

CHAPTER 3

HOSPITALITY BUSINESS STRUCTURES

3.1 THE IMPORTANCE OF BUSINESS STRUCTURE

3.2 COMMON HOSPITALITY ORGANIZATIONAL STRUCTURES

- Sole Proprietorship
- General Partnership
- Limited Partnership (LP)
- C Corporation
- S Corporation
- Limited Liability Company (LLC)

3.3 COMMON HOSPITALITY OPERATING STRUCTURES

- Owner-Operator
- Franchise
- Management Contracts
- REITs
- Condo Hotels

3.4 THE AGENCY RELATIONSHIP

- The Master-Servant Relationship
- The Agent-Principal Relationship
- The Independent Contractor

“THANKS FOR MEETING with me,” said Chris Joseph. “When Professor Laskee suggested I call you, I wasn’t sure if you would find time for me. You sure have a nice-looking hotel!”

“Thank you,” said Trisha Sangus, general manager of the property. “I always liked Professor

Laskee. He was one of my favorites. I learned a lot from him. Anything I can do for him is truly my pleasure. How can I help you?”

“Well,” Chris replied earnestly, “I want to start my own restaurant!”

“Great!” replied Trisha. “How can I help?”

"I have some questions," Chris replied. "Do you think it is better to do this all on my own or to have partners? And can you give me any tips on securing funds? I don't have enough money to do it all by myself. I have some capital but probably not enough to do the entire project. I do have some friends and family who can help. Also, I have been thinking about an independent place, but maybe a franchise makes more sense for my first restaurant. What do you think?"

"Time out," said Trisha with a smile. "First things first. I think it's wonderful that you want your own place. Owning a restaurant can be one of the most rewarding things you will ever do. I admire your enthusiasm. If you truly love serving people, and enjoy hard work, you'll make it!"

"I know I will," replied Chris.

"That's great. Confidence is important," said Trisha. "But let me ask you, have you considered the possibilities for structuring your business?"

"What do you mean, 'structuring'?" asked Chris.

"Well, let's look at your first question: to have a partner or go it alone. Your decision will be affected by how you like to work and the amount of control you want to retain, but it will also affect how much freedom you have if you decide to sell the business. An accountant can advise you there, but you should know your options."

"Okay," said Chris. "I'll look into that. What about incorporating? Is that a good idea? For liability, I mean."

"Incorporating can reduce your personal liability if things don't work out, but there are other ways to do

that, and some of them are less expensive. But they do have limitations. An attorney can help you there; but again, you should understand your options."

"How about taxes?" asked Chris. "Are there differences there? I'd want to put most of the restaurant's earnings back in the business, at least for the first few years."

"Reinvesting in your business is smart," said Trisha, "and you are right to consider taxation. The type of organizational structure you select will definitely affect your tax rates."

"Wow," said Chris. "Selling, liability, taxes . . . what else is affected by the structure I choose?"

"Capital," replied Trisha. "Most people have to raise or borrow money to start their businesses."

"That would be me!" said Chris with a laugh.

"That's okay," said Trisha. "I don't know of a successful businessperson who has zero debt. It isn't what you owe; it's your ability to repay it. And creditors will look at your business and operating structures to determine, in part, how likely you will be able to repay them."

"Will franchisors look at that, too?" asked Chris.

"Absolutely," replied Trisha. "Look, Chris, you want to make your own place happen. You can do it. But let me give you some reading material, then let's get together again next week. Sound good?"

"Sounds great," replied Chris. "I want to do this right, and I really appreciate your experience, and your willingness to help."

"Just remember," said Trisha with a smile, "free advisors always get a good table!"

"You got it," said Chris. "The best in the house."

IN THIS CHAPTER, YOU WILL LEARN:

1. The importance of selecting the proper organizational and operational structures for a hospitality business.
2. The various organizational business structures used in the hospitality industry.
3. The most common operational business structures used in the hospitality industry.
4. The responsibilities and obligations created by an agency relationship.

3.1 THE IMPORTANCE OF BUSINESS STRUCTURE

One of the most appealing aspects of the hospitality industry is the opportunity for owning your own business. Whether they are interested in owning restaurants or hotels, one establishment or a whole chain, self-ownership is a strong factor in many people's excitement about the field of hospitality.

