A Preliminary Study on the Sustainability of The Hotel Management Agreement

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Abstract
In 2008 at the United States District Court in Maryland, an Indonesian hotel owner of a luxurious resort hotel in Bali sued and won vs. the Ritz-Carlton Hotel Company, one of the most reputable management companies in the world. The focus of the suit was a breach of the 20-year hotel management agreement signed in 1991. The jury awarded the plaintiff the right to terminate the hotel management agreement and $10,000,000 in punitive damages. This court decision was "astonishing" in the hotel industry because it suggested a serious doubt about the sustainability of the hotel management agreement, which has been the de facto standard tool for hotel chain development. In this study, at first the general description of a hotel management agreement shall be stated. Next, a detailed analysis of the litigation will be explored. Finally, a few ideas on how a hotel management agreement can make the business relationship between a hotel management company and a hotel owner more satisfactory and efficient shall be proposed.

Key words
hotel management agreement, agency, contractor, brand, fiduciary, non-competitive clause
Author's Background

I had been working in an airline-based hotel management company for more than three decades, and was specifically engaged in the drafting of hotel management agreements as well as negotiating with hotel owners in Japan and overseas. At the initial stage, I was charmed by the fine composition of the hotel management agreement, sometimes quoted as "Hilton method", and aggressively persuaded investors and/or land owners to sign the hotel management agreement with our company. However, after a couple of years, I have come to encounter with several complaints from hotel owners, and majority of them were related to the provisions of the hotel management agreement. While sparing long time to mitigate those complaints in various hotel projects, I have kept searching for the ideal hotel management agreement - a genuine win-win instrument for both hotel companies and hotel owners. However, I could not manage to visualize such an ideal hotel management agreement before leaving the company. Chekitan S. Dev, a professor of Cornell University is expressing the similar view; “The business model under which many hotels operate, in which a property owner uses hotel management agreement to engage a hotel firm to run its facility, has not always worked smoothly because of the complexities involved in the use of by the property of the firm’s resources and brand name.” 1)

In May 2014, I have visited Bali Island, and stayed in Ayana Resort and Spa Bali. While talking with a hotel manager, it was found by chance that the hotel was bearing Ritz-Carlton name, one of the most prestigious hotel brands in the world, until 2009. Upon researching the context behind the change of the hotel brand, I came to understand that the change occurred after the serious litigation between Ritz-Carlton and the owner of the hotel, an Indonesian real estate developer, on the hotel management agreement they have signed in 1991. This study shall first elucidate, based on my working experience in the front line of the hotel industry, the general description of the hotel management agreement. Thereafter, I would like to refer to the litigation on Ayana as one of the typical example of the disputes between hotel owners and hotel management companies. At closing, I will propose a few ideas on the hotel management agreement to make the business relationship of hotel management com-
pany and hotel owner more satisfactory and efficient. Hotel management agreement is often called as hotel management contract and/or hotel operating agreement, however, for convenient reference; hotel management agreement is used in this study.

1. General Description of Hotel Management Agreement

1-01 Raison d'etre of Management Agreement

There are many motivations and/or incentives to build and open hotels such as but not limited to:

For land/building owners - to capitalize the properties they own
For airlines, railway companies and theme park operators - to pursue the synergy effect
For real estate developers - as a core of area redevelopment project
For factory owners - after the relocation of the factory, to utilize ex-factory land
For successful business person - as a hunger for fame

On the other hand, entering in hotel business is not so easy. Followings are just a part of the burden hotel developers must take into considerations before approaching hotel business:

1 Prior to construction work of the hotel building:

(a) Detailed feasibility study must be prepared to justify the investment, and to determine the facility Plan. No financial institutions will lend the construction fund or working capital without it.

(b) Specific marketing strategy and operating policies must be established based on the feasibility study.

(c) Detailed flow planning for employees and customers are critical for the smooth operation. However, few architects or designers have necessary experience and know-how.

