

Real Estate Trends

HOSPITALITY LAW

Hotel Franchises: A Potential Shift in Power?

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There are few commercial relationships with a more inherent imbalance of power than that of a franchisor and franchisee. In the hotel industry, franchisors possess the intellectual property in the form of the brand name, the marketing power, and the reservation systems sought by the franchisees, and therefore can demand highly favorable terms in exchange for allowing a franchisee to be part of the brand's system.

Often, the franchise agreement is presented to proposed franchisees as non-negotiable because, as the argument goes, it is part of the Franchise Disclosure Documents approved by government regulators.

Consequently, franchise agreements generally afford franchisors wide latitude to direct franchisees in the conduct of their business and even empower franchisors to terminate the relationship and "pull the flag" if the franchisee does not comply with the franchisor's requirements.

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As discussed below, however, there are recent efforts by an influential group of franchisees seeking to level the playing field through the legislative process, including a bill currently pending in New Jersey that seeks to codify certain protections for hotel franchisees.

Indicative of the stakes presented by this legislation, Marriott, a leading hotel franchisor, has severed ties with the Asian American Hotel Owners Association (AAHOA)—the largest hotel owners association in the United States—over the AAHOA's support of the proposed bill. This proposed legislation presents a potential seismic shift in franchisor/franchisee relations.

Agreements Favor Franchisors

Hotel franchise agreements often empower franchisors to dictate virtually every physical and

operational component of a hotel, with franchisees having little control or discretion. The franchisor is also empowered to impose mandatory renovations requirements to be funded by the hotel owner, to select preferred vendors from which the owner must purchase operating supplies (which vendor may be franchisor-affiliated), and to require the hotel owner to pay all overhead costs incurred by franchisors, including any out-of-pocket expenses (such as travel to the hotel to monitor compliance with the brand's requirements).

Franchise agreements may also permit brands to unilaterally impose updated brand requirements, and even new fees, without warning or limit. And if franchisees do not comply with these obligations, franchisors may assess steep penalties, or even de-flag a hotel.

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Conversely, hotel franchise agreements usually minimize the obligations of the franchisor. A franchisor can choose how (or even whether) it markets a specific brand or hotel, and may contractually disclaim any responsibility for brand success.

Although courts may impose a requirement that the franchisor perform with some level of good faith and/or commercial reasonableness, onerous terms in franchise agreements leave franchisees, often family-run businesses that may own only one or two franchises and are at a great economic and political

disadvantage, with little ability to challenge a franchisor's business decisions.

Laws Offer Minimal Protections

In recognition of the unequal bargaining power inherent in these relationships and in an effort to ensure uniformity, federal regulations require franchisors to provide prospective franchisees with a Franchise Disclosure Document (FDD) to assist franchisees in making a more informed business decision.

FDDs outline, among other things, the terms of the franchise agreement, the fees a franchisee can expect to be charged, a brand's historical financial performance, and past and ongoing legal disputes in which the franchisor is involved.

Many states have also enacted laws that restrict a franchisor's broad authority, with such laws focused on protecting a franchisee's investment. For instance, several states—including California, Connecticut, Delaware, Illinois, Michigan, New Jersey, Virginia, and Wisconsin—restrict a franchisor's ability to terminate a franchise agreement, or to refuse to renew a franchise agreement, except for good cause.

Some states—such as California, Connecticut, Maryland, and Washington—require franchisors, under certain circumstances, to purchase the franchisee's inventory upon expiration of the franchise agreement.

The levels of protections vary by state, with certain states being particularly protective of their local franchisees (including California and Rhode Island, which have laws that void provisions of a franchise agreement that purport to require the franchisee to litigate with the franchisor in a state other than where the franchise is located).

These laws, however, do not address the franchisee's broad discretion (such as its ability to impose substantial costs and expenses not initially contemplated in the franchise agreement, or power to institute changes to policies and brand standards irrespective of its effect on franchisees). And recent decisions highlight the high burden faced by hotel franchisees in seeking recourse in court.

For example, in an ongoing class action of franchisees against Intercontinental Hotels Group (IHG), *Park 80 Hotels LLC v. Holiday Hospitality Franchising LLC*, 2023 WL 2445437 (N.D. Ga. Feb. 16, 2023), the U.S. District Court for the Northern District of Georgia recently issued a decision adopting IHG's position that its wide authority under its franchise agreements effectively precludes challenges to its discretionary decisions over brand standards, marketing, property improvement plans, and vendors.

The court also rejected the franchisees' claims that IHG made misrepresentations in its FDD, finding that the franchise agreement superseded any representations in the FDD. Although the court permitted some contractual and statutory claims to proceed, this decision highlights the difficulty franchisees face in getting relief against franchisors.

New Jersey's Proposed Changes

This dynamic is now being challenged in the New Jersey Legislature. Assembly Bill No. 1958, and its counterpart Senate Bill 3165, propose to require—as a matter of law—that hotel franchisees in New Jersey be granted new benefits and protections not ordinarily found in franchise agreements.

The bill remains under consideration and was reported (*i.e.*, passed) out of the Assembly Commerce and Economic Development Committee on March 20, 2023, albeit with some amendments.

The proposed bill, among other things, prohibits franchisors from: (1) receiving rebates from franchisor-mandated vendors, unless such rebates are disclosed and passed through to the franchisee; (2) requiring franchisees to purchase goods, services, or supplies from the franchisor or franchisor-selected vendors, when comparable items are available from other sources; (3) unilaterally changing material terms of a franchise agreement; (4) imposing fees or charges not disclosed in an FDD or franchise agreement; and (5) selling loyalty points for a profit without providing reasonable compensation to franchisees. In effect, the law would reconfigure the relationship between owners and franchisors.

In pushing direct legislation, franchisees are testing other avenues to challenge their restrictive franchise contracts. Hotel brands are, as expected, forcefully opposing the bill. In fact, AAHOA's support for the bill has led to a deterioration of its relationship with Marriott, causing Marriott to refuse to sponsor or attend events organized by AAHOA.

Although Marriott's response thus far has been unique among major brands, it is evidence of the hotel stakeholders' keen understanding that this legislation, if passed, would represent a significant shift in the franchisor-franchisee relationship.

It remains to be seen whether franchisee advocacy groups seek to introduce similar legislation around the country. In the interim, the hotel industry will be closely watching.