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HOSPITALITY LITIGATION

Marriott/Starwood Merger: Good for Brands, Not Owners


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The announced $12.2 billion acquisition of Starwood Hotels and Resorts by Marriott will unite two of the top 10 largest international hotel operators, creating the world's largest hotel operator, with more than 5,500 hotels and 1.1 million rooms worldwide. An exciting prospect to many, nevertheless this combination may present serious concerns for current owners of Marriott and Starwood-branded hotels, cutting to the very core friction between owners and operators in the hotel industry—how loyal are the brands to their owners? Setting aside the predictable messaging from Marriott/Starwood of how efficient and otherwise beneficial this will be for their owners—and there will be some benefits—the reality is that owners may now be faced with increased competition within their own brand umbrella and will have their hotels managed by an organization with whom they may have consciously chosen not to do business. So, what now?

The issue of loyalty between brand and owner is not new and frequently presents itself in the contracts common to the industry. Nearly all management agreements require a manager to act as a reasonable and prudent operator of the hotel, having a primary regard for the hotel's performance and maximization of profits for the owner. This universal clause captures the essence of the agreement and the duty of loyalty is of paramount importance to the hotel owner because the owner typically relinquishes to the manager extensive control over the operations of the hotel business. In addition to the above standard of care, to further insure loyalty, many hotel management and license agreements define the standards by which the operator must run the owner's business through radius restrictions and transfer of control/anti-assignment provisions.

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This article explores these provisions and analyzes an owner's rights and remedies when presented with issues of brand loyalty.

Manager's Duty of Loyalty

While hotel operators have wide discretion and authority in the operation of the owner's hotel, the hotel operator typically remains bound to operate the hotel with a primary loyalty to the owner and the profitability of the hotel.

In *Madison 92nd St. Assocs. v. Courtyard Mgmt.*,[1] which involved a dispute between the hotel owner and Marriott concerning the manager's performance, Marriott argued that an obligation in its management agreement that it must operate the hotel as a "reasonable prudent operator of the hotel, having regard for the status of the hotel," was simply a guiding principal of conduct that could not be breached. In accordance with the unremarkable common law theory that contracting parties are free to bind themselves through an express contractual promise to a higher standard of performance than the implied "reasonable care and competence,"[2] the court rejected Marriott's argument, holding that this clause imposed specific contractual duties on the manager and did not simply serve as guiding principles.

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Marriott also argued that because management agreements provide an operator with broad discretion to operate the hotel's business, that such discretion relieves the operator from the obligation to comply with any specific, express performance standard contained in the management agreement. The court rejected this argument as well, holding that "while the management agreement expressly allows [manager] to conduct the activities and programs…[manager's] actions are still subject to certain reasonableness standards specifically provided for in the contract."[3]

The acquisition of Starwood is likely to call into question whether Marriott will be in fundamental violation of its obligation to operate as a reasonable and prudent operator with primary regard for its individual hotel owners and their particular profits. This is especially so when the result of the transaction will be the introduction of many new, competing hotels in dense regions, all being operated under the same Marriott umbrella. While the major hotel brands work hard to align their interests as manager with the interests of their owner-clients, the inevitable result of this transaction for some will be a fundamental misalignment of interests: the brand possessed with discretion in running the owner's business will be focused on checker-boarding the globe with its guests—which will enhance Marriott's profitability, but perhaps without due regard for the inherent conflicts presented by the multitude of competing hotels and in particular for the owner's profits. This will be a delicate—and perhaps impossible—balancing act.

In the wake of this transaction, hotel owners would be wise to focus their attention on whether their manager is capable of maintaining its contractual duty of loyalty and to react accordingly.

Radius Restrictions

To secure an operator's duty of loyalty, a material contractual provision contained in some management agreements is what is commonly known as a "radius restriction," pursuant to which the management company is prohibited from opening or operating another hotel within a certain distance from, or within a geographic region proximate to, the hotel currently under management. The plain purpose is to protect the hotel owner from having its business undermined by its manager operating a competing hotel down the street and diverting specific guests and business to a competing hotel. But what can a Marriott-branded hotel owner do when the W Hotel or Westin down the street comes under the umbrella of Marriott management as a result of the transaction?

