"All the News That's Fit to Print"

The New York Times

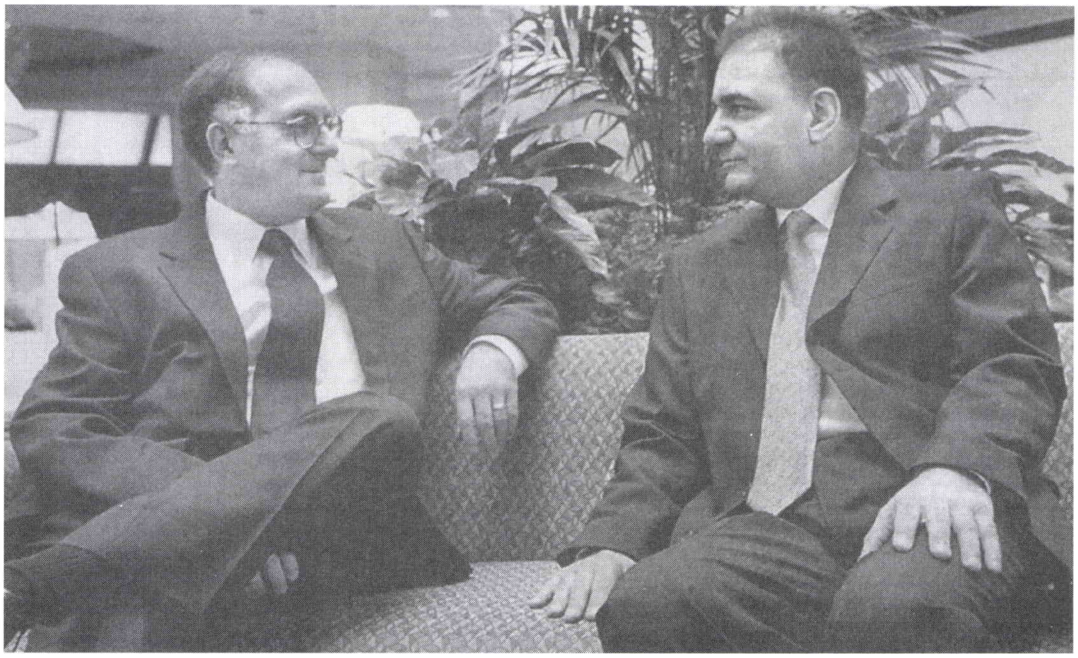
Late Edition
New York: **Today**, mainly sunny, high 70. **Tonight**, light winds, few clouds, low 59. **Tomorrow**, mix of sunshine and clouds, high 73. **Yesterday**, high 74, low 63.

VOL. CLII . . . . No. 52,256 NEW YORK, SUNDAY, SEPTEMBER 29, 2002 $3.75 beyond the greater New York metropolitan area. $3.00

Money&Business

May I Speak to the Manager? A Storm at Marriott

By LYNNLEY BROWNING



Photograph by G. Paul Burnett/The New York Times

The accountants Warren M. Schneider, left, and Raymond R. Ciccone.

FOR John J. Flatley, a multimillionaire property developer, the eviction of his trusted overseer was more than he could bear.

Mr. Flatley, an experienced real estate executive, had hired Marriott International to run his big new hotel in Quincy, Mass., south of Boston, but had installed his own man, Steven Lambert, to keep an eye on the business. The relationship between Mr. Flatley's team and Marriott had grown contentious over some disputed invoices, and the breaking point came last March, when Mr. Lambert asked Marriott to explain what he said was a vaguely worded bill to the hotel for $3,000 in unspecified sales and marketing services.

"Marriott said, 'You're not privy to that information,' " said Philip A. Baldi, the chief financial officer of the Flatley Company, in Braintree, Mass., which runs a Flatley family trust that owns the hotel. Marriott, Mr. Baldi said, then ousted the asset manager from his hotel office.

Last month, just 15 months after his Boston Marriott Quincy Hotel opened, Mr. Flatley sued Marriott in Federal District Court in Boston, accusing it of fraud, accounting irregularities, mismanagement and taking kickbacks from suppliers.

