

AAHOA 2008 PROGRESS REPORT ON LA QUINTA HOTELS FAIR FRANCHISING COMPLIANCE

By Stanley Turkel, MHS, ISHC

Every month, for the past year, I have reviewed each of AAHOAs 12 Points of Fair Franchising and reported on them on the Hotel Interactive website. At the recent AAHOA Convention in San Antonio (March 26-29), AAHOA released its long-awaited Performance Appraisal Report (PAR) which evaluated the franchise agreements of five leading franchise companies including ACCOR, Carlson, Choice, La Quinta and Wyndham. The object of this report is to determine how these companies comply with the 12 Points of Fair Franchising.

Why is this important? Since AAHOA members own approximately 13,500 franchised hotels and have long-term franchise agreements with their franchisors, fair franchising is an essential factor in achieving profitable operations.

In preparing its PARs, AAHOA utilized the Uniform Franchise Offering Circulars (UFOCs), actual franchise agreements and related business policies and procedures.

Following the preparation of draft versions of the Performance Appraisal Report, AAHOA provided each franchisor with a copy of the report and an opportunity to comment on it. The comments received by AAHOA were considered and, if pertinent, were integrated into the Performance Appraisal Report.

This long-awaited (and some would say long-overdue) report enables franchisees to better understand the provisions of the franchise agreements so that they can make informed decisions before signing a franchise agreement and committing to a long-term franchise relationship.

Here is a summary of the performance appraisal of La Quinta Franchising as compared to AAHOAs 12 Points:

Point 1: Early Termination and Liquidated Damages

1(a) Most franchisors assess liquidated damages at unfair and punitive rates often 36 to 60 months of royalty fees. AAHOA states that franchisees should only have to pay 6 months of royalty fees.

LA QUINTA POSITION:

In its 2006 and 2007 UFOCs and franchise agreements, La Quinta provides that after the first 12 months, if a franchise is terminated early, the liquidated damages (“LDs”) will equal three (3) times the average annual total Royalty fees.

After meeting with AAHOA, La Quinta agreed to include various important terms in its franchise agreements that protect its Franchisees. Specifically, a Franchisee can voluntarily terminate its franchise agreement without penalty, or with reduced LDs, if it has experienced average occupancy rates below 50-70% for the past 12 months.

1(b) Windows Provisions- Most franchise agreements contain “window” or additional termination right provisions which allow the parties to terminate the agreement on specific anniversary dates (e.g. on the fifth, tenth or fifteenth anniversary) without having to pay liquidated damages. Unfortunately, many franchisors have included “gotcha” clauses in their franchise agreements which prevent early termination if the franchisee encountered monetary or operational problems at any time after the opening of the facility.

LA QUINTA POSITION:

In its 2006 and 2007 standard franchise agreements, La Quinta offers a “reciprocal right to terminate without cause” on the 10th and 15th anniversary dates of the opening of the Facility. Facilities that have been converted to a La Quinta Lodging Facility are also given a right to terminate without cause on the 5th anniversary date.

The conditions for exercising this right are that the Franchisee must (a) be in full compliance with the franchise agreement, (b) execute a general release of

La Quinta, and (c) give at least 12 months prior written notice. (See, e.g., 2006 franchise agreement, section 15.01, p. 28.)

1(c) Underperforming Properties

LA QUINTA POSITION:

As set forth in its UFOC and standard franchise agreement, La Quinta offers its Franchisees various options to terminate early with the payment of little or no liquidated damages (“LDs”) based on average room occupancy rates for the prior twelve (12) consecutive months, as follows:

- (i) If occupancy rates are less than 50%, by giving 90 days notice, the Franchisee may exit without paying any LDs;
- (ii) If occupancy rates are greater than 50% but less than 60%, by giving 120 days notice, the Franchisee may exit by paying LDs equal to the total Royalty fees paid during the prior 12 months; and
- (iii) If occupancy rates are more than 60% but less than 70%, by giving 180 days notice, the Franchisee may exit by paying LDs equal to the total Royalty fees paid during the prior 30 months.