Under New York law, a radius restriction, as a restrictive covenant, is enforceable as long as it is reasonable as to time and area, protects legitimate business interests, and does not unreasonably burden the restricted party.[4]

Such a clause usually comes in one of two varieties. For instance, the clause may prohibit the operator from opening or operating a specific hotel brand within a certain geographic region:

> Operator (typically including the operator's parent company who makes ultimate decisions) shall not open, operate, or cause to open or operate a hotel under X Brand, within a X Mile Radius of the Hotel for a period of X Years commencing on a date certain.

These clauses are structured to exclude any of the manager's hotels that are already under management or operation at the time the management agreement is executed because the owner would be aware of the existing competition. And in certain radius clauses, there is an express carve-out for a merger with another large hotel operator.

A radius clause may also be structured as an affirmative agreement from the owner that the management company is permitted to open and operate a specific set of hotels in the region. Typically, such a restrictive covenant is included where the manager is aware of potential deals with other owners in the area and the parties expressly provide the name, brand, and location of the competing hotel.

Faced with these provisions, what can an owner do to prevent either unwanted market competition or an assignment of its hotel to Marriott?

One option is that an owner can move to enjoin the violation of the radius clause or anti-assignment provision. Courts in New York enforce restrictive covenants as if they are self-imposed injunctions agreed-upon by the parties:

> It is a question of intention, to be deduced from the whole instrument and the circumstances; and if it appear that the performance of the covenant was intended, and not merely the payment of damages in case of a breach, the covenant will be enforced.[5]

As with any motion for a preliminary injunction, the owner will need to establish the three prongs for obtaining an injunction: (1) a likelihood of success on the merits, (2) the existence of irreparable injury, and (3) a balancing of the equities in its favor.[6]

On the likelihood of success prong, unless there is a specific carve-out that contemplates and authorizes Marriott or Starwood to engage in such an acquisition, whether or not the operator breaches the clause should be rather cut and dry based on the terms of the agreement and the location of the competing hotels.[7]

With respect to irreparable harm, New York courts have held that the impact of prohibited competition warrants a finding of irreparable harm.[8] Courts in New York have found irreparable injury where a plaintiff's customer base, revenue and good will are threatened by competitive acts of another in violation of a restrictive covenant that the parties clearly intended to serve as a mutually agreed-upon injunction against such activity.[9]

And for the balance of the equities, there is a strong argument that such a balance tips in the owner's favor[10] because Marriott, Starwood and the merged-entity are world-wide conglomerates who would suffer very little if a preliminary injunction were granted to enforce a restrictive covenant that exists in only a subset of agreements in the first place. Whereas, the owner stands to suffer greatly without an injunction as its customers are actively diverted to other, new Marriott hotels competing in the same market.

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Whether successful or not, a violation of the restrictive covenant may create an environment in which the owner can negotiate: (i) an amendment to the management agreement with better terms; (ii) a particular brand for the hotel; or (iii) an overall exit from the management agreement.

The Anti-Assignment Clause

Another measure of protection for an owner—relevant to owners of Starwood hotels here—is the anti-assignment provision, pursuant to which an operator is prohibited from transferring or assigning its interest in the management agreement to another operator without the consent of the owner.[11] However, most anti-assignment provisions have specific carve-outs that allow the operator to effectuate a transfer if, among other things: (i) the operator remains or is an affiliate of the new operator; or (ii) the transfer is a result of a merger, consolidation or reorganization of the operator.

Marriott's acquisition of Starwood, which is being effectuated through a sale of stock and will result in Starwood investors owning roughly 37 percent of the resulting company, would likely fit into either of the above carve-outs.

Thus, Starwood owners, many of whom likely chose a Starwood-branded hotel because the hotel chain was formed to be the opposite of Marriott, may have no contractual right to consent to or reject the transfer under their respective anti-assignment clauses. But each contract must be evaluated on its own merits to determine the scope of potential change of control provisions.

Depending upon whether the management agreement expressly states that an improper assignment will be rendered void, an owner's potential remedies for a breach may include: (i) a declaration that the improper assignment is void, if the agreement contains the appropriate language; or (ii) seeking monetary damages against the manager, in the event the agreement lacks the necessary language.[12]

Conclusion

As the transaction between Marriott and Starwood makes apparent, having well-tailored contract provisions setting forth the operator's duty of loyalty, which are then secured with favorable radius clause and anti-assignment provisions, are crucial to protecting an owner from a manager whose fundamental interests and motivation can diverge with the owner's subsequent to execution of a management agreement.

