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Hotel Franchises: A Shift in Power Through the Courts?

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As we discussed in an article published on April 11, 2023, influential hotel owners are seeking to use the legislative process to address the perceived imbalance of power between a hotel franchisor and franchisee.

Led by the largest hotel owners association in the United States, these hotel franchisees are advocating in favor of a bill currently pending in New Jersey that seeks to codify certain protections for hotel franchisees and, in effect, reconfigure the relationship between hotel owners and franchisors.

While these legislative efforts continue, hotel franchisees also continue to petition courts for relief from onerous hotel franchise agreements. As we noted in our prior article, a pending case of particular note is a multi-district litigation, brought by a class of hotel franchisees, in the U.S. District Court for the Northern of Georgia, *Park 80 Hotels, LLC et al. v. Holiday Hospitality Franchising LLC et al.,* (21-cv-4650) (N.D. Ga. filed May 19, 2021).

While the District Court issued a decision earlier this year which was favorable to the franchisor's (IHG) position that its wide authority under its franchise agreements precludes challenges to its discretionary decisions over brand standards, marketing, property improvement plans and vendors, the District Court permitted some contractual and statutory claims to proceed to discovery, which is now underway. In this article, we discuss this effort by hotel franchisees to seek redress in court, and key takeaways for hotel industry stakeholders.

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The Class Actions Against IHG and Consolidation

In *Park 80 Hotels*, originally filed in the Federal District Court for the Eastern District of Louisiana on behalf of all similarly situated franchisees in the state of Louisiana, the plaintiffs are a number of hotel owners who have entered franchise agreements with defendants Holiday Hospitality Franchising LLC and Six Continents Hotels, Inc. d/b/a Intercontinental Hotels Group (collectively, "IHG") under which plaintiffs were

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granted licenses to operate hotels within the IHG family of brands, such as Holiday Inn, Crowne Plaza, and Staybridge Suites.

IHG successfully moved to transfer the case to the Northern District of Georgia in accordance with a forum selection clause in the Franchise Agreements.

Park 80 Hotels was the first of several cases to be filed over the last few years alleging common facts and legal issues relating to hotel franchise agreements.

Subsequently-filed putative class actions were commenced in the District of Connecticut (*Aaron Hotel Group, LLC v. Holiday Hospitality Franchising, LLC et al.* (filed May 27, 2021)), the Southern District of Texas (*PH Lodging Tomball, LLC v. Holiday Hospitality Franchising, LLC, et al.* (filed June 3, 2021)), the Southern District of Ohio (*Synergy Hotels, LLC v. Holiday Hospitality Franchising, LLC, et al.* (filed June 7, 2021)), the Eastern District of Pennsylvania (*Bensalem Lodging Associates, LLC v. Holiday Hospitality Franchising, LLC, et al.* (filed June 29, 2021)), and the District of New Mexico (*110 SUNPORT LLC v. Holiday Hospitality Franchising, LLC et al* (filed Aug. 27, 2021)).

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After *Park 80 Hotels* was transferred to the Northern District of Georgia, the parties to that case and four of the others moved to consolidate and transfer the cases to the N.D. Ga. Those five cases are jointly proceeding to trial.

Allegations in the Class Action Complaint

Once consolidated, plaintiffs filed a class action complaint alleging seven causes of action under federal and Georgia state law, including claims for breach of contract (and by extension, breach of the covenant of good faith and fair dealing); violations of the Sherman Antitrust Act and a state law corollary, the Georgia Uniform Deceptive Trade Practices Act; and a declaratory judgment that the form franchise agreement entered by each of the plaintiffs was unconscionable, illusory or unenforceable.

The "unconscionable" conduct alleged in the complaint focuses both on the process by which hotel owner applicants enter franchise agreements with IHG, and on the strictures of the form franchise agreement itself.

Plaintiffs alleged that the application process is inherently unconscionable, as it requires a five-figure initial application cost, which is forfeited if an applicant fails to execute a form agreement with IHG. The form cannot be negotiated and is not disclosed to applicants until after they pay the fee.

