The Kickback Fallout

Lessons in money, agency, and the law.

Some months ago, the following headline startled the hotel industry: "Owner Awarded $50 Million Against Operator." It also was widely reported that the case involved "kickbacks," a concept that always manages to gain the industry's undivided attention.

Law firms jumped on the bandwagon of publicity, fanning the flames of interest. Everyone wanted to know what new rule of law had been involved and what the operator was found to have done. If hotel operators wore boots, one would have heard some shaking in them.

Then, the hubbub disappeared, except for a stray article here and there by a commentator or a law firm. Everyone in the industry went back to business as usual.

What exactly were the legal issues involved in this case? And how would its particulars and consequences affect you?

The Case

The case is known on the books as 2260 Woodley Road Joint Venture v. rrr Sheraton Corporation. Heard in the United States District Court for the District of Delaware, the case stems from a management agreement that Sheraton entered into with the hotel owners involved in the Woodley Joint Venture. The agreement began in the late 1970s and—as a result of renewal options—could have run through 2030.

By the 1990s, a variety of disputes had broken out between the hotel owner and ITT Sheraton. As a result, the owners conducted an audit of Sheraton's books and accounting practices. A lawsuit was filed when complex and ongoing negotiations between the groups failed in 1997.

Among the claims was that Sheraton had received so-called kickbacks—payments received by an agent, from some person other than his principal, without the principals consent and related to its business. They are illegal under various state (and some federal) statutes. The underlying harm in a kickback is that the agent is required to be loyal and faithful to his principal. When he takes money relating to the principal's business without the consent of the principal, the law says that the duty of loyalty has been breached.

In its most pernicious form, a kickback operates like this: A vendor "pays off" the agent to buy only from that vendor, the agent, to line his own pockets, does this, thereby increasing the cost to the principal. However, even without proof that the payment to the agent actually influenced his conduct or the principal's business, such disclosed payments usually are illegal.

In Woodley, the owner claimed that Sheraton had received such payments from vendors and had imposed on the property various costs not fairly allocated to the property. This, it claimed, breached the duty of loyalty, as well as various statutes. Sheraton fought these claims, asserting that it had authorization for the alleged wrongful practices and that the owners knew about them.

At the base of all of the claims appears to have been the claim that Sheraton became the owner's agent under the management agreement.

Agency relationships are created as a matter of law, even if the agreement does not use the word "agency." Generally, one becomes an agent when he agrees to act on behalf of another (the principal) in dealing with that person's affairs. Because the agent is acting on behalf of the principal, the law requires him to deal honestly and fairly with the principal, in order to prevent (for example) the agent from taking unfair advantages. Thus, it is said that an agent has a fiduciary duty to the principal. Among the things that an agent can't do is profit personally from the conduct of the principal's business (above and beyond what he is paid by the principal).

As an example, let's say that a buyer of meat for a hotel chain is given money by a meat vendor to purchase from him. This is a kickback, since the agent (the buyer-employee) is lining his pockets while conducting the hotel's business. It is this type of kickback that is often prosecuted criminally in court.

In the Woodley case, it appears that something quite different was being alleged. Apparently, Sheraton was alleged to have received rebates from various service and product providers, and the charge was that those rebates were kickbacks: However, such payments have none of the normal indicia of kickbacks—as in, they are hidden and the industry knows that they occur. Nevertheless, one can (and the owner did) argue that they satisfy the technical definition of kickbacks.

Also involved in the case was a Rack-
eteer-Influenced and Corrupt Organization Act claim. RICO is a law enacted to fight organized crime, but it is so broad that it can apply to virtually any behavior. In order to bring a claim alleging a RICO violation, the plaintiff has to show that at least two criminal violations have occurred.

Under the laws of the United States, it is a crime to use the U.S. mail in an attempt to defraud. Thus, it is possible to argue that if, for example, someone breached a contract, he also committed a crime by lying about it in letters sent through the mail, and hence was violated RICO. Plaintiffs like Rico because they can win even more in damages.

What Happened
The jury ultimately awarded Woodley $37.5 million in punitive damages. Another $10 million was awarded in "actual" damages due to Sheraton's Mure to act as the owner's agent.

It's hard to determine what the verdict means, however. The case in and of itself sets no legal precedent because it establishes no new rules of law. As a result of cases decided over the past decade or so, it can be established that, depending on the relationship between the parties, a management company can—and often will—be designated as the agent of the owner. It has always been the law that agents must act in a certain fashion, and the jury, apparently, found that in this particular case, Sheraton had not behaved accordingly. None of these findings is particularly newsworthy.

There are some lessons to be learned from this case, however.

The primary lesson is that when principles of law (again, in this case, agency) are imposed upon an existing contract, the outcome can be surprising. It is probably safe to assume that no one involved had viewed the contract involved as creating an agency relationship. Rather, it was undoubtedly viewed as creating a management company/owner relationship. That relationship may well be very different from an agency relationship. However, since there exists the very real possibility that the law will be read into management contracts, one would be well advised to review those contracts now, before a dispute breaks out.

Equally important is the lesson that companies learn over and over again, typically in court—namely, that in 99.9 percent of the lawsuits involving your business, the only thing at stake is money. Consequently, you will almost always be better off resolving business disputes without the added cost of lawyers and die uncertainty of litigation. You can and often do get crazy results in litigation. Certainty and restoration of good business relationships is the best course of action to follow in most cases.