2) By the opening day of the hotel

(a) All operating and service policies and procedure are to be established.

(b) Experienced hoteliers must be hired who watch and take care of 24 h/day for 365 days/year operations.

(c) Employees are to be fully hired, and trained well enough to compete with the nearby hotels.

(d) Hotel name and logo mark are to be penetrated in the targeted markets through public relations, advertising and marketing activities.

(e) Sales and reservation contracts with major travel agents to be signed.

3) After the hotel opens its door to the public:

(a) Through day-to-day operations, customer satisfaction is to be pursued in parallel with employee satisfaction.

(b) Anticipating the future change of business environment, necessary measures must have been planned in advance, and implemented without fail.

(c) All transactions must be recorded, and booked in detail.

(d) When any one of key hoteliers resigns, vacancy must be filled without delay.
Therefore, most of business entities that plan to enter into the hotel business tend to seek assistance to hotel companies. And many hotel companies offer them to execute the hotel management agreement. Dev states as follows; “The hotel management agreement is ideally beneficial for both the property owner and the operating management company. The owner benefits from the value added to the property by prestige, marketing skill, and good management of the operator. The operator has a profitable revenue source from a property in which the capitalization is provided by the owner.”

1–02 History of The Hotel Management Agreement

In 1889, Cesar Ritz (1850–1918) was invited as General Manager of Savoy Hotel in London, and successfully opened the hotel for affluent customers. Ritz also opened his hotel in Paris, and put his name in the hotel’s name. Because of those successful accomplishments, many investors in Europe have invited him to open their hotels. In response, he dispatched his leading disciples to those hotels on the condition to put his name “Ritz” in those hotels’ entrance. Prior to his death, total number of such hotels had reached to 18. However, except the hotel name, Ritz did not pay serious attention to the unification of the services and operating procedures, which are the most essential element of hotel chain management.

In America, Ellsworth Milton Statler (1846–1935) launched a moderate priced hotel for the rising business travelers in Buffalo, New York in 1908. He expanded his hotel chain to 11 hotels with the brand name “Statler”. All hotels had a standardized concept of “Small but comfortable and clean”, and Statler penetrated his operating and accounting policies into those hotel properties. The excellence of his hotel management style was well demonstrated by the fact that no hotel in his hotel chain went out of business during the Great Depression.

After Statler passed away, his hotel chain was sold to Conrad Nicholson Hilton Sr. (1887–1979). Hilton changed its hotel name from “Statler” to “Hilton”, and had aggressively expanded his hotel chain in America and overseas. To expedite the expansion of the hotel chain, he invented so called “Hotel Management Agreement”. Since then, many hotel management companies such as Sheraton, Hyatt, Westin and Marriott have inherited the concept of the hotel management agreement invented by Hilton. Thus, the business model to expand its chain hotels using the hotel management agreement is often called as “Hilton method”.

1–03 Basic Concept of The Hotel Management Agreement

The hotel management agreement is a legal document that records the relationship between hotel owner and a hotel management company. The negotiation of the hotel management agreement, focusing on the respective rights and obligations of hotel owner and a hotel management company, is very critical to the success of hotel business and the return on hotel owner’s investment. Listed below are the most critical elements subject to in-depth negotiations:

1) Responsibility of hotel owner

Hotel owner is responsible to build hotel buildings and furnish interior decorations and
FF&E - furniture, fixtures and equipment. Throughout the term of the agreement, standard of such facilities have to be maintained by their own fund. Furthermore, hotel owner assumes the responsibility to supply working capital to a hotel management company as and when it is needed.

(2) Responsibility of the hotel management company
The hotel management company is responsible for the day-to-day running of the hotel, including hiring and firing employees, taking reservations and conducting the marketing and promotion of the business. Furthermore, the hotel management company assumes the responsibility to undertake the routine maintenance of hotel owner’s properties. However, very important decision and/or judgment are subject to the prior consultation and/or consent of hotel owner. Therefore, definition of "very important decision" is always one of the key agenda during the course of negotiation.

