AGENCY LAW, FIDUCIARY DUTIES, AND HOTEL MANAGEMENT CONTRACTS

Robert H. Wilson
University of Massachusetts

A series of recent court cases have given hotel owners the power (although not necessarily the right) to terminate hotel management contracts, with or without cause. The courts have also affirmed the existence of a principal-agent relationship in hotel management contracts. Future court decisions involving hotel management contracts will apply traditional agency law, and will impose a fiduciary duty on the hotel operator as set out in the Restatement (Second) of Agency *(1958). In one case recently, a jury awarded $57 million to the hotel owner because the hotel operator did not disclose hidden profits and kickbacks and breached its fiduciary duties.*

KEYWORDS: *hotel management contracts; agency law; fiduciary duty; termination.*

Agency law requires that the agent (the hotel operator) is obligated to provide to the principal (the hotel owner) the following:

- the fiduciary duty to always act in the best interests of the principal,
- the duty of service and obedience,
- the duty to keep and render accounts regarding spending and budgets,
- the duty to obey the requests of the owner,
- the duty to account for profits arising from employment,
- the duty of loyalty,
- the duty to provide information,
- the duty not to compete,
- the duty not to act for someone else who has a competing interest, and
- the duty not to use or disclose confidential information.

The fiduciary duties imposed on hotel operators by the application of agency law will have wide-ranging implications for hotel owners and hotel operators. Hotel operators will be required to provide (as a result of the application of agency law) more accurate, honest, detailed, and timely information relating to system reimbursable expenses and practices, personnel practices and costs, receipt of undisclosed profits, financial and accounting information, and operator competition.

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Agency Law, Fiduciary Duties, and Hotel Management Contracts

Until recently, most parties to hotel management contracts believed that all of their rights and obligations were governed by the terms contained in the written management contract. An ongoing series of court cases, in a variety of legal venues, continues to redefine the obligations, rights, and terms of management contracts. The cases are *Wooley v. Embassy Suites* (1991), *Pacific Landmark v. Marriott* (1993), *Government Guarantee Fund of the Republic Finland v. Hyatt* (1996, 1998), and *2660 Woodley Road Associates, Inc., John Hancock Mutual Life Insurance Company and Sumitomo Life Realty, Inc. v. ITT Sheraton Corporation and Sheraton Operating Corporation* (1998, 1999).

Although each of the cases are different, they all involve the owner of a hotel terminating an existing management contract without cause, and then ordering the management company to cease all management functions and to leave the property. In each case, the management contract contained language prohibiting the owner from terminating without cause, and the management company contested the termination, claiming that a wrongful termination had occurred. One finding in all of the cases is clear: Most hotel management contracts create a principal-agency relationship, and the law of agency defines and regulates the application of the rights and obligations that the parties have agreed on in the written management agreement.

Although these cases focus on the power of hotel owners to terminate existing management contracts without cause by examining the existence or nonexistence of an "agency coupled with an interest," their importance goes well beyond those issues. The author strongly believes that when traditional agency law theory is applied by courts to decide new disputes between owners and operators, hotel operators will continue to be jolted by the decisions. Disputes involving operator system reimbursable expenses, owner input into budgets, personnel practices, purchasing programs, financial and operational reporting, noncompetition clauses, and books and records are some of the hot spots that cause disputes and litigation between owners and operators (Eyster, 1997). The erosion of operator power by court decisions will continue to evolve as the courts begin to apply agency law principles to disputes other than those involving termination of existing management contracts. In January 2000, a U.S. District Court in Maryland awarded $50 million based on possible kickbacks in Sheraton's purchasing program in the *2660 Woodley Road Associates, Inc., John Hancock Mutual Life Insurance Company and Sumitomo Life Realty, Inc. v. ITT Sheraton Corporation and Sheraton Operating Corporation* (1998) case. The award included $37.5 million in punitive damages.