1. No. 602762/09, Slip Op. at *6-7 (Sup. Ct. N.Y. Co. July 13, 2010).
2. *Milau Assocs. v. North Ave. Dev. Corp.*, 42 N.Y.2d 482, 486-87 (1977); *Donkov Realty, LLC v. Radjb Realty,* No. 603095/05, 2008 N.Y. Slip Op. 31967 (Sup. Ct. N.Y. Co. July 8, 2008).
3. *Madison 92nd St. Assocs*., at *7.
4. *Gelder Med. Grp. v. Webber*, 41 N.Y.2d 680, 683 (1977); *Emerging Vision v. Main Place Optical*, 815 N.Y.S.2d 494 (Sup. Ct. 2006).
5. *Karpinski v. Ingrasci*, 28 N.Y.2d 45, 52-53 (1971); *Wirth & Hamid Fair Booking v. Wirth*, 265 N.Y. 214 (1934); see generally *Granite Broadway Dev. v. 1711 LLC*, 44 A.D.3d 594, 594-95 (1st Dept. 2007).
6. See *Chrysler v. Fedders*, 63 A.D.2d 567, 568-69 (1st Dept. 1978); *Bashein v. Landau*, 96 A.D.2d 479, 479 (1st Dept. 1983); *Bingham III v. Struve*, 184 A.D.2d 85, 88 (1st Dept. 1992); *Aon Risk Servs. v. Cusack*, 102 A.D.3d 461, 463 (1st Dept. 2013).
7. *Gelder Med. Grp. v. Webber*, 41 N.Y.2d 680, 683 (1977); see also *Emerging Vision v. Main Place Optical*, 815 N.Y.S.2d 494 (Sup. Ct. 2006); *McLaughlin, Piven, Vogel v. W.J. Nolan & Co.*, 498 N.Y.S.2d 146, 152 (2d Dept. 1986); *Gambar Enterprises v. Kelly Services*, 69 A.D.2d 297, 306, 418 N.Y.S.2d 818, 824 (4th Dept. 1971); *4th Ave. Realty Holding Corp. v. Pappas*, 254 A.D.2d 250 (2d Dept. 1998).
8. *Purchasing Associates v. Weitz,* 13 N.Y.2d 267, 273 (1963); see also *Brintec v. Akzo,* 129 A.D.2d 447 (1st Dept. 1987); *Register.com v. Verio*, 356 F.3d 393, 404 (2d Cir. 2004).
9. *Axios Prod. v. Time Mach. Software,* No. 13825/10 (EHE), 2010 N.Y. Misc. LEXIS 4843, at *13 (Sup. Ct. Oct. 04, 2010); *Matter of Rockwood Pigments v. Elementis Chromium LP,* No. 651617/2014 (MLS), 2014 N.Y. Misc. LEXIS 3619, at *12-13 (Sup. Ct. Aug. 4, 2014); *Confidential Brokerage Servs. v. Confidential Planning Corp.,* 85 A.D.3d 1268, 1269 (3d Dept. 2011); *Liberty Ashes v. Taormina*, 988 N.Y.S.2d 523 (2014).
10. *L.I.R. Management*, 184 A.D.2d 235, 235 (1st Dept. 1992); see also *Weiss v. Mayflower Doughnut Corp.*, 1 N.Y.2d 310, 316 (1956); *Adirondack Appliance Repair*,148 A.D.2d at 798; *Laro Maint. Corp. v. Culkin*, 255 A.D.2d 560, 561 (2d Dept. 1998), aff'd, 267 A.D.2d 431(1999); see also *Credit Index, LLC v. RiskWise Int'l LLC*, 282 A.D.2d 246, 246 (1st Dept. 2001).
11. See *Marion Blumenthal Trust v. Arbor Commercial Mtge. LLC*, 40 Misc. 3d 1215(A) (Sup. Ct. N.Y. Co. 2013) ("Anti-assignment clauses in contracts that expressly prohibit assignment are valid and enforceable.").
12. Id.; see also *Macklowe v. 42nd St. Dev. Corp.*, 170 A.D.2d 388 (1st Dept. 1991); *Allhusen v. Caristo Const. Corp.*, 303 N.Y. 446 (1952).