(3) Brand
One of the most valuable intangible assets the hotel management company has is their own brand name, and, under hotel management agreement, the hotel management company grants the use of it to hotel owner. There are numerous definitions on "brand". The American Marketing Association defines a "brand" as "name, term, design, symbol, or any other feature that identifies one seller’s goods or service as distinct from those of other seller’s. “From the viewpoint of marketing, brand is an effective tool to attract customer to buy goods or service with an expectation that the goods or service associated with such brand will satisfy the customer’s purpose.”

(4) Remunerations to the hotel management company
For the services the hotel management company provides to hotel owner under the hotel management agreement, the hotel management company receives certain remuneration from hotel owner. Such remuneration are typically subdivided into the following two categories:

(a) Basic Management Fee: calculated based on gross revenue of the hotel
(b) Incentive Fee: additional fee paid to the hotel management company for meeting specific benchmarks, typically related to profit or cash flow such as but not limited to the followings:
   GOP (Gross Operating Profit)
   Available Cash Flow
   Operating Cash Flow (Income before Income Tax)

Definition of GOP is rather complicated, and slightly different by the hotel management company. However, it can be generalized to be the profit calculated by deducting the operating costs from the gross revenue. Usually, for the computation of incentive fee, basic management fee is included in the operating costs.

Hotel owner may also be responsible for paying additional fees, such as but not limited to the followings:

Group marketing fee
Accounting fee
Project management fee
Reservation fee

(5) **Term of agreement**

25-30 years were common in the initial stage. However, as more hotel management companies entered the marketplace, competition for the hotel management agreements has increased and term has been shortened. According to the hotel consulting firm HVS, during the period of 2000-2004, the average initial term for large hotel management companies dropped to a low of 16.3 years.

(6) **Termination by performance clause**

Termination by performance clause allows hotel owner to terminate the agreement mid-term if the hotel management company turns out to be incompetent or does not do a satisfactory job of managing their hotel. The hotel management company is often given the right to cure the performance failure and avoid termination by making up for the amount of such shortfall in cash or by waiving their entitled remuneration.

(7) **Area Restrictions**

Some hotel management agreements have non-competition clause that prevents the hotel management company from building or managing hotel properties bearing the same brand near the hotel. These restrictions commonly encompass certain miles radius around the property but sometimes cover an entire city or whole island.

2. **Litigation between the Ritz-Carlton Hotel Company LLC, v. P.T. Karang Mas Sejahtera**

2-01 **Timeline of the litigation**

1991 A management agreement was signed by and between The Ritz-Carlton Hotel Company LLC, (referred to as “Ritz-Carlton HC”) and P.T. Karang Mas Sejahtera (referred to as “KMS”) to build and operate a luxury class resort hotel at Jimbaran, Bali, Indonesia. Term of the agreement was 1991-2021.

1995 Marriot International acquired 49% share of Ritz-Carlton HC.

1996 The Ritz-Carlton Bali Resort & Spa opened its door to the public.

1998 Marriot International acquired additional 50% share of Ritz-Carlton HC to retain 99% ownership in total.

Horst Schurlze, co-charter member and ex-president of Ritz-Carlton HC resigned.

2001 Marriot International and a prominent jewelry company Bvlgari S.p.A. formed a joint venture hotel development company Bvlgari Hotels & Resorts to develop Bvlgari brand hotels in the world. Marriot International held 35% and Bvlgari S.p.A. held 65% share of Bvlgari Hotels & Resorts respectively.

2002 Horst Schulze inaugurated a hotel management company named West Paces Hotel Group.

2004 The first Bvlgari brand hotel opened in Milan, Italy by Bvlgari Hotels & Resorts.

Bvlgari Hotels & Resorts and Marriot International announced the signing of hotel management agreement to build and open a new
hotel in Bali, only 7 km apart from The Ritz-Carlton Bali Resort & Spa.