When individual entrepreneurs elect to start their own business, they face a variety of decisions about location, product offerings, and financing, to name but a few elements. An extremely important decision, and one that will affect the future success or failure of the business, is that of their *organizational structure* and their *operating structure*. In this chapter, you will learn about the most common types of organizational and operating structures used in the hospitality industry.

Organizational structure refers to the legal formation of the business entity. It represents the relationship between the business owners and the outside world. This legal formation is important because the courts and all levels of government treat businesses and their owners differently, based on their organizational structure. Therefore, it is important to select an organizational structure that works to the advantage of both the business and its owner.

Operating structure refers to the relationship between a business's owners and its management. The composition of a business's management can be just as important as its type of structure. Operating structures of different hospitality organizations vary greatly. For example, the individual owner of a restaurant may, in fact, also manage it on a day-to-day basis. In another operating structure, however, a hotel may actually be owned by one legal entity, be managed by another legal entity, and have contractual relationships about precisely how it is to be managed with yet another legal entity.

To understand better the importance of structure, consider the case of John Graves, an individual who, after years of working for a national restaurant chain, wishes to open his own restaurant. Depending on the type of organizational structure John selects, the income tax he must pay on profits will vary considerably. In addition, the limits of his personal liability for the debts of his business will be directly influenced by the organizational structure he chooses.

Banks and other sources of capital will often make decisions on the worthiness of lending to a business venture based on the organizational structure. As well, investors may make investment decisions based on the organizational structure selected by a business's owners. Vendors may also determine whether to extend credit to a business based, in part, on its organizational structure.

Equally as important, an individual's ability to sell or transfer ownership of the business will be affected by the organizational structure selected. As you have learned, the organizational structure selected for a business is important, and a variety of organizational structures are available to an entrepreneur. The most common ones are discussed in section 3.2.

It is also important to determine where the business will be formed in order to get the most benefit out of the laws available to businesses. Generally speaking, business entities are governed by state law, and these requirements often vary from state to state. Thus, it is important to know which state law governs the requirements of a business entity.

The applicable law that governs a business entity is determined by which state the entity is formed in, which in most cases is easily determined by where that entity—say, a corporation—has filed its creation documents. A corporation has the ability to choose the state in which it will be incorporated, which does not necessarily have to be the state in which it is physically located, and a corporation has the ability to incorporate in multiple states.

Some uniformity does, in fact, exist amongst the state laws, however, because of the overwhelming number of business entities that decide to incorporate in the state of Delaware. In order to attract revenue, Delaware has created a set of laws that are extremely favorable to business entities that decide to incorporate in that state. In fact, a significant amount of Delaware's state revenue directly comes from business entity incorporation filings and fees. Thus, the Delaware business laws have become a sort of model standard that most states adopt as their own state's laws, and business owners should be aware of this standard in not only choosing which type of business entity to create but also choosing exactly where to create it.

LEGALESE

Organizational structure:

The legal entity that owns a business.

LEGALESE

Operating structure:

The relationship between a business's ownership and its management.

3.2 COMMON HOSPITALITY ORGANIZATIONAL STRUCTURES

Sole Proprietorship

LEGALESE

Sole proprietorship: A business organization in which one person owns and, often, operates the business.

A *sole proprietorship* is the simplest of all organizational structures. In this structure, a single individual owns all of the business and is responsible for all of its debts. The majority of small businesses in the United States are sole proprietorships. Examples in the field of hospitality could include a local hamburger stand, a doughnut shop, or perhaps a small bed and breakfast. In a sole proprietorship, the personal assets of the owner can be used to pay any losses, taxes, or damages resulting from lawsuits against the business. There is no personal protection from any of the risks associated with owning a business. Put another way, the *sole proprietor* has unlimited liability for the indebtedness of his or her business.

Profits in a sole proprietorship are taxed at the same rate as the owner's personal income tax. Each year, the owner files a tax return listing the proprietorship's income and expenses. Any profit or loss is reported on the individual owner's tax return. If the owner has income not directly related to the business, losses from the business can be used to reduce the overall amount of income subject to taxation.

Should the owner of a sole proprietorship wish to sell the business or pass his or her ownership rights on to others, he or she is free to do so.

Sole proprietorships can be started simply by opening a bank account to keep track of the business's income and expenses. Because the owner will have unlimited liability, lenders to a sole proprietorship evaluate the financial position of the owner carefully before providing capital to the business.