Plaintiffs also allege that the terms of the franchise agreement are unconscionable, as the franchise agreement reserves to IHG vast authority to alter the requirements for complying with IHG "Brand Standards," and to assess a multitude of fees, costs, fines and other penalties against hotel franchisees deemed to be out of compliance. One such requirement is that franchisees must procure supplies and services through an "IHG Marketplace," which the plaintiffs allege harms the franchisees in two principal ways: (i) the goods and services are overpriced and of poor quality, requiring constant replacement; and (ii) the inflated pricing is due to "kickbacks" being paid by the vendors to IHG.

According to plaintiffs, the only apparent check to IHG's power is franchisees' option to join the "IHG Owners Association," which purports to operate "consistent with the best interests" of the franchisees. Yet plaintiffs allege that IHG controls the Owners Association and manipulates its operations to the detriment of franchisees.

The Motion To Dismiss And the Surviving Claims

IHG moved to dismiss each of the causes of action for failure to state a claim. Plaintiffs' first cause of action alleged conduct amounting to twelve separate breaches of contract and eight violations of the duty of good faith and fair dealing.

While conceding that the plain language of the franchise agreement grants IHG broad discretion in performing its obligations, plaintiffs argued that IHG must exercise that discretion in a reasonable and good-faith manner.

The District Court rejected this interpretation, finding in almost every instance that the conduct complained of was explicitly permitted by the language of the franchise agreement, which gives IHG "sole judgment" over almost every aspect of hotel operations, and that Georgia law does not impose a 'reasonableness' standard on discretion.

The court further held that the franchise agreement's merger clause barred any claim arising out of representations contained in the "Franchise Disclosure Document" provided to potential franchisees before they applied.

The court likewise dismissed those portions of the complaint alleging that the same conduct supported the alleged breaches of the covenant of good faith and fair dealing, or provided a basis for a declaratory judgment that the franchise agreement was unconscionable or unenforceable.

Nevertheless, one breach of contract claim survived dismissal.

The court found that plaintiffs stated a claim where it alleged that IHG had unfairly stacked the Owners Association's Board of Directors and manipulated its administration to the franchisees' detriment, preventing dissent and extracting further payments from Plaintiffs. As the court held, because the Franchise Agreement "does not specify how the [Owners Association] Board is to be elected[,]…binding Georgia law requires defendants to 'exercise…good faith' setting up the details of the IGHOA's operations."

Further, the franchise agreement provides that IHG use its "best efforts to cause the governing rules of the [Owners Association] to be consistent…with the best interests of all persons using the System."

The court held that this alleged manipulation of the Owners Association was sufficient to state a claim that IHG violated its contractual obligation to look out for the "best interests" of its franchisees.

In connection with the sole remaining breach of contract claim, the court also upheld plaintiffs' claim for an accounting to determine the amounts owed to the parties under the franchise agreement.

The court also found that while the misleading conduct alleged did not satisfy the pleading standard for a claim under the federal Sherman Act, it could support a claim under the Georgia UDTPA. Finally, the court dismissed plaintiffs' claim for punitive damages, but upheld their claim for statutory attorneys' fees.

Following the motion to dismiss, IHG answered and discovery commenced on the remaining claims. The case is currently in the expert discovery phase, with summary judgment motions on the horizon for early 2024.

Takeaways for Hotel Owners and Brands

Park 80 Hotels signals that courts are unlikely to rewrite seemingly iron-clad agreements, even on the basis of unconscionability. Potential franchisees should carefully review franchise disclosure documents and the franchise agreement before execution, as potential fees and costs beyond the fixed, baseline monthly licensing and marketing fees can rapidly add up to 10% or 20% of monthly revenues. Potential franchisees should consider whether they can reasonably expect to extract sufficient value from affiliating with a hotel brand to merit the strictures of a franchise agreement.

For franchisors, on the other hand, the *Park 80 Hotels* case demonstrates that courts will not allow franchisors to act with impunity in its commercial relationships with franchisees. Franchisors should keep in mind that while bargaining power is typically in their favor, they cannot escape the covenant of good faith and fair dealing or bypass contractual obligations to operate within the bounds of commercial reasonableness.