KMS immediately sued Ritz-Carlton HC and its parent company Marriott International as breach of the hotel management agreement signed by and between KMS and Ritz-Carlton HC. However, both defendants did not respond in good faith, according to KMS.

2006 Bvlgari Resort, Bali opened.
2007 KMS finally decided to pursue the jury trial in America.
Marriott International, originally a co-defendant, was voluntarily dismissed by KMS at trial.
2008 The jury ruled that Ritz-Carlton HC breached the hotel management agreement.
2009 KMS terminated the hotel management agreement with Ritz-Carlton HC, and signed a new hotel management agreement with West Paces Hotel Group. The hotel was named Ayana Resort and Spa.

2–02 Main points of dispute
(1) Whether Ritz-Carlton HC is an agent of KMS, or just a contractor responsible to conduct the specific services stipulated in the hotel management agreement? In other words, whether the relationship between Ritz-Carlton HC and KMS is an agency relationship or not?

The legal concept of “agency” is defined as follows: The principal is the party who gives legal authority to another party to act on his or her behalf in business transactions, and the agent is the party who is legally authorized to act on behalf of the principal in business transactions. As such, not only hotel business, many business transactions take place using an agency relationship. An agency relationships can be construed as fiduciary relationships. This means that the relationship involves a high level of trust and confidence between the principal and the agent. This means the agent is obligated to act in the best interests of the principal. Agency allows the agent to work on behalf of the principal as if the principal was present and acting alone. Therefore, the agent is obliged to make business decisions that are conducive to how the principal would act. When the agent agrees to the agency relationship, the agent is agreeing to accept certain fiduciary duties. This means the agent must generally act to benefit the principal while upholding several particular obligations to the principal. Among others, the two obligations of an agent i.e. loyalty and performance are critically important for both parties. The first duty is loyalty. Generally speaking, this means the agent must act with the principal’s best interests in mind. The second duty is performance. This is sometimes known as the duty of care. This means the agent must act prudently and cautiously while performing agency duties. The agent must exercise reasonable care and skill and keep confidential any information obtained while performing agency duties.

Ritz-Carlton HC and its parent company Marriott International insisted that Ritz-Carlton Hotel Company was not an agent of KMS, and was liable only to comply with the specific responsibilities stipulated in the hotel management agreement. Because the hotel manage-
ment agreement signed by both parties specifically defined Ritz-Carlton HC as an “independent contractor”.

KMS claimed that the relationship between them are to be deemed as “agent” and “principal” because Ritz-Carlton HC was empowered, under the hotel management agreement, to act “on behalf of” KMS in the operation of their hotel. Under this interpretation, “agent” is liable to do every possible acts to maximize the benefit of “principal”, and such liability does not always be limited to the specific provisions of the agreement.

(2) Whether Ritz-Carlton HC’s managing Bvlgari Resort, Bali is against the non-competitive clause of the hotel management agreement signed between Ritz-Carlton HC and KMS or not? In other words, the right of KMS on “Ritz-Carlton” brand equity under the hotel management agreement is diluted or not?

Section 2.7 of the hotel management agreement states that “while this agreement shall be in effect, Operator shall not, without the prior approval of Owner, which approval shall not be unreasonably withheld or conditioned, open or operate another hotel using the Ritz-Carlton Rights within the Island of Bali, Indonesia. This territorial restriction shall terminate upon the tenth (10th) anniversary of the hotel.” And the definition of “Ritz-Carlton Rights” was stated in Section 1.10 of the agreement as follows: “Ritz-Carlton Rights means (i) the names and marks “Ritz-Carlton”; (ii) the Ritz-Carlton logo attached hereto as Exhibit B; and (iii) all other words, trademarks, service marks, trade names, symbols, logos, insignias, indicia of origin, slogans and designs (including restaurant names, lounge names, or other outlet names) used or registered by Ritz-Carlton or any of its Affiliates and which are used to identify or are otherwise used in connection with Ritz-Carlton Chain hotels (whether registered or unregistered and whether used alone or in connection with any other words, trademarks, service marks, trade names, symbols, logos, insignias, indicia or origin, slogans and designs)- all of the foregoing being indicative of the renowned Ritz-Carlton mystique, programs, processes, procedures and systems (including the philosophy that drives customer satisfaction, the business management model, business strategies, the employee selection, training, and career development approach and the Ritz-Carlton Standards).”