At least three other lawsuits by the owners of Marriott-run hotels - including Ritz-Carltons, Marriotts and Renaissances in several cities - make similar complaints, tarnishing the company's reputation and its stock price.

At stake is not just Marriott's market value but tens of millions of dollars in fees - and, perhaps, the balance of power in the $80 billion hospitality industry.

Hotel owners now pay Marriott up to 17 percent of their gross revenue in fees, up from about 9 percent in the early 1990's, said Jack Westergom, an asset manager at Manhattan Hospitality Advisors, a consulting firm in Manhattan Beach, Calif.

In some cases, hotel owners say Marriott's fees have unexpectedly doubled or tripled, in part because of what one lawsuit calls self-dealing by Marriott.

"Marriott had always seemed to run great properties," Mr. Baldi said. "But then they built a culture of secrecy in their accounting practices. Had we known what we were getting into, we wouldn't have gotten into it." Last year, he said, Marriott billed the hotel about $8 million, but despite repeated requests by Flatley has yet to provide invoices backing up the expenses. Flatley has hired two forensic accountants, Warren M. Schneider and Raymond R. Ciccone, to review Marriott's books in connection with the lawsuit.

Marriott, based in Bethesda, Md., denies the allegations and dismisses the suits as harassment by a tiny fraction of the 500 independent business owners who have hired the company to manage almost 2,500 hotels.

"We are in these lawsuits because we will not submit to extortion by owners who are trying to renegotiate contracts or insist that we rescue them from their bad business investments," said James E. Akers, a senior vice president and associate general counsel at Marriott.

Still, some investors - increasingly concerned about what many say is Marriott's opaque accounting and the specter of lawsuits like Mr. Flatley's - smell blood. Short-sellers have been putting pressure on the stock in recent weeks, betting that its price will fall. And it has fallen, by 34 percent from its high of $46.45 in April. It closed on Friday at $30.48.

In addition to accusing Marriott of refusing to explain additional fees that can double or triple the management fees set out in their contracts, the plaintiffs' lawsuits contend that Marriott is reaping hundreds of thousands and possibly millions of dollars in kickbacks from hotel suppliers. They say that it does this by channeling goods and services for hotels through Avendra, a purchasing company that is run by former Marriott executives. (Marriott is half-owner of Avendra; the remainder is owned by Hyatt, ClubCorp, Six Continents Hotels and Fairmont Hotels and Resorts.) The hotels say that the payments originate as rebates on volume purchases and that the money belongs to them.

The New York Times

Owners of the Rancho Las Palmas Marriott resort in Rancho Mirage, Calif., are among those suing Marriott International, complaining of its hotel management.

IN addition to Flatley, the other companies suing Marriott include Strategic Hotel Capital of Chicago, which owns 27 luxury Marriott-brand hotels. It sued Marriott last month over the way it has run three resorts in Southern California - the Ritz-Carlton Laguna Niguel, the Rancho Las Palmas Marriott and the Renaissance

Beverly Hills. In Town Hotels, the owner of a Marriott in Charleston, W.Va., and CTF Hotel Holdings, one of the biggest owners of Marriott hotels, have also sued. In its suit filed last April, CTF, which is based in Hong Kong and is a unit of the New World Development Company, also asserted that Marriott had violated racketeering laws.

The plaintiffs contend that Marriott refuses to provide invoices detailing what it or Avendra pay for goods and services bought on behalf of its client hotels, and whether those hotels could have procured them elsewhere for less.

The lawsuits, which seek unspecified damages, challenge a significant part of the $236 million in profit that Marriott reported last year on revenue of $10.15 billion.

Marriott's profit last year was already down 51 percent from a year earlier, and its earnings could fall further if it loses the lawsuits or decides to renegotiate its management agreements on terms more favorable to owners.

A handful of owners have already renegotiated their contracts, gaining more influence over Marriott's management of their affairs and a greater cut of profits. Host Marriott, a real estate management company that is the biggest owner of Marriott-managed hotels, won new terms last July, having made claims similar to those in the lawsuits. (Marriott, which is run by J. W. Marriott Jr., and Host Marriott, whose chairman is his younger brother,

Richard E. Marriott, were created in 1993 by the breakup of the Marriott Corporation.) CTF reached a similar agreement, in 1999, but its lawsuit complains that Marriott has violated the terms of that deal.

