New York Law Journal

ALM Properties, Inc.
Page printed from: *New York Law Journal*

Back to Article

The Termination of Hotel Management Agreements: Part II

Todd E. Soloway and Joshua D. Bernstein

New York Law Journal

04-17-2013

As explained in our April 18, 2012 column, "The Termination of Hotel Management Agreements," and as the Appellate Division, First Department confirmed last month in the highly publicized case, *Marriott International v. Eden Roc*,[1] there is no longer any doubt that hotel management agreements are terminable by the hotel owner notwithstanding that there may be decades remaining on the term of the contract and even the absence of any default. The law is clear: these contracts are terminable under common law and constitutional principles concerning the revocability of agency agreements and personal services contracts.[2]

The ability to terminate a hotel management agreement is, not surprisingly, of critical importance to hotel owners, providing owners with the ability and flexibility to protect their multi-million dollar investments from mismanagement by an unwanted manager of its business. For decades, courts have repeatedly protected this significant termination right, refusing to enjoin terminations and even middle-of-the-night takeovers by hotel owners even if such termination may constitute a breach of the contract. The reason: hotel management agreements are often both agency contracts, revocable at will by the principal hotel owner, and personal services contracts, the termination of which courts have long refused to enjoin as antithetical to this country's prohibition against involuntary servitude.[3]

Faced with these principles, for years the hotel management companies have led a concerted effort to circumvent this basic, black letter law. First, they argued that their management agreements were agencies "coupled with an interest," and therefore irrevocable even though the operators had no present ownership stake in the hotels they managed.[4] To preserve this fiction, the operators went so far as to include language in the contracts by which the parties agreed that the agency was "coupled with an interest." But courts around the country rejected reliance upon those clauses, peering behind the veneer of the verbiage employed, examining the true relationship between the parties, and finding only routine revocable agency contracts.[5]

Next, the hotel managers sought to include in their contracts outright disclaimers of the existence of an agency relationship. This effort has also failed because agency disclaimers are not controlling in determining whether an agency relationship exists. Rather, courts examine the actual relationship of the parties,[6] which in many hotel management cases demonstrates the existence of an agency relationship.[7] And, in any event, as the First Department confirmed in *Eden Roc*, regardless of whether hotel management agreements are found to be agency contracts, they are "classic example[s] of a personal services contract that may not be enforced by injunction."[8]

Hotel operators then attempted to accomplish by legislation what they could not in the courts. The hotel operators lobbied the Maryland Legislature, where the two largest hotel management companies are domiciled, to pass a statute—the Operating Agreement Statute—applicable solely to hotel and retirement community operating agreements, which purports to vitiate centuries of law.[9] Specifically, the operating agreement statute (the only one of its kind in the country) provides:

If an operating agreement states that it shall continue for a period of time or until the happening of an event, the operating agreement shall be enforceable between the parties until the expiration of the period of time or the happening of the event unless the operating agreement contains a right of early termination.[10]

Further, the statute provides that "[a] court may order the remedy of specific performance for anticipatory or actual breach or

attempted or actual termination of an operating agreement notwithstanding the existence of an agency relationship between the parties to the operating agreement."[11]

Since the enactment of the operating agreement statute, a growing number of hotel management agreements, including several governing the management of New York hotels, now incorporate Maryland law, even where the hotels and the parties have no connection to that state.

Despite their lobbying victory, the operating agreement statute offers hotel operators no solace. To these authors, the statute is unconstitutional. Among other infirmities, the statute's attempt to grant a court the discretion to order specific performance violates the Thirteenth Amendment's prohibition on involuntary servitude, as well as a taking without just compensation under the Fifth Amendment and, to the extent applied retroactively, violates the Contracts Clause of the U.S. Constitution. This article examines these issues.