In the Wooley case, the court defines an agent as "anyone who undertakes to transact some business, or manage some affair for another . . . and to render an account of such transactions" (*Wooley v. Embassy Suites*, 1991, p. 1531). In each of the cases, the courts determined clearly and unequivocally that a principal-agent relationship existed between the owner of the hotel and the hotel operator. The existence of the principal-agent relationship gives the hotel owner (the principal) the power to revoke an operator's (the agent) authority (terminating the

contract) at any time before the agent has completed performance "except in the case of an agency coupled with an interest" (p. 1522).

In the Pacific Landmark Hotel case, the court also found that a principal-agent relationship existed: "It is undisputed that management agreements create an agency relationship between the Owners as principal and Marriott hotels as agent" (*Pacific Landmark v. Marriott*, 1993, p. 824), and that the hotel owner had the power to terminate an existing management contract. In addition, the court also discussed the issue of a "power coupled with an interest." In the Government Guarantee Fund case, the court also found that a principal-agent relationship existed. The hotel owner (principal) could terminate the management contract because a simple agency relationship existed, and because there did not exist either a power coupled with an interest or a power given as security. In the 2660 Woodley Road Joint Venture case, the U.S. District Court found that an agency relationship existed between the owner and operator, that the owner had the power to revoke, and that an agency coupled with an interest did not exist. This article will not discuss either the right to terminate existing management contracts or agency coupled with an interest. Three interesting and informative articles, two by Michael Shindler, "The Principle of the Principal" (1997) and "The Precedents and the Principle: An Update on Hotel Management Agreements and the Laws of Agency" (1998), and one by Robert Wilson, "Hotel Management Contracts: Breach of Contract, Termination, and Damages" (1999), discuss these topics.

A review of some of the basic principles of agency law will provide a road map to the direction that courts will likely take in the future to help decide disputes involving hotel management contracts.

REVIEW OF THE LAW OF AGENCY

Agency law creates a series of duties or obligations that are placed on the agent. These obligations will be discussed in subsequent sections. The obligations placed on the agent by the *Restatement (Second) of Agency* (1958) create rules and guidelines that both the principal and agent must follow. The obligations placed on the agent (the hotel operator) by agency law are obligations that go beyond the terms of the written management contract signed by the parties. The obligations modify, clarify, and expand on the obligations that the parties have agreed to in their written contract. They are written obligations imposed by agency law that apply in all situations where a principal-agent relationship exists. Some of the obligations are as follows: the fiduciary duty to always act in the best interests of the principal, the duty of service and obedience, the duty to keep and render accounts regarding spending and budgets, the duty to obey the requests of the owner, the duty to account for profits arising from employment, the duty of loyalty, the duty to provide information, the duty not to compete, the duty not to act for someone else who has a competing interest, and the duty not to use or disclose confidential information. All of these obligations and duties, taken together, provide a possible weapon to hotel owners in the ongoing disputes that sometimes exist with hotel operators.

Fiduciary Duty of Agency to Always Act in the Best Interests of the Principal

The *Restatement (Second) of Agency* (1958) is followed by most courts and sets out the rights and obligations of the agency relationship:

> Agency is a fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act. (p. 7)

As a general rule, the extent of the duties of the agent to the principal are usually determined by the terms of the contract that the parties have signed. In many situations, however, agency law will be applied to alter the contractual terms.

> Even specific agreements, however, must be interpreted in the light of the principles, which are applicable to the relation of principal and agent. The existence of the fiduciary relation between the parties, and the duty of the agent not to act for the principal contrary to orders, modify all agency agreements and create rules which are sui generis and which do not apply to contracts in which one party is not an agent for the other. (*Restatement (Second) of Agency*, 1958, p. 171)

As an example, in the case of *Wooley v. Embassy Suites* (1991), the court was considering the ability of Wooley, the hotel owner, to terminate an existing management contract where the terms of the contract specifically prohibited an early termination. The court determined first that an agency relationship did exist. The court then applied agency law to modify and revise the terms of the written contract allowing the owner to terminate the written contract.