Ritz-Carlton HC claimed that they were not breaching the non-competitive clause based on the following reasons:

(a) No guest can find Ritz-Carlton signage, the word ‘Ritz-Carlton’ or any Ritz-Carlton trademarks on the property of Bvlgari Resort, Bali.

(b) Bvlgari Resort, Bali is a super-exclusive, contemporary, Italian designed hotel with a contemporary design featuring dark wood and volcanic rock. Bvlgari Resort, Bali is an intimate resort with only 59 villas, 2 restaurants, a pool, a spa, a fitness center, and a meeting room. The Ritz-Carlton Bali Resort & Spa, in contrast, is a more traditional styled, family friendly hotel featuring light colored marble and traditional accents. Physically, it is a massive resort comprised of 78 villas, 290 guest rooms, 11 restaurant and food service venues, 2 lounges, a ball-
room, meeting rooms, a spa, a fitness center, 5 pools, a Ritz Kids Club, and 2 wedding chapels. The difference between the two hotels was well represented by their relative average room rates: $814 for Bvlgari Resort, Bali against $205 for The Ritz-Carlton Bali Resort & Spa.

(c) Customers who booked the rooms of Bvlgari Resort, Bali must have been attracted by the brand equity of “Bvlgari”, one of the most prominent jewelry manufactures, and not dependent upon “Ritz-Carlton” name.

On the other hand, PMS contended that they must have absolute and exclusive rights to enjoy the full benefit of “Ritz-Carlton Rights” under the hotel management agreement with Ritz-Carlton Hotel Company at least for 10 years. And KMS quoted the following incidents to justify their appeal that their entitled “Ritz-Carlton Rights” were diluted:

(a) Major travel agents have classified both hotels as “luxury resort hotel in Bali”.

(b) The distance between two hotels is too close to justify the non-competitive location.

(c) The name of “Ritz-Carlton” was frequently used throughout the pre-opening campaign activities of Bvlgari Resort, Bali.

(d) The two hotels locating within a point-blank were frequently represented in the same booth in the trade shows all over the world.

(e) Guests were encouraged to book rooms at the Bvlgari Resort, Bali through Ritz-Carlton reservation channels.

(f) The opening of Bvlgari Resort, Bali was announced in the Ritz-Carlton guest magazine.

(g) Bvlgari Resort, Bali was promoted through Ritz-Carlton’s regional sales offices.

(h) Invitation letter to the opening reception of Bvlgari Resort, Bali were sent to the customers of The Ritz-Carlton Bali Resort & Spa based on its customer database.

On the above, I take (d), (e), (f) and (g) are within normal chain operations, and Ritz-Carlton HC is not responsible to be blamed. However, jury members having no experience in hotel business might have taken them as evidence of Ritz-Carlton HC’s breach of the hotel management agreement.

2-03 Decision of the court

In 2008, after a 3-week trial in Maryland, the jury ruled out that the hotel management agreement was breached by Ritz-Carlton Hotel Company, and awarded KMS the right to terminate the hotel management agreement, $382,304 in compensatory damages, and $10,000,000 in punitive damages, plus the refund of attorney fees and cost to be incurred.