OTHER owners are also considering legal action, according to several lawyers and owners, most of whom spoke on condition of anonymity.

"We're following all of these litigations very closely and are trying to get an understanding of what they mean for our hotels," said Michael D. Barnello, the chief operating officer of LaSalle Hotel Properties, a real estate investment trust in Bethesda that owns four Marriotts.

Marriott, which owned scores of hotels before selling them in the early 1990's, manages several chains, including the midpriced Courtyard and Residence Inn names.

A brand that promotes its origins in a 1927 root-beer stand owned by the parents of J. W. and Richard Marriott, Marriott has long been considered a leading example of solid leisure service. The company is not the only hotel manager to be criticized by the actual owners of its various hotel properties. Hyatt and Starwood Hotels and Resorts Worldwide have also been hit with lawsuits making similar claims in recent years. Rebates, extra fees and an unwillingness to share documentation with owners are industrywide practices, said Donald Winter, an independent hotel consultant based in San Francisco.

Management contracts have been an industry fixture for two decades. And for most of that time hotel owners operated with almost blind trust in their operators.

Owners typically pay a hotel management company like Marriott management fees of around 3 to 4 percent of a hotel's gross revenue, incentive fees of around 20 percent of cash flow, marketing fees of around 2 percent of gross revenue and centralized service fees of around 5 percent of gross revenue. In return, the management company handles all of a hotel's operations, from hiring staff and booking guests to buying food, linens and furnishings to running marketing programs for frequent guests. The owners send revenues directly to Marriott-controlled bank accounts, and Marriott pays their bills, often providing no more than general invoices.

Such arrangements have let real-estate developers focus on what they do best - building hotels - while leaving the details of operating the hotels to professional managers. Those managers, in turn, get the benefits of steady fees and access to owners' capital - all without risks like mortgages and pressing loans.

This relationship began to unravel in the economic downturn of the late 1980's, and the process accelerated through the last decade. Some owners, desperate to shore up profits, began questioning charges. Managers, eager for new sources of revenue, began levying new fees for an expanding list of services like guest loyalty programs and audio-visual equipment rentals.

Now, with the economy again weak, the stock market floundering and occupancy rates down, the owners are stepping up their campaign.

They are emboldened by a recent verdict against a management company. In 1999, a Federal District Court in Delaware awarded $51 million to the owner of a Sheraton hotel in Washington after finding that the Sheraton unit of Starwood took payments from suppliers that were in fact rebates belonging to the owner. While the award was later reduced, to $30 million, the case validated the legal theory that management companies have a duty to build wealth for their clients, the owners - much as mutual fund managers are entrusted with making money for investors.

In their suits, hotel owners complain about poor service as well as high fees. The Flatley lawsuit, for example, contends that Marriott filled a job at the hotel in Quincy with a convicted drug dealer who kept a gun in the hotel's health club. It also complained that Marriott booked a convention for fans of the fantasy game Dungeons and

Dragons last January at a deeply-discounted price - a move that the owner's lawyer said would make it harder to attract the professional groups that the hotel had hoped to draw. "Once you get those guys, you're not going to get the orthopedic surgeons convention," said William E. Wallace III, a lawyer at Milbank, Tweed, Hadley & McCloy who represents Flatley.

The plaintiffs' biggest complaints against Marriott concern Avendra, a centralized joint venture created in March 2001. Marriott said the company is the successor to its internal purchasing arms, and buys everything from lightbulbs to cleaning supplies to little bottles of shampoo.

The complaints contend that Marriott uses Avendra's enormous power for bulk purchases to secure millions of dollars in rebates each year from suppliers. The suits claim that any rebates are owed to the owners and that for Avendra to keep them, they amount to kickbacks.

In Town, for example, contends that Marriott took rebates for long-distance services, newspapers and other goods it bought through Avendra from AT&T, USA Today and American Express. USA Today did not respond to questions about the matter. Representatives of AT&T and American Express said the two companies sometimes offered incentives - which they characterized as a standard practice - in co-marketing deals with other entities, but declined to be specific.