> Even if the contract did attempt to restrict the power of the owner to terminate the manager, such provision would be ineffective. The principal's power of revocation is absolute and applies even if doing so is a violation of the contract or the agency is characterized as irrevocable. (*Wooley v. Embassy Suites*, 1991, p. 1531)

The courts take the position that hotel management contracts involve an agency relationship between the owner and the operator. When an agency relationship is created, the agent becomes a fiduciary. The heart of the agency relationship is the fiduciary duty that the hotel operator (agent) owes to the hotel owner (principal). When a contract creates an agency relationship, agency law obligates the agent to numerous fiduciary responsibilities that go beyond the scope of the written contract.

Duty to Provide Information

> Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person. (*Restatement (Second) of Agency*, 1958, sec. 381, p. 182)

Hotel operators frequently simultaneously manage competitive properties in other markets, manage properties in the same city in different market segments, or operate or own other similar competitive properties. The courts have not yet explored the agency requirements of the operator to provide information to an owner when the owner and agent are also competitors. The courts have also not yet explored the agency requirements of the operator to refrain from using or sharing information that has been obtained from the hotel owner to either further their own interests or the interests of other competing properties.

The notes on the *Restatement (Second) of Agency* (1958, p. 182) provide that the agent is obligated to provide the principal with information of facts that might be important to the principal that are known to the agent:

> The duty exists if he has notice of facts which, in view of his relations with the principal, he should know may affect the desires of his principal as to his own conduct or the conduct of the principal or of another agent.

The agent may have an obligation to provide information to the owner that may be privileged information that is important to the owner but also important to the agent. The agent has the obligation to provide the information. If the agent deems that the information cannot be provided because it will violate some confidence or trust to another person or to the interests of his own company, then the agent may be prohibited from continuing to act as the owner's agent.

> If the agent has, or if he represents another who has, interests adverse to the principal as to matters within the scope of the agency, or if he is competing with the principal and using information acquired during his agency, he is under a duty to the principal to reveal such facts. (*Restatement (Second) of Agency*, 1958, p. 182)

If the agent has interests with competing hotels, if the agent owns subsidiaries that are hired to provide services to the owner (as found in the Hyatt case), if the owner is making profits from transactions that are not being disclosed (as found in the Hyatt case and the ITT Sheraton case), then the agent must disclose the information. The owner need not ask; the agent has the obligation to disclose the information even if the owner does not request it. If the agent cannot disclose the information, then the agent must decline to act.

Duty to Keep and Render Accounts

One of the continuing battlegrounds between owners and operators is obtaining information from the operator with regard to spending and the budget, and who has control of those issues.

> Control of the hotel's books, records, and cash balances, as well as the definition of what documents even constitute hotel books and records, are frequently matters of controversy. Operators historically have been reluctant to provide owners with adequate back up materials for owners to monitor property perfor-

> mance—in some cases, operators have flat out refused to provide such documentation. (Eyster, 1997)

As the following paragraph points out, the law is clear: The agent has the duty to render accounts of money received or paid out.

> Unless otherwise agreed, an agent is subject to a duty to keep, and render to his principal, an account of money or other things which he has received or paid out on behalf of the principal. (*Restatement (Second) of Agency*, 1958, sec. 382, p. 185)

The reader may be interested in the case of *Government Guarantee Fund of the Republic Finland v. Hyatt* (1998). It is another case involving the early termination of an existing management contract, even though the management contract contained a provision prohibiting the owner from terminating without cause. In this case, the owner terminated the management contract. Hyatt refused to leave the hotel and continued to manage the hotel after the termination. Although the court determined that an agency relationship existed and that the owners had the power to revoke the existing management contract, they also determined that Hyatt had an obligation to vacate the property and to cease management of the property as soon as the owner terminated the contract. When Hyatt refused to leave the property, the court found that Hyatt "owed a fiduciary duty to properly account for all funds coming into the hotel during the holdover period," and that the management company "breached that duty by not turning over any of those funds" (*Government Guarantee Fund of the Republic Finland v. Hyatt*, 1998, p. 332). The case, which had dragged on since 1995, was finally settled in 1998. Prior to the settlement, the court found Hyatt's lawyers in contempt of court and ordered that Hyatt might have to turn over $24 million in gross receipts that Hyatt had received after the termination of the management contract. Hyatt had failed to comply with court orders to make adequate disclosures of financial records, and had not fully disclosed that Hyatt-owned subsidiaries were profiting from payments received by Hyatt (Dent, 1998).