A law firm in America describes the judgment as follows; “The court ruled that Ritz-Carlton had violated a broad non-competition provision barring the use of “Ritz-Carlton Rights” in Bali, Indonesia by permitting those rights to be used in connection with a Bvlgari branded hotel in the owner’s protected area. The court also ruled that, despite language in
the agreement defining Ritz-Carlton as an “independent contractor,” Ritz-Carlton was in fact an agent that breached its fiduciary duties when it breached the non-competition provision. Based on these rulings, the court permitted the hotel’s owner to terminate Ritz-Carlton’s management agreement with 13 years remaining on the term.”

2-04 Perceived background of The Court Decision

(1) Accumulation of preceding cases

Until nineties, neither hotel management companies nor hotel owners paid serious attention on the description of the hotel management agreements whether they are under Agency Act or not. In 1991, however, a lawsuit between Embassy Suites, Inc. (an affiliated company of Hilton International) and Robert E. Woodley (the owner of its chain hotel) ignited the new era of dispute. Since then, several trials such as Hyatt Corporation v. Government Guarantee Fund of the Republic of Finland were disclosed. And in most cases, hotel management companies have failed to convince the courts that they were a mere contractor, but the general impression that the hotel management agreement was an agency agreement had been accumulated. Dave states in his thesis as follows; “we argue that, as confirmed by four major legal cases that played out over the 1990s as well as a recently adjudicated case, hotel companies should view their relationship with property owners with whom they agree to manage as a form of agency.”

(2) Limit of protection by the text of agreement

We have to understand that courts can supersede the specific terms or wording in the written agreement. Although the relationship between KMS and Ritz-Carlton HC was expressly stipulated as contractual relationship in the hotel management agreement, the jury court judged it as an agency relationship based on their own assessment of the mutual business relationship as a whole. It is worth paying attention that Omni Hotels Management Corporation, a popular hotel management company in America, is acknowledging that they are an agent of hotel owner in its hotel management agreement. Section 2.1.1. of Hotel Operating Agreement between Dallas Convention Center Hotel Development Corporation “Owner” and Omni Hotels Management Corporation “Manager” dated August 1, 2009 states as follows; “Owner hereby engages Manager, and Manager hereby agrees to be engaged by Owner and does hereby undertake to supervise, direct, and control the management, operation, and promotion of all aspects of the Hotel as the agent of Owner and as exclusive manager and operator of the Hotel during the Operating Term.”

(3) Take-over of Ritz-Carlton HC by Marriot International

In 1995, only 4 years after signing of the hotel management agreement, Marriot International acquired 49% of Ritz-Carlton HC. Soon after Marriot International held 99% of Ritz-Carlton HC in 1998, Horst Schurlze, co-charter member and ex-president of Ritz-Carlton HC resigned. It is highly probable that those incidents gave serious negative impact on the trust and confidence of KMS to Ritz-Carlton HC. Based on the fact that KMS signed a hotel management agreement in 2009 with West Paces Hotel Group, a hotel manage-
ment company founded by Horst Schurlze, it is believed that the take-over of Ritz-Carlton HC by Marriot International is one of the important factors behind the scene.

There is a similar case in Japan. When Hilton International and Tokyu Corporation agreed to open the first Hilton Hotel in Japan, Keita Goto, the founder of Tokyu Corporation and Conrad Hilton in 1956, signed a letter of intent of the hotel management agreement. Since then, mutual trust and confidence between Goto and Hilton could jointly overcome various barriers to pursue the hotel project- a dream project for them. Keita Goto died in 1959, and his son Noboru Goto succeeded Goto’s position. He took the hotel project not as “dream”, but rather one of many real estate investments of Tokyu Corporation. On top of it, Hilton International was acquired by TWA, an airline company without prior notice to Tokyu Corporation. Since then the relationship between Tokyu Corporation and Hilton International have gotten sour year by year.

(4) Co-Brand Strategy of Marriot International

It should be understood that frequent merger and acquisition of hotel management companies nowadays are making hotel brand competition in disorder. Marriot International has 17 hotel brands as of August 2014, and it is not easy to draw clear lines among those hotel brands. As per the chart below, which is extracted from Marriot's homepage, “Ritz-Carlton” and “Bvlgari” are listed in the same category.