Mr. Akers, the Marriott lawyer, said Avendra saved hotel owners about 8 percent a year on what they would have paid had they used other suppliers. He added that Avendra lost $1 million in its first year. The company said it spends $10 billion on supplies each year.

Richard S. Hoffman, a senior vice president for finance at Marriott, said his company "makes no money on rebates" from any vendors. He said Marriott distributed back to some hotel owners "several million dollars in rebates" last year but declined to provide details.

Hotel owners also say Marriott engages in related-party transactions - doing business with companies in which it owns a significant stake - and that this is to their detriment. In its suit, Flatley contends that Marriott uses one of its own subsidiaries, Marriott Distribution Services, to transport supplies - an arrangement that Flatley believes raises costs.

Separately, CTF contends in its suit that Marriott received rebates from the Molloy Corporation, an audio-visual services company, via a Marriott program called "Marriott Visual Presentations," or MVP. Molloy owns MVP, said Roger W. Conner, a Marriott spokesman. John Molloy, Molloy's director, declined comment.

CTF also says in its suit that, at Marriott's urging, it signed a contract in 1998 with Molloy to provide video presentations at corporate meetings. CTF says that it paid $1.03 million to Molloy in 2000 but that $706,809, or 70 percent, went back to Marriott. CTF says Marriott returned to it more than $2 million it had paid to Molloy.

Marriott says it never tried to conceal its arrangement with Molloy, and did get permission from CTF before beginning. "They knew we were making a profit on it, and they agreed to it," said Richard Hoffman, Marriott's senior vice president for finance. "These are not kickbacks."

Hotel owners are also increasingly upset about the fees they pay for new services and programs created by Marriott, like preferred-guest perks and restaurant upgrades. The fees are in addition to those covered by the basic management contracts and are often embedded in other charges.

"The managers have been looking for various ways to increase their fee income, and they've been incredibly creative," Mr. Westergom said. He said Marriott and other managers charge 40 to 50 separate fees for services ranging from daily accounting and bandwidth connection to souped-up national reservations offices, brochures and trade shows.

Some owners complained that some fees were for services they had never requested. CTF says it never agreed to partake in Marriott's Renaissance Street Restaurant and Bar initiative, which creates trendy restaurants at Marriott-managed Renaissance hotels. But CTF says it was charged for it anyway - $394,000 last year and $137,000 in 2000.

In a similar gripe, the Flatley complaint alleges that Marriott overbills for some commissions paid to travel agents it trains. Independent agents who complete Marriott's Hotel Excellence program receive 10 percent commissions when they book guests into Marriott-managed hotels, compared with 8 percent for other agents. Flatley says that its basic management fee already covers training and commissions and that the surcharge for higher payments is unjustified and raises its own costs.

Mr. Flatley's investment trust paid almost $940,000 last year in what it says were unjustified extra charges, nearly twice the $561,250 core management fee it paid to Marriott, according to the complaint.

CTF contends that in 2000 it paid Marriott extra charges and fees of $48 million, on top of a base fee of $18.45 million and an incentive fee of $7.8 million. A lawyer for CTF, Jonathan J. Lerner of Skadden, Arps, Slate, Meagher & Flom, said that only some of the fees were justified because CTF had agreed to participate in certain programs, but he declined to provide details.

EVEN some Marriott clients who have not sued the company said they don't like the way it accounts for its charges. "We've had issue with their disclosure for years,"said Mr. Barnello, the LaSalle executive. "When our hotel is charged something, we want to know what it's for and how does it benefit my property."

Not even the head accountant for the Boston Marriott Quincy, who was hired by Marriott and works at the hotel, has access to detailed invoices and charges, said Mr. Baldi, the financial officer for Flatley. Through a program called Project Mercury, Marriott now runs all of its accounting from Knoxville, Tenn.

Mr. Akers, the Marriott lawyer, said the company could be "hard to understand" because it has a centralized business model that spreads costs among its clients. Last month, Marriott representatives began meeting with hotel owners to explain its methods and fees.

Marriott said it is also preparing a Web site on which it will detail invoices and charges for each owner. The site should be running early next year, the company said. ❖