Personal Services Contracts

Hotel management agreements are "classic example[s] of a personal services contracts."[12] It is a well-settled principle that "a court will not order the specific performance of a contract for personal services."[13] As the New York Court of Appeals explained in *American Broadcasting Companies v. Wolf*, this rule, dating back to English common law, "[o]riginally…evolved because of the inherent difficulties courts would encounter in supervising the performance of uniquely personal efforts."[14] However, "[d]uring the Civil War era, there emerged a more compelling reason for not directing the performance of personal services: the Thirteenth Amendment's prohibition of involuntary servitude."[15] Accordingly, "[f]or practical, policy and constitutional reasons…courts continue to decline to affirmatively enforce employment [and other personal services] contracts."[16]

The Thirteenth Amendment "declares that involuntary servitude shall not exist within the United States and gives Congress power to enforce the article by appropriate legislation."[17] Specifically, the Thirteenth Amendment provides that "[n]either slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction."[18]

As the Supreme Court explained in *Bailey v. State of Alabama*, the "words involuntary servitude have a 'larger meaning than slavery,'" and the purpose of including those words in the Thirteenth Amendment was to "make labor free, by prohibiting that control by which the personal service of one man is disposed of or coerced for another's benefit which is the essence of involuntary servitude."[19]

Thus, "the term 'involuntary servitude' necessarily means a condition of servitude in which the victim is forced to work for the defendant by the use or threat of physical restraint or physical injury, or by the use or threat of coercion through law or the legal process."[20]

The Thirteenth Amendment bars state legislatures from passing any law that compels the performance of personal services through legal coercion.[21] Numerous state statutes have been held unconstitutional for precisely this reason. For example, in *People v. Lavender*, the New York Court of Appeals held that a New York State statute that made it a misdemeanor to willfully fail to perform a home improvement contract without justification, violated the Thirteenth Amendment as an unconstitutional "proscription of involuntary servitude."[22]

Similarly, in *Pollock v. Williams*, the Supreme Court held that a Florida statute making it a misdemeanor to induce another to pay an advance of salary upon a fraudulent promise to perform labor where the mere failure to actually perform the labor constituted prima facie evidence of the fraud, also constituted a violation of the Thirteenth Amendment.[23] Based on the Thirteenth Amendment, no government may "directly or indirectly command involuntary servitude, even if it was voluntarily contracted for."[24]

While the courts have not yet addressed this issue, the operating agreement statute, in providing that a "court may order the remedy of specific performance for…attempted or actual termination of an operating agreement," is substantively no different than the statutes at issue in *Pollock* and *Lavender* and is directly at odds with the Thirteenth Amendment.[25] The operating agreement statute seeks to compel by injunction (i) a hotel operator to perform its services on behalf of an owner even if the operator no longer wishes to perform those services; and (ii) a hotel owner to accept the services of an operator even if it no longer wishes to employ that operator.[26]

The operating agreement statute seeks to compel the performance and acceptance of personal services under threat of injunction and contempt if that injunction is violated[27] and therefore, just as the statutes at issue in *Lavender* and *Pollock*, constitutes the compulsion of involuntary servitude in violation of the Thirteenth Amendment.

The Takings Clause

The operating agreement statute may also constitute a taking without just compensation in violation of the Fifth Amendment. Under the Takings Clause, no person shall "be deprived of life, liberty or property, without due process of law; nor shall private property be taken for public use, without just compensation."[28] In short, the government is prohibited from imposing improper restrictions or regulations upon property without providing just compensation to the property's owner. "The general rule at least, is that while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking."[29]

The operating agreement statute is likely in direct conflict with the Takings Clause because the statute[30] improperly imposes the forced occupation of a hotel by a terminated operator without regard for the hotel owners' property rights.

The "power to exclude has traditionally been considered one of the most treasured strands in an owner's bundle of property rights."[31] Thus, regardless of how small or large[32] or permanent or temporary[33] a government-authorized occupation is, a property owner must be provided just compensation under the Takings Clause. This is so regardless of whether the statute serves a legitimate public interest (and here, no legitimate public interest is served by the operating agreement statute).[34]

When a hotel owner terminates its operator based upon its common law and constitutional rights, the operator no longer has any right to occupy the owner's property. The operating agreement statute turns that principle on its head by bestowing upon the operator the right to physically occupy the owner's hotel without any just compensation either for the elimination of the owner's "right to exclude" or for the continued detrimental financial impact the operator will have on the hotel—typically the reason the owner terminated the operator in the first place.

The Supreme Court has historically found violations of the Takings Clause to exist with respect to analogous statutorily authorized occupations of real property, regardless of whether that occupation was by the government itself or by third parties. For example, in *Loretto v. Teleprompter Manhattan CATV*, the court held that a New York statute violated the Takings Clause because it authorized a third-party cable company to install television cables—measuring just ½ inch in diameter and 30 feet in length—in a privately owned building without providing just compensation.[35]

Similarly, in *United States v. Pewee Coal*,[36] the court held that the government's temporary occupation of a privately owned coal mine during World War II constituted a taking under the Fifth Amendment, requiring that the owner of the coal mine be justly compensated.