Although the court was dealing with an "equitable accounting" request in the Hyatt case, Chief Judge Moore does write that agency law imposes a continuing and ongoing obligation on the operator to

> keep and render accounts to the principal of all financial affairs which the agent has handled on behalf of the principal. (*Government Guarantee Fund of the Republic Finland v. Hyatt*, 1998, p. 333)

Section 382 of the *Restatement (Second) of Agency* (1958, p. 185) provides that the obligation exists in all situations in which a principal-agency relationship exists and begins when the agency relationship begins. It does not come into effect only if there is a termination of the contract. It exists whenever a hotel owner has a management company managing the operations of the hotel.

Do the duty to keep and render accounts and the duty to render and provide information require the operator to provide more information on an ongoing basis

than the hotel operators are generally providing now to hotel owners? Once an owner claims a breach of the management agreement, the courts order a full accounting, in accordance with section 382 of the *Restatement (Second) of Agency* (1958, p. 185). A full accounting must be made to determine damages due, if any.

Hotel owners frequently want additional information from the operator regarding payments by the operator to third parties, allocations by the operator of expenses, payments made by the operator to subsidiaries or affiliates owned or controlled by the operator, and system reimbursable expenses. System reimbursable expenses require that

> the owner reimburse the operator for a hotel's pro-rata share of operator system-wide marketing, sales, reservation, accounting, and training expenses, as well as the cost of travel, room, and board for the operator's corporate personnel carrying out their duties supervising the hotel. In addition, the operator often charges a procurement fee when purchasing on the owner's behalf furniture, fixtures, equipment, and other capital items for the hotel. (Eyster, 1997, p. 27)

Eyster (1997, p. 27) continues by stating,

> Owners and asset managers constantly cite their inability to receive specific information from operators when monthly system-reimbursement charges are made and when new or unusual charges appear against their hotel operations.

The obligation to provide a full accounting or to provide additional information is not just a posttermination remedy available only if ordered by the courts. The language of the *Restatement (Second) of Agency* (1958, sec. 382) requiring a "full accounting" clearly imposes a continuing obligation on an agent that exists as part of the fiduciary obligations that the operator owes to the owner and that arise out of the existence of the principal-agency relationship. It is an obligation to provide relevant information. The obligation is not dependent on the principal claiming a default of the agreement. It is up to the owner to determine what information is important; it is not up to the agent to either provide or not provide relevant information. The owner has the right to receive and the operator has the obligation to provide the information as part of the ongoing business relationship with the operator. A failure by the operator to voluntarily provide all relevant information would be considered a breach of the principal-agent relationship as well as a breach of the management agreement.

Duty to Obey

Hotel owners frequently spar with their hotel operator over what information should be made available to the owner, who controls budgetary decisions, who controls personnel issues, and other numerous operational questions. The custom and practice of the hotel management industry is to sometimes not provide as much information as the owner desires. Owners want more information and to be kept better informed, whereas operators sometimes provide less than the owner

wants. Agency law imposes obligations on the operator (agent) to keep and render accounts (see previous section), to provide information (see previous section), and to obey requests; they are requirements that may take precedence over the terms of the written agreement or over custom and practice. The *Restatement (Second) of Agency* (1958, sec. 385, p. 192) provides the following:

1. Unless otherwise agreed, an agent is subject to a duty to obey all reasonable directions in regard to the manner of performing a service that he has contracted to perform.
2. Unless he is privileged to protect his own or another's interests, an agent is subject to a duty not to act in manners entrusted to him on account of the principal contrary to the directions of the principal, even though the terms of the employment prescribe that such directions shall not be given.

