

# When Do Rebates Become Kickbacks?

By Stanely Turkel

I recently completed a consulting assignment for an investment firm with a hotel managed by a first-tier hotel company. In the course of an operational audit, I stumbled upon an issue that is one of the hotel industry's most vexing problems.

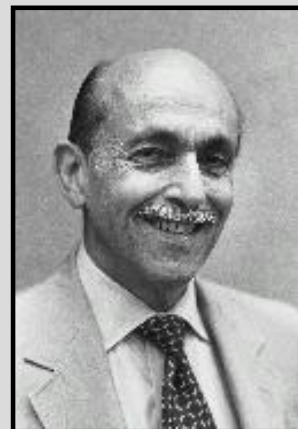
The issue is how management companies purchase on behalf of owners. In the hotel I investigated, the management company purchased everything: ff&e, operating supplies, f&b, services and promotional.

The basis for these purchasing efforts was spelled out in the management agreement: "Operator shall purchase such supplies and equipment and other expendable items as are necessary to operate the hotel and shall pay for such supplies out of the General Account. Opera-for shall obtain competitive prices and shall receive a 4% fee for such purchasing services."

In investigating the purchasing tactics of the management company, I discovered a pattern of behavior that was self-serving at best and fraudulent at worst:

- The management company negotiated contracts with hundreds of manufacturers and suppliers which produced millions of dollars of rebates directly from the vendors to the management company.
- The management company retained these rebates as a profit center.
- The management company had equity investments in some of these vendors and owned others outright.
- The management company did not disclose its rebate program or its ownership interests to the hotel owner.

My 25 years of hotel consulting experience have taught me that a management company serves as an agent for the hotel owner. The agent/principal relationship was well described by Professor James I. Eyster in a recent issue of *Cornell Hotel and Restaurant Administration Quarterly*: "Agency law places the following fiduciary responsibilities on agents: It requires agents to place their principals' interest over their own; precludes agents from competing with their principals; and precludes self-dealing-agents may not operate on their own behalf without disclosure to and approval of their principals."



Turkel: Beware how operators purchase for your hotel.

Under the terms of the contract, the operator was only entitled to receive basic fees and incentive fees all clearly spelled out in the contract. Nowhere in the contract was there any disclosure of the extensive and rebate program.

When the management company failed to inform the hotel owners about these rebates, a simple transformation took place: The rebates became kickbacks. The dictionary defines the word "kickback" as "a secret rebate of part

of a purchase price by the seller to the buyer or to the one who directed or *influenced* the purchaser to buy from such seller."

The management company tried to justify its actions by pointing to so-called common industry practice. Operators engage in a wide variety of purchasing practices, so under no realistic circumstances could anyone conclude that there was one common industry practice."

I recommend hotel owners take the following actions:

1. For existing management contracts, read your purchasing clause carefully. If the management company collects a purchasing fee and fails to disclose its rebate policy, the owner should receive the benefit of all discounts and rebates received in connection with purchasing.

Additionally, general fiduciary duties require disclosure of dealings with operator affiliates. Armed with this information, you should be able to negotiate a new purchasing agreement. The savings could be substantial over the life of a management contract.

2. For new management contracts, you should negotiate clauses with the following language: "Operator shall purchase such Consumable Supplies and other expendable items as are necessary to operate the Hotel and shall pay for such supplies out of the General Account. When taking bids or issuing purchasing orders, Operator shall be under a duty to use its reasonable best efforts to secure for and credit to Owner any discounts, commissions or rebates obtainable as a result of such purchase. Operator shall obtain competitive prices and shall receive a XX<sup>0</sup>/<sub>0</sub> fee for such purchasing services."

"Operator shall promptly remit to Owner all discounts, rebate profits, commissions or other emoluments received by Operator or by any "Affiliate," which term shall mean any corporate or other entity related to Operator or any officer, director, employee or shareholder of Operator or of such related corporation or other entity, in connection with the Hotel. This clause is intended to ensure that neither Operator nor any Affiliate of Operator shall receive, directly or indirectly, any compensation other than that to be paid by Owner to Operator hereunder."

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