some of the hotels that they manage, creating another direct conflict of interest. Now that management companies disclaim agency responsibilities, there are less disclosure requirements, and discovery of abuse is much more difficult for hotel owners.

Moreover, when courts found an agency relationship existed between owners and management companies, courts routinely held that hotel owners were free to terminate the management agreement because a principal's powers of revocation are absolute. Owners could possibly become subject to wrongful termination contract damages, but the owners would be able to get out of the arrangement earlier, and management companies would have to be candid in discovery in order to show that there was no wrongdoing. This was a big

106 Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., ITT, 139 F.3d 1396, 1410 (11th Cir. 1998).
107 Id. at 1406.
112 Online Interview with K.C. McDaniel, supra note 10.
113 Fitch, supra note 6 ("Hilton and Starwood each hold 30% of the full-service rooms under their flags.").
114 Online Interview with K.C. McDaniel, supra note 10.
116 Woolley, 278 Cal. Rptr. 719 at 725.
117 Online Interview with K.C. McDaniel, supra note 10.
strength for hotel owners because the management companies do not want to disclose everything to hotel owners. However, now that some courts allow management companies to disclaim any agency relationship, this right to terminate becomes more doubtful, especially in light of a recent Maryland statute.

2. Maryland Statute

Title 23 of the Commercial Law section of the Maryland Code, which relates to operating agreements for hotels, states that where the implied terms of an agreement conflict with the express terms, the express terms will govern. Therefore, even though the parties’ conduct may imply an agency relationship, which in the past been construed to create an agency with its attendant fiduciary duty, the disclaimer of agency will indemnify the management company from any fiduciary obligations. Additionally, the statute provides that the management agreement cannot be terminated before the expiration of the operating agreement, unless the operating agreement contains a right of early termination. Of course, this also directly contradicts the established agency rule of the principal’s absolute right to termination. Finally, the statute effectively “allows courts to order the specific performance of management agreements, notwithstanding that this forces an owner to grant fiduciary powers and accept an imposed agency relationship.”

Now, hotel management companies can impose a personal services contract on hotel owners through the courts, although there are several important arguments against requiring specific performance of personal services contracts. Among the most important reasons against requiring specific performance of a personal services contract, in this context particularly, are the “friction and social costs which result when the parties are reunited in a relationship that has already failed, especially where the services involve mutual confidence and the exercise of discretionary authority.” Yet, this law may require hotel own-

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118 Id.
121 Id.
123 Client Advisory, supra note 120.
124 Id.
125 See Woolley v. Embassy Suites, Inc., 278 Cal. Rptr. 719, at 727 (listing several reasons why courts are loathe to order specific performance of personal services contracts).
126 Id.
ers to remain in a relationship with a disenchanted management company, who is responsible for protecting the owner's investment in the hotel, with no real duty to protect that investment. It is interesting to note that both Marriott (which is headquartered in Maryland) and Starwood Hotels (which is incorporated under Maryland law) submitted written statements in favor of the statute.

3. Summary of Hotel Management Company Regulation

Hotel management companies' fee structure of receiving a percentage of revenues rather than a percentage of profit creates an inherent conflict of interest. Specifically, the hotel management companies that are responsible for hotel owners' investments have incentive to make more money at the expense of the hotel owners. The potential for abuse in this arrangement is further facilitated by technologies which allow management companies access to hotel owners' proprietary information and the ability to exploit it for the benefit of the management company and at the expense of the hotel owner. Finally, this technology and the nature of the industry allow these management companies to abuse hotel owners on a national, or even international, level. While hotel owners have tried various ways to protect their investment, management companies have continued to erode that protection to the point that a Maryland statute forces hotel owners to remain in long-term contracts with potentially abusive management companies who owe no duty to protect an owner's investment.

IV. ANALYSIS

Franchise encroachment began as a very local problem. Franchisees were simple businessmen trying to operate their business and earn their livelihood without their corporate giant franchisor placing a direct competitor across the street from them. The problem was at least visible however. Franchisees could see when they were losing business to a new pair of golden arches half a mile down the road. With hotel impact, the problem is neither local nor visible. Rather, the problem of hotel impact is one of global significance. Management companies may persuade an organization to hold its convention in London or Tokyo, for example, rather than in San Francisco or New York. Additionally, unlike seeing customers in the drive-thru, hotel owners do not see potential customers accessing the hotel website and choosing a more favorably advertised alternative. The potential scope of this problem and the uncertainty surrounding it create an unfair situation. A hotel owner can have business, if not directly taken from them, at least diverted elsewhere, without ever knowing it, all by a management company that should be looking out for the owner's interests.

127 See Fitch, supra note 6.
128 Client Advisory, supra note 120.
tel management companies are entrusted with an owner’s investment and some duty of care should be required of them. Consider the scrutiny of corporate CEOs responsible for shareholder investments. If not a general fiduciary duty, management companies should at least be required to make certain disclosures to potential investors and refrain from self-dealing.