Under this same analysis, the operating agreement statute violates the Takings Clause because it authorizes the physical occupation by the operator of the owner's property without providing just compensation, expressly depriving a hotel owner of one of its "most treasured strands"[37] of property rights, the power to exclude others from its property.

The Contracts Clause

Finally, to the extent applied retroactively (i.e., applied to contracts incorporating Maryland law that were entered into before the statute was passed), the operating agreement statute would violate Article 1, Section 10, Clause 1 of the U.S. Constitution, commonly known as the Contracts Clause.

In general, a state has broad police power encompassing "the sovereign right of the Government to protect the lives, health, morals, comfort and general welfare of the people, and is paramount to any rights under contracts between individuals."[38] However, under the Contracts Clause, a state is limited in abridging existing contractual rights and the contractual relationship specifically bargained for by private citizens, thus protecting private contracts from alteration by subsequent legislation.[39]

To the extent applied retroactively, the operating agreement statute violates the Contracts Clause because it alters the contractual relationship between hotel owner and operator by both expressly eliminating a principal's right to revoke its agency contract and authorizing specific enforcement of personal services contracts that traditionally could not be specifically enforced.

In determining a statute's constitutionality under the Contracts Clause, the "threshold inquiry is whether the state law has, in fact, operated as a substantial impairment of a contractual relationship."[40] If there is substantial impairment, the court must then determine whether a "significant and legitimate public purpose behind the regulation" exists, and if one is found, the statute will only be constitutional if "the rights and responsibilities of contracting parties [is based] upon reasonable conditions and [is] of a character appropriate to the public purpose justifying [the legislation's] adoption."[41]

Applying this analysis, when faced with similar statutes that purport to impair a party's right to terminate the services of an agent or an agreement in general, several courts have found a violation of the Contracts Clause. For example, in *Shell v. Metropolitan Life Insurance*, the West Virginia Supreme Court of Appeals struck down a statute as violative of the Contracts Clause because it prohibited an insurance company from firing an insurance agent without good cause, thus altering the at-will

relationship between the insurance company and its agent.[42]

Similarly, when faced with a statute altering the conditions upon which parties could terminate a hotel franchise agreement in *Holiday Inns Franchising v. Branstad*,[43] the U.S. Court of Appeals for the Eighth Circuit held that the statute was unconstitutional because it "substantially impaired the obligations previously owed" in violation of the Contracts Clause. And in *Ward v. Chevron U.S.A.*,[44] the Arizona Court of Appeals held unconstitutional a statute that limited an oil-supplier's power to terminate or refuse to renew a franchise agreement.

The operating agreement statute is the product of major hotel operators lobbying the Maryland legislature in the hope of protecting their most valuable asset—hotel management agreements. There is no legitimate public purpose that justifies the operating agreement statute. The operating agreement statute alters the basic contractual relationship between hotel owners and operators, rendering the statute unconstitutional under the Contracts Clause to the extent applied retroactively.

Conclusion

Given the dearth of case law addressing the operating agreement statute, hotel operating companies have succeeded, thus far, in creating a chilling effect on owners' termination of hotel management agreements that incorporate Maryland law. However, when the statute is finally challenged, the courts should find that the state of Maryland's attempt to coerce hotel owners to continue to accept the services of a terminated and unwanted manager will fail to pass constitutional muster for the reasons set forth above (and for additional reasons outside the scope of this article).

Todd E. Soloway *and* **Joshua D. Bernstein** *are partners at Pryor Cashman.* **Jared D. Newman***, an associate at the firm, assisted in the preparation of this article.*

Endnotes:

1. Index No. 653590/12, 2013 N.Y. Slip Op. 2013 (1st Dept. March 26, 2013). The authors represented the hotel owner in the *Eden Roc* case.

2. Id.

3. *FHR TB v. TB Isle Resort*, 865 F. Supp. 2d 1172, aff'd, 2011 U.S. Dist. LEXIS 155752 (S.D. Fla. 2011); *Woolley v. Embassy Suites*, 227 Cal. App. 3d 1520 (Ct. App. 1991); *Pacific Landmark Hotel v. Marriott Hotels*, 19 Cal. App. 4th 615 (Cal App. 1993); U.S. Const. amend. XIII.