Reasonable directions or requests for information from the principal must be complied with, even when the management agreement or custom and practice suggest otherwise. Coupled with the obligations of the duty to provide information, the duty to keep and render accounts (supra), and the duty to account for profits arising out of employment (infra), the failure to provide reasonable requests for information may subject the operator to breach of contract actions.

Duty to Account for Profits Arising Out of Employment

Operators sometimes own insurance companies, telephone providers, cleaning and maintenance services, food service operations, security services, and accounting and tax services. As part of their management of hotels, they may hire their own company-owned businesses to provide services to those hotels. The hotel owners are billed for the services rendered by the subsidiaries. The hotel owners have hired the operators to take care of items such as security, cleaning, insurance, and so forth. The hotel owner expects that the hotel operator will hire the best service companies and negotiate the lowest cost contracts. The owners are not always informed by the operators that they are hiring their own subsidiaries and are making an additional, undisclosed profit. The owner does not know that the operator has a business relationship or owns the service providers.

In addition to the requirement for the operator to provide information (supra), an operator must also account for profits that are made as part of their management of the property.

> Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him or in behalf of the principal is under a duty to give such profit to the principal. (*Restatement (Second) of Agency*, 1958, sec. 388, p. 203)

Unless the operator discloses to the owner that the operator has made undisclosed profits, has business relationships with service providers, or owns the service providers, then the operator is under a duty to give the profit to the owner. There exists an obligation that exceeds simply providing information. The operator is not

allowed to retain any secret profits that have been made. If the management company hires other independent companies to provide services or purchases items from independent vendors and receives kickbacks or receives any compensation or payment from the vendor, the management company must disclose the receipt of the additional funds.

In the case of *2660 Woodley Road Associates, Inc., John Hancock Mutual Life Insurance Company and Sumitomo Life Realty, Inc. v. ITT Sheraton Corporation and Sheraton Operating Corporation* (1999), the Sheraton corporation added 7% onto the best prices that it obtained from vendors supplying services, materials, and supplies. Sheraton kept the 7% to cover its administrative costs. The jury awarded damages of more than $50 million to the hotel owners including the following amounts: $1.1 million for breach of fiduciary duty, $10.2 million for breach of contract as to the obligations of the agent to the owner, and punitive damages of $37 million (Dent, 2000). This is the first case where the courts have awarded damages to the owners for kickbacks (the failure to disclose hidden profits) that amounted to violations of fiduciary duties. Sheraton is appealing the jury awards at this time.

Duty of Loyalty and Associated Obligations

The *Restatement (Second) of Agency* (1958, sec. 387, p. 201) provides the following:

> Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.

A basic obligation of the agent is to act on behalf of the principal and not for his own benefit. In addition,

> The agent's duty is not only to act solely for the benefit of the principal in matters entrusted to him, but also to take no unfair advantage of his position in the use of information or knowledge acquired by him because of his position as or because of the opportunities which his position affords. (*Restatement (Second) of Agency*, 1958, p. 202)

This obligation, along with others mentioned in this section, should be viewed as part of the entire set of obligations that are owed by the operator to the hotel owner.

In addition, unless otherwise agreed, the agent (operator) has an obligation to provide information to the principal and to obtain permission from the principal (hotel owner) whenever the agent is involved in the following situations:

acting *as* an adverse Party *without* principal's consent,
acting *as* an adverse Party *with* principal's consent,
acting *for* an adverse Party *without* principal's consent, and
acting *for* an adverse Party *with* the principal's consent.

The agent must disclose the activity and obtain consent or permission from the hotel owner whenever the agent is involved in any of those situations. The agent owes a duty of full and complete disclosure and of fair dealing. A full and complete disclosure of all relevant facts is necessary to meet this obligation to the principal.

Competition as to Subject Matter of Agency

"Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of the his agency" (*Restatement (Second) of Agency*, 1958, sec. 393, p. 216). If the principal knows and agrees to the fact that the agent will compete, no violation of the duty will exist. If the matter is not within the field of the agency, then the agent may compete and act on his/her own account. At the same time, questions as to whether the agent can or cannot compete will normally be decided in favor of the principal.