In booming cities or resorts where hotels are mushrooming from time to time, it is getting extremely difficult to enjoy the sole and exclusive brand equity for long term. Because, in near future, it is highly probable that a hotel with sister brand or co-brand of the same hotel group may open in a short distance. Before the take-over, “Ritz-Carlton” was the only brand of the management company. However, after the take-over, “Ritz-Carlton” is one of numerous brand names of Marriot International. Although Ritz-Carlton HC kept being an independent company even after take-over, from the viewpoint of Marriot International, “Ritz-Carlton” is one of many brand names. It highly probable this might affect the sympathy of KMS by one way or another.

(5) Jury System

In America, unlike in Japan, a plaintiff or

Table 1. Hotel Brands of Marriot International by category

<table>
<thead>
<tr>
<th>Iconic Luxury</th>
<th>Bvlgari, The Ritz-Carlton, The Ritz-Carlton Destination Club</th>
</tr>
</thead>
<tbody>
<tr>
<td>Luxury</td>
<td>JW Marriott</td>
</tr>
<tr>
<td>Lifestyle Collections</td>
<td>EDION, Autograph Collection, Renaissance Hotels</td>
</tr>
<tr>
<td>Signature</td>
<td>Marriot</td>
</tr>
<tr>
<td>Medium Essentials</td>
<td>Courtyard, Protea Hotels, Springhill Suites, Fairfield Inns &amp; Suites</td>
</tr>
<tr>
<td>Extended Stay</td>
<td>Residence Inn, Towne Place, Marriot Exec. Apartment</td>
</tr>
<tr>
<td>Destination Entertainment</td>
<td>Gaylord Hotels, Marriot Vacation Club</td>
</tr>
</tbody>
</table>

a defendant of civil case can elect a jury trial. And jury cannot only judge the guiltiness but also assess the culpability. Jury court awarded KMS, $10,000,000 in punitive damages, which is more than 26 times of compensatory damages. My commonsense deems it exorbitant. As Ritz-Carlton HC and Marriot International succeeded to locate the venue of jury court to Maryland, their hometown, I would suspect Ritz-Carlton HC and Marriot International took it for granted. And they might have relaxed their serious attention. It is said that radical judgments based on the emotion of jury members are seen often in America.

3. Proposals to extend the sustainability of hotel management agreement

As key elements affecting the business relationship between hotel management company and hotel owner today, I would like to indicate the following 4 points:

1. Increase in the number of hotel management companies
2. Frequent merger and acquisition among hotel management companies
3. Entry of large companies with ample management resources into hotel business
4. Spread of co-branding strategy

Based on my experience as hotelier, taking the above elements into consideration, I would like to propose the following ideas to extend the sustainability of hotel management agreement.

3-01 Cafeteria method

In cafeteria dining room, we can take whatever dishes we like to eat then. Same as this, the hotel management company shows its menu to proposed hotel owner for their selection.

The menu shows full range of their services with each remuneration clause:

1. Technical and Pre-opening assistance service
2. Dispatch of key hotelier
3. Undertaking of the operations of the hotel as an independent contractor
4. Permission to use the brand name and logo mark of the hotel management company
5. Inclusion in the global reservation system of the hotel management company
6. Inclusion in the joint advertisement and promotions of the hotel management company

As to the remuneration, it may be worth considering offering a concession if proposed hotel owner agrees to take more than two services. By this approach, the hotel management agreement might not be deemed to be an agency agreement, thus the hotel management company would have a good chance to waive the excessive fiduciary duties. On the other hand, hotel owner can pick up only what they want or what they need on the particular timing, and can enjoy the reduction of remuneration to the hotel management company.