2. Impact/Encroachment/Cross Brand Protection All franchisors should grant each of their franchisees (over the term of the agreement) contractual rights to a geographic “area of protection” (AOP) in which the franchisor will not allow another property to operate with the same or similar brand name as the franchisees hotel.

LA QUINTA POSITION:

In its 2006 UFOC and franchise agreement, La Quinta did not offer an exclusive area or protected territory to its Franchises, and did not offer any right to request an impact study.

Following its review of the PAR, La Quinta made changes to its 2007 UFOC and its corresponding business practices, to reflect the fact that (a) it now provides an exclusive Area of Protection (AOP) to its Franchisees and (b) when

La Quinta receives an application for a new hotel, it provides notice to all existing Franchisees within a 15-mile radius of the proposed facility.

In addition, during a conference call between AAHOA and La Quinta executives on May 25, 2007, La Quinta agreed that it will allow a Franchisee to request an impact study if the Franchisee reasonably believes that an applicant hotel will have an impact on its existing facility.

3. Minimum Performance & Quality Guarantees If a franchisee's hotel is not able to maintain certain occupancy levels over a designated period and has not received a minimum level of reservations, franchisee should be able to terminate the agreement without penalty.

LA QUINTA POSITION:

According to La Quinta, it would not be prudent for a franchise company to develop meaningful, system-wide performance and quality levels or guarantees.

4. QA Inspections/ Guest Surveys

LA QUINTA POSITION:

La Quinta's 2006 UFOC and franchise agreement provided that the Franchisees shall be responsible for maintaining the condition of their hotels, and failed to offer any assurances that La Quinta would conduct its quality assurance ("QA") inspections in a fair and unbiased manner.

Following its review of the PAR, however, La Quinta provided AAHOA with important information about its compliance with this Pont No. 4, as follows:

(1) La Quinta reported that since the inception of its QA program, it has issued only two default notifications to its Franchisees for service or quality failures. Of these two defaults, one of the defaults was cured, and the other default resulted in a termination of the property from La Quinta's franchise system.

(2) La Quinta explained that it provides its Franchisees with no less than three quarters of a year to address a service or quality issue. In the first quarter, La Quinta issues a warning to the Franchisee; in the second quarter, if the service or quality failure is not corrected, La Quinta issues a default notice; in the third quarter, if the default still is not cured, La Quinta issues another default notice. At the end of the third quarter, if the problem has not been corrected, a company representative will typically meet with the Franchisee and, if necessary, allow the Franchisee until the end of the year to correct or cure any outstanding issues.

(3) La Quinta relies on an outside independent company, known as Medallia, to determine a hotel's compliance with service and quality standards through guest survey scores. These overall guest survey scores for the facilities do not account for any guest complaints.

(4) La Quinta reported that once in compliance, a prior failure of a hotel is not counted against the Franchise in the future.

(5) Finally, all information regarding a problem facility comes directly from La Quinta's regional Service Directors. Therefore, as explained by La Quinta, legal notification of a service or quality failure is only initiated by regional Service Directors who have hands-on experience with the property, understand why a hotel might be failing, and are aware of the actions that have been taken to remedy such a failing.

5. Vendor Exclusivity

LA QUINTA POSITION:

After reviewing the PAR, La Quinta provided AAHOA with valuable feedback concerning this Point No. 5. Specifically, La Quinta reported that, as a matter of practice, it provides the Franchisees with a list of at least three (3) preferred vendors for most of its products and services. In addition, if a vendor is not on La Quinta's preferred list, a Franchisee can seek approval from La Quinta to purchase products or services from the proposed vendor. La Quinta does not charge a fee for reviewing the proposed vendor, and simply asks the vendor to provide the specifications for its products or services so that La Quinta can

ensure that they are in compliance with the necessary standards and uphold brand consistency.

La Quinta mandates certain vendors only for computer hardware and software. According to La Quinta, it supplies the equipment and maintenance for the computer hardware and software to the Franchisees, and then only charges the Franchisees what it pays to the mandated vendors.