It is the agent's duty to further his principal's interest at the expense of his own in matters connected with the agency (*Restatement (Second) of Agency*, 1958, p. 216).

In addition, if,

> without the violation of a duty on the part of agent, a situation arises in which the principal's affairs conflict with those of the agent, the agent has a duty to deal fairly in the protection of the principal's interests. (*Restatement (Second) of Agency*, 1958, p. 216)

Hotel operators sometimes find themselves competing with their principals, having interests adverse to their principals, acting on behalf of someone who has interests that conflict with the owner, or making undisclosed profits. The agent must be able to demonstrate that they are acting in the best interests of their principal. In those situations where they might be acting in an adverse capacity with competitors, or for their own benefit, the obligation exists to provide a full and complete disclosure of all information that the principal would deem relevant. Otherwise, the operator has breached his fiduciary obligations that are owed to the principal (hotel owner).

Using or Disclosing Confidential Information

While acting as an agent, the agent will usually obtain information and data that is confidential to the owner.

> Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge. (*Restatement (Second) of Agency*, 1958, sec. 395, p. 221)

SUMMARY AND CONCLUSION

A series of recent court cases, decided in a variety of different venues, have affirmed the power of hotel owners to terminate hotel management contracts without cause: *Wooley v. Embassy Suites* (1991), *Pacific Landmark v. Marriott* (1993), *Government Guarantee Fund of the Republic Finland v. Hyatt* (1996, 1998), and *2660 Woodley Road Associates, Inc., John Hancock Mutual Life Insurance Company and Sumitomo Life Realty, Inc. v. ITT Sheraton Corporation and Sheraton Operating Corporation* (1998).

The focus of these cases has been on the issue of existence or nonexistence of the power of the hotel owner to revoke or terminate existing management contracts. By affirming the existence of a principal-agent relationship in hotel management contracts, future litigation between hotel owners and hotel operators will be forever changed. In trying to determine exactly what the duties and obligations of the owners and operators are to each other, the language contained in hotel management contracts is only a part of the puzzle. Future litigation involving hotel management contracts will apply traditional agency law to guide the courts in their decisions. What the contracts state will be modified, clarified, and revised when agency law is applied. The contracts and the actions of the parties must conform to the obligations and requirements set out in the *Restatement (Second) of Agency* (1958). Agency is a fiduciary relationship that results from the consent by one person to another that the other shall act on his or her behalf and subject to his or her control. The series of fiduciary duties and obligations contained in the *Restatement (Second) of Agency* (1958) are as follows:

- duties of service and obedience,
- duty to provide information,
- duty to keep and render accounts,
- duty to obey,
- duty to account for profits arising out of employment,
- duty of loyalty,
- competition as to subject matter of agency,
- acting for one with conflicting interests, and
- using or disclosing confidential information.

These duties and obligations taken together and applied to the written hotel management contract create obligations for the operators that go well beyond the obligations contained in the written agreements and well beyond the existing custom and practice in the industry. The entire hotel industry was jolted as each one of the cases discussed in this article was decided. The courts have clearly stated that each hotel management contract creates a fiduciary relationship that is controlled by the law of agency as contained in the *Restatement (Second) of Agency* (1958). The cases should put the hotel operator on notice that the courts will apply all of the obligations of agency law to disputes between hotel owners and hotel operators. (See the prior discussion with regard to the award of $50 million in the case of *2660 Woodley Road Associates, Inc., John Hancock Mutual Life Insur-*

ance Company and Sumitomo Life Realty, Inc. v. ITT Sheraton Corporation and Sheraton Operating Corporation [1999] for receiving undisclosed kickbacks.) Some hotel operators will need to change their practices to avoid putting themselves at risk for future legal challenges and damage awards.

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Robert H. Wilson, J.D. (e-mail: rwilson@hrta.umass.edu) is an associate professor in the Department of Hotel, Restaurant and Travel Administration at the University of Massachusetts, Amherst (203 Flint Hall, Amherst, MA 01003).