3-02 Phased hotel management agreement

In general, upon signing hotel management agreement, power relationship between the hotel management company and hotel
owner keeps changing year by year. Especially, hotel owner having ample management resources can learn and master the know-how of day-to-day hotel operations quickly, and is inclined to evaluate rigorously the performance of the hotel management company. Thus, they start taking the remuneration payable to hotel management companies as excessive or sometimes unnecessary expenses. For such hotel owner, following phased hotel management agreement could be easier to agree:

Phase A: Date of signing - opening of the hotel

Phase B: 1st year - 10th year

Phase C: 11th year - 15th year

Phase D: 16th year - 20th year

A hotel owner might want their successor to become a general manager of their hotel upon expiry of the hotel management agreement. In such instance, under this formula, the hotel management company can accept the successor as an executive trainee in the hotel, and undertake the intensive training to make the successor a competent general manager before phase B is over. On the other hand, the hotel management company can enjoy the inclusion of the hotel in their hotel chain pamphlets for phase C and D and can continue to receive certain remuneration.

3-03 Non-competitive clause

Crandell, Dickinson, and Kanter, an International hospitality consulting firm is describing the current situation as follows: “It is increasingly difficult for owners to ensure that their hotel is the sole beneficiary of a brand’s strength in a particular market”;7)

I would like to propose that the hotel management agreement should include the following provisions:

(a) Complete list of hotel brands with specific definition and respective target markets
(b) Commitment not to build or manage the hotel bearing the same brand name within specific area
(c) Name(s) of arbitrator jointly appointed by hotel owner and the hotel management company.

In case the hotel management company plans to build or manage a new hotel bearing other hotel brand name within the restricted area, both parties will ask the arbitrator(s) to conduct an economic impact study. If the economic impact study concludes the dilution of brand equity of hotel owner, both parties can discuss and select from the following alternatives:

- c-01 Hotel owner to terminate the hotel management agreement by receiving the agreed amount of liquidated damage from the hotel management company
- c-02 Hotel owner to continue the hotel management agreement by receiving the agreed amount of liquidated damage from the hotel management company

This applies also to the case when the hotel management company tries to enter in the restricted area with the subsequently created brand name.

3-04 Respect to the hotel owner

This may have nothing to do with hotel
management agreement; however, it is worth considering in the day-to-day operation of hotels. Most hotel management companies tend to make hotel staff in favor of them rather than the hotel owners so that the hotel management company can control them. It is understandable that hotel owner is not happy with it. As hotel owner is the one to bear the ultimate business risk of the hotel, they ought to be respected by the employees of the hotel. Therefore, it is my belief that the hotel management company has to educate employees to respect hotel owner.

Ritz-Carlton’s “Credo” is very famous tool to motivate its hotel staff for their ultimate commitment to the satisfaction of their customers. All employees have it, and chant at every meeting. However, “Credo” does not contain any specific reference to hotel owner. Horst H. Schulze, an inventor of “Credo”, developed a similar tool “The Canon” for the employees of hotels under its management. Brand name of those hotels is Capella. Unlike “Credo,” the statements occupy one page of “Canon” as follows: “The Capella Hotel Group is in business to create value and unparalleled results for our owners by creating products which fulfill individual customer expectations. We deliver reliable, genuinely caring and timely service superior to our competition, with respected and empowered employees who work in an environment of belonging and purpose. We are supportive and contributing members of society, operating with uncompromising values, honor and integrity.”

Conclusion

In 2008 an Indonesian hotel owner sued Ritz-Carlton HC as a breach of the hotel management agreement, and hoteliers all over the world took the defeat of Ritz-Carlton HC as “sensational”. One of the main issues was whether the hotel management agreement is construed as an agency agreement or not. This critical point is not clarified yet up to date. However, the author believes that the basic concept of the hotel management agreement will survive as an indispensable management tool to bridge the hotel owners and hoteliers so long as the effectiveness of each provision is evaluated from time to time. A few ideas were presented by the author in this study to ascertain the truly win-win relationship between both parties, but further exploration is needed.

References