4. *FHR TB*, 865 F. Supp. 2d 1172; *Woolley*, 227 Cal. App. 3d 1520.

5. Id.

6. *Gulf Ins. v. Transatlantic Reins.*, 69 A.D.3d 71 (1st Dept. 2009); *Rubenstein v. Small*, 273 A.D. 102, 104 (1st Dept. 1947).

7. *P.L. Diamond v. Becker-Paramount*, 16 Misc. 3d 1105(A), 2007 N.Y. Slip. Op. 4648, at *22 (Sup. Ct. N.Y. Co. 2007); *FHR TB*, 865 F. Supp. 2d at 1195; *Woolley*, 227 Cal. App. 3d at 1531-32; *Pacific Landmark Hotel*, 19 Cal. App. 4th at 624; 1 Restatement (Third) of Agency §3.10, Illustration No. 3 (2006).

8. *Eden Roc*, 2013 N.Y. Slip Op. 2013, at *1.

9. Charles S. Hale, II, "Student Work: Market Impact In The Information Age: Protecting Hotel Owners From Hotel Management Companies," 108 W. Va. L. Rev. 573, 587-88 (Winter, 2005); Lori E. Raleigh and Rachel J. Roginsky, "Hotel Investments: Issues & Perspectives," Chapter 12: Key Legal Issues, pg. 226, Fn. 18 (Fifth Edition).

10. Maryland Com. Law Code §23-104 (2004).

11. Maryland Com. Law Code §23-102(b) (2004).

12. *Eden Roc*, 2013 N.Y. Slip Op. 2013, at *1; *FHR TB*, 865 F. Supp. 2d 1172; *Woolley*, 227 Cal. App. 3d 1520.

13. *Battani v. Bar-Car*, 59 Misc. 2d 530, 532 (1969); see also *Eden Roc*, 2013 N.Y. Slip Op. 2013; *In re Mitchell*, 249 B.R. 55, 59 (Bankr. S.D.N.Y. 2000); *American Broad. v. Wolf*, 52 N.Y.2d 394, 401 (1981); *Woolley*, 227 Cal. App. 3d at 1533-35.

14. *Wolf*, 52 N.Y.2d at 401-02.

15. Id.

16. Id.

17. *Pollock v. Williams*, 322 U.S. 4, 7-8 (1944).

18. U.S. Const. amend. XIII.

19. 219 U.S. 219, 241 (1911).

20. *United States v. Kozminski*, 487 U.S. 931, 952 (1988).

21. Id.

22. *People v. Lavender*, 48 N.Y.2d 334, 336 (1979).

23. 322 U.S. at 26.

24. Id. at 24.

25. Maryland Com. Law Code §23-102(b).

26. Id.

27. See *Sheets v. City of Hagerstown*, 102 A.2d 734 (Md. Ct. App. 1954).

28. U.S. Const. amend. V.

29. *First English Evangelical Lutheran Church of Glendale v. County of Los Angeles*, 482 U.S. 304, 316 (1987).

30. Maryland Com. Law Code §23-102(b).

31. *Loretto v. Teleprompter Manhattan CATV*, 458 U.S. 419, 435 (1982).

32. Id. at 421-22.

33. *First English Evangelical*, 482 U.S. at 318 ("These cases reflect the fact that 'temporary' takings…are not different in kind from permanent takings, for which the Constitution clearly requires compensation").

34. *Loretto*, 458 U.S. at 426.

35. Id. at 422.

36. 341 U.S. 114 (1951).

37. *Loretto*, 458 U.S. at 435-36.

38. *Allied Structural Steel v. Spannaus*, 438 U.S. 234, 241 (1978).

39. Id.

40. *Energy Reserves Group v. Kansas Power & Light*, 459 U.S. 400, 411 (1983).

41. Id. at 411-12, citing *United States Trust v. New Jersey*, 431 U.S. 1, 22 (1977).

42. 380 S.E.2d 183, 191 (W. Va. Sup. Ct. 1989), citing *Energy Reserves*, 459 U.S. at 412.

43. 29 F.3d 383 (8th Cir. 1994).

44. 123 Ariz. 208 (Ct. App. 1979).