With regard to commissions earned from any vendor or supplier arrangements, La Quinta reported that all commissions and rebates received from vendors and suppliers are used to defray expenses associated with La Quinta's Annual Conference. La Quinta stated that this benefits the Franchisees because it minimizes the amount of registration fees, and makes it possible for La Quinta to provide the Franchisees and their key employees with educational seminars on improving bottom line performance and property operations.

6. Disclosure and Accountability

La Quinta a) does not provide its Franchise Advisory Council ("FAC") with audited financial statements concerning its National Advertising Fund ("NAF"), (b) did not consult with its FAC on its marketing strategies, and (c) spent approximately 24% of its NAF for the "management of sales and marketing programs" in 2005.

Following its review of the PAR, La Quinta agreed to provide audited financial statements concerning the NAF to any Franchisee who requested a copy. La Quinta reported that it had previously offered to provide the NAF financial statements of its FAC, but that the FAC members requested that, instead of providing them with a line-by-line analysis of the expenditures of the monies in the NAF, La Quinta merely summarized the information and make the NAF financial statements available by request.

With regard to marketing strategies, La Quinta asserted that it presents such information to its FAC, and routinely asks for their opinions and feedback. Finally, La Quinta indicated that it had discussed the 2007 marketing strategy with the FAC at its Annual Conference, where it was well received.

7. Maintaining Relationships with Franchisees

LA QUINTA POSITION:

In its 2006 UFOC and franchise agreement, La Quinta failed to make any commitments whatsoever to build on its relationships with the Franchisees, including establishing an independent Franchise Advisory Council (“FAC”), or working with a FAC in any capacity.

Following its review of the PAR, La Quinta provided AAHOA with valuable feedback information concerning its relationship with its Franchisees, including the fact that it not only has a Franchise Advisory Council (“FAC”), but La Quinta is also actively involved in various hotel industry associations.

Specifically, La Quinta has had a FAC for four (4) years. It consists of seven (7) Franchisee members, with each member representing a separate region of the country, and three (3) corporate representatives. For the past four years, La Quinta appointed the Franchisee members to the FAC. Starting in 2008, however, all Franchisee members will be elected by the Franchisees themselves. La Quinta asserted that it regularly consults the FAC members on all aspects of its program, and greatly values their input in analyzing material decisions that are made by La Quinta.

In addition, La Quinta is involved in associations that analyze industry issues and seek important feedback. For example, La Quinta executives are members of the AH&LA Inns & Suites Council, and La Quinta has been founding member of AAHOA since the inception of the La Quinta’s franchise program.

8. Dispute Resolution

LA QUINTA POSITION:

For the resolution of any disputes concerning the terms of the franchise agreement itself, or the relationship between a Franchisee and La Quinta. La Quinta does not mandate that the parties go to final and binding arbitration. Rather, La Quinta recognizes the importance of mediation as a means of resolving disputes, and allows its Franchisees to file their claims in court if they cannot be resolved informally. With that said, however, La Quinta has still included certain provisions in its franchise agreement which deprive its Franchisees of important legal rights.

Specifically, in its franchise agreement, La Quinta included provisions that require all Franchisees to waive their claims for punitive damages, waive their right to a jury trial, waive their right to file a class action lawsuit, and that impose shortened time limits on when a lawsuit may be filed.

9. Venue and Choice of Law Clauses

LA QUINTA POSITION:

In its UFOC and standard franchise agreement, La Quinta provides that for any disputes, the venue and exclusive jurisdiction shall be in the U.S. District Court for the Northern District of Texas, or the District Court for Dallas County, Texas. La Quinta also provides that its franchise agreements shall be construed under the laws of the State of Texas, provided that this does not constitute a waiver of any rights under the applicable franchise laws of another state.