Just as the Maryland legislature has responded to this problem, other legislatures should respond, except to protect hotel owners. While the Maryland law accommodates abusive hotel management companies, other legislatures should insist on fair business practices. Just as franchise regulators enacted disclosure laws and other measures to control greedy, over-reaching franchisors, legislatures should require similar controls for the large, secretive hotel management companies. Because, while no longer dealing with the stereotypical unsophisticated franchisee running the corner filling station, we are also no longer dealing with shady hotel management companies making a few extra bucks on hotel towels. The abuses in the Camp Creek Hospitality case of stealing customer lists, rate specials, etc. were problems from the early 1990s. Today, we are in an era where grocery stores print customized coupons for the next stop based on your purchases from the current or past visits. Marketing experts track every imaginable trait of consumers and use them to their firm’s advantage. In a national or international market, the scope of the potential abuses exhibited in Camp Creek and other similar cases have expanded exponentially. It is a given that large conventions can only go to one hotel at a time, however, where it can be shown that a hotel management company deliberately diverts business to a particular location at the exclusion of another because of self interests, this should constitute a breach of a duty. However, the self-dealing will not always be as egregious, or as obvious, as a management company sending business to a hotel that the management company owns. The business may be diverted to another owner’s hotel, yet be more profitable for the management company. Because this type of self-dealing is more subtle, and thus more difficult to discover, it is important to impose disclosure duties on management companies to deter these abusive practices. This is a 21st century problem where the need for protection of hotel owners is greater than ever. This is not a time to continue to erode that protection.

Franchisors often argued against the need to protect franchisees from encroachment because of the freedom to contract and the benefit of the bargain. However, this is not merely burying a term, or failing to include one, in

129 Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., ITT, 139 F.3d 1396, 1410 (11th Cir. 1998).
131 See Rust, supra note 5, at 490-91, and accompanying text. See also RESTATEMENT (SECOND) OF CONTRACTS, Chapter 8, Unenforceability on Grounds of Public Policy, Introductory Note (1981).
a form contract. Rather, relying on management companies to protect an owner's investment is more like blind faith. Without more adequate disclosure and assurances from hotel management companies, owners have no idea what management companies are doing with their proprietary information, what it is costing them, or how it is benefiting the management companies. Also, without disclosure, owners don't even know where to look, or how to find evidence of abuse, making actual damages very hard to prove. Then, if owners do suspect abuse, there are rules, such as the Maryland law that require these owners to stay in these long term contracts. For example, when Mr. Geller's problem arose, he had sixteen years at four million dollars a year remaining on his contract with Marriott. This is a ludicrous result: an owner who is possibly being taken advantage of is forced to remain in a long term contract with the abusive party. This Maryland law basically amounts to legislative acquiescence of hotel management company abuse. A sixty-four million dollar problem for a hotel owner that is possibly being abused, like Mr. Geller, is one that needs to be addressed.

Specifically, courts and legislatures should require hotel management companies to disclose operating and financial details to hotel owners similar to franchise disclosure laws. Because actual damages can be so difficult to prove with such an expansive, secretive, technology-encrypted system, regulators must require information and impose any affirmative duties on the front end of the agreement. Hotel management companies should have to report any complaints, pending, or past litigation to potential hotel owners. If not in Maryland, when given the chance, courts should absolutely find that an agency relationship exists, at least with respect to the narrow issue of the confidential information. There should be a quasi-fiduciary relationship, constructive trust, or similar duty imposed on hotel management companies to not self-deal, using the sensitive information arising from the confidential relationship with hotel owners, at the expense of hotel owners. Finally, management companies found to violate this duty, or not adequately disclose information to hotel owners, should be subject to termination of the management contract and compensatory and punitive damages.

In sum, the problem of hotel impact is one of international scope, largely facilitated by sophisticated technology and access to proprietary information. However, this technology not only enables hotel management companies to take advantage of their owners, but also aids them in keeping it secret. Without the benefit of tangible evidence to point to, hotel owners are unlikely to know when they are being taken advantage of by hotel management companies. Additionally, when hotel owners suspect that they have been taken advantage of

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132 See, e.g., Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., ITT, 139 F.3d 1396 (11th Cir. 1998).
133 Fitch, supra note 6, at 68.
134 Online Interview with K.C. McDaniel, supra note 10. See also Rust, supra note 5, at 506-08.

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by management companies, they will be unable to prove so. Therefore, it is very important to impose affirmative duties on hotel management companies to be honest and forthcoming from the outset. The information about past abuses and complaints that franchise disclosure laws would require for example, would caution potential owners of problems to be wary of, and make them think twice before entering a relationship where they would be dependant upon the fairness of a notoriously abusive management company. More importantly, these required disclosures would serve as a strong deterrent to management companies when considering engaging in potentially abusive practices. Providing for stiff penalties and termination upon any breaches of a management companies’ duties to a hotel owner would then also serve both punitive and deterrent purposes. Then, having to report the most recent breach or termination to the next potential hotel owner through disclosure laws should begin a perpetual cycle toward a fairer, more transparent relationship between hotel management companies and hotel owners.

V. CONCLUSION

When franchising began, the concept of encroachment was a local geographic infringement problem. However, with today’s technology, hotel management companies are able to infringe on their hotel owners on a much wider scale. Also, just as the judicial protection against encroachment from franchisors to franchisees has decreased over the years, so too has the protection afforded hotel owners from their management companies. But, most franchisees now at least have the protection of disclosure laws which require franchisors to disclose most potential abuses before entering the relationship. Meanwhile, as technology expands, court protection decreases, and pro-management company statutes are passed, the information gap between management company and owner continues to broaden. Courts and legislatures must step in and re-assert the importance of, and strengthen, the duty that management companies owe hotel owners before the impact of these abuses make hotel ownership an unbearable risk.

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135 Rust, supra note 5, at 528.

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