After reviewing the PAR, La Quinta admitted noncompliance on this Point No. 9. During a conference call on May 25 2007, however, La Quinta indicated that it is willing to consider the possibility of providing for non-exclusive jurisdiction in the U.S. District Court for the Northern District of Texas, or the District Court for Dallas County, Texas. This would mean that if a Franchisee

initiated a lawsuit against La Quinta, it could do so in an appropriate venue and forum, which might include the county and state in which the subject Facility was located. However, if La Quinta was the first to file the lawsuit, La Quinta could do so in the U.S. District Court for the Northern District of Texas, or the District Court for Dallas County, Texas.

10. Franchise Sales Ethics and Practices

LA QUINTA POSITION:

La Quinta's 2006 UFOC and franchise agreements did not include any written commitments that La Quinta would insist on fair and honest selling practices for its sales force, and did not adopt a "good faith and fair dealing" provision concerning La Quinta's franchise sales ethics and practices.

Following its review of the PAR, La Quinta provided valuable feedback concerning its franchise sales ethics and practices, including the fact that La Quinta has very strict policies regarding the types of information that is salespersons may represent to prospective Franchisees. Specifically, the only representations that can be made by salesperson regarding the brand and its performance are limited to what is disclosed in the UFOC, which may be supplemented by market specific earnings claims.

With regard to the negotiations between a potential Franchisee and a La Quinta sales associate concerning the terms of the deal, La Quinta reported that any concessions made or additional terms negotiated at the time of sale are included on the first two pages of the Franchise Agreement under the section entitled "Basic Terms." A sample of the "Basic Terms" is attached as Exhibit "A" to the La Quinta UFOC. Prior to execution of the franchise agreement, prospective Franchisees are told to review the Basic Terms section to ensure that all agreed-upon terms have been included. La Quinta has emphasized that it is committed to giving Franchisees everything that they have been promised by the salespersons and agents.

11. Transferability

LA QUINTA POSITION:

Following review of La Quinta's 2006 UFOC and franchise agreement, AAHOA concluded that La Quinta's transfer fees were too high. Following its review of the PAR, La Quinta explained that its current transfer fee is \$2,500 for all transfers of entity ownership over 50%, or upon sale of the property to a third-party purchaser. As a practice, La Quinta reported that it has never charged \$2,500 for transfers to family members or business partners, regardless of the percentage of ownership being transferred. With regard to the \$4,500 property improvement plan fee, La Quinta also stated that it has never charged this fee to any Franchisee or transferee.

12. Sale of the Franchise System Hotel Brand The new franchisor should maintain the same or higher level of quality as the prior franchisor owners and offer assurances that the transition is as smooth as possible.

LA QUINTA POSITION:

In its UFOC and franchise agreement, La Quinta provides that it can sell the franchise system to any person or legal entity, and that it does not offer any assurances that it will attempt to work with the new Franchisor owner to ensure the transition is as smooth as possible, or to protect the rights of its Franchisees.

Following its review of the PAR, La Quinta admitted that it did not comply with this Point No. 12. La Quinta asserted, however, that its practices with regard to the sale of the Baymont brand demonstrated that it had used its best efforts to ensure a smooth transition during and after the transfer. Specifically, upon the sale of the Baymont brand to affiliates of The Cendant Corporation ("Cendant"), there were several logistical issues that arose related to the Franchisees' property management system. La Quinta reported that it continued to support all of these properties on its systems long after the deal had been finalized, and until it could be assured that these properties were able to transition to Cendant's systems seamlessly.

Stanley Turkel, MHS, ISHC operates his hotel consulting office as a sole practitioner specializing in franchising issues, asset management and litigation support services. Turkel's clients are hotel owners and franchisees, investors and lending institutions. Turkel serves on the Board of Advisors and lectures at the NYU Tisch Center for Hospitality, Tourism and Sports Management. He is a member of the prestigious International Society of Hospitality Consultants. His provocative articles on various hotels subjects have been published in the Cornell Quarterly, Lodging Hospitality, Hotel Interactive, Hotel Online, AAHOA Lodging Business, etc. If you need help in negotiating a franchise agreement or with a problem such as encroachment/impact, termination/liquidated damages or litigation support, call Stanley at 917-628-8549 or email stanturkel@aol.com.