If the owner of a sole proprietorship is operating under an "assumed name," a name other than his or her own, an assumed-name certificate should be filed with the local government. Thus, if David Daniels began operating a diner and called it Davey's Diner, the term Davey's Diner would be the trade name. Accordingly, the assumed-name certificate filed with the local government would let anyone know that when they do business with Davey's Diner, they are actually doing business with David Daniels, or, put another way, they are doing business with David Daniels d/b/a (doing business as) Davey's Diner.

Any entity operating under an assumed name—not just sole proprietorships—should file a certificate disclosing the ownership and ownership structure of the operation. In many states, filing this certificate is required by law.

General Partnership

LEGALESE

General partnership: A business organization in which two or more owners agree to share the profits of the business but are also jointly and severally liable for its debts.

A *general partnership* is similar to a sole proprietorship, except that it consists of two or more owners who agree to share the responsibility for the operations, financial performance, and liability of the business. Partnerships are formed through oral or written contracts. Generally, these agreements will specify the contributions and responsibilities of each partner:

- How much money each partner will contribute to the business
- How much time each partner will contribute to the business
- Who will make decisions on how the business is operated
- How profits will be divided
- How losses will be shared
- A procedure for transfer of ownership, if one or more partners wishes to sell his or her portion of the business or becomes unable to participate as a partner

In hospitality, partnerships are occasionally used to begin small operations; but as the risk of liability increases, the operations are better served by converting to one of the limited liability structures discussed later in the chapter.

As in a sole proprietorship, the partners in a general partnership have unlimited liability for the indebtedness of the business. Additionally, the partners are liable jointly and severally for the partnership's debt; that is, they are liable jointly as partner/owners, but they are also liable severally, meaning that one partner alone could be liable for the entire amount of the debt. Thus, even if the partnership is owned on a 50–50 basis, should one partner be unable to pay his or her portion of the debt, the other partner will be liable for the entire amount of the debt. If loans are needed to establish the business, potential lenders will evaluate the personal assets of each partner. Profits from the business are distributed to the partners and taxed at the same rate as the owners' personal income tax.

Partnership agreements can be simple or complex, but as described in Chapter 4, "Business Contracts," because they are complex contracts, they are best documented in writing. This is particularly important when addressing the transfer of ownership rights by one or more partners.

Consider the case of Greg Larson and Mike Haley, who have been equal partners for 20 years in a business that operates a ski run and lift for a resort hotel in Wisconsin. This year, at age 50, Greg would like to sell his portion of the partnership to his daughter. If there were nothing in the partnership agreement prohibiting such a sale, Greg would be free to transfer his half of the business to his daughter. If, however, there is language in the partnership agreement that allows the remaining partner the right of first refusal, Mike would be able to purchase the other half of the business himself, should he so desire, before Greg has the right to sell it to anyone else.

Limited Partnership (LP)

While a sole proprietorship has only one owner, and a general partnership may consist of several owners, a *limited partnership (LP)* consists of two classes of owners: the *limited partner* and the *general (or managing) partner*. The limited partner is simply someone who invests money in the partnership. The general partner may or may not be an investor but serves as the business's operating and financial manager.

Many successful hotel chains began as limited partnerships. A limited partnership is so named because of the "limits" it places on the limited partner's liability. As a general rule, liability will be limited if a partner is not directly involved in the day-to-day managerial decision making of the business. The legal principle involved is one of control. A general partner exercises control over day-to-day operations but as a result bears unlimited liability for any debts or damages incurred by the business. A limited partner risks only his or her investment in the business but must give up the control of that investment in exchange for a limitation on the amount of liability. In fact, if a limited partner becomes actively involved in the business's managerial decision making, the state may revoke the limited partnership's protected status, which would then subject the limited partner to potential unlimited liability for the debts of the business.

The taxation on the profits of a limited partnership is similar to the taxation requirements of general partnerships. The profits are distributed to the partners and taxed at the same rate as the owner's personal income tax.

The limited partnership is a special type of business arrangement provided for by state law. Most states require specific forms to be filed with the secretary of state or some other government official in order for a business to be granted limited partnership status. A limited partnership is closely regulated by the state in which it operates, and it is the state that permits limited partners to invest in a business and be exempt from a large share of the liability should the business fail. Most states require a written limited partnership agreement to be filed as well. Even in a state where it is not required, it is a good idea to have an attorney draw up an agreement prior to the start-up of the business.

LEGALESE

Limited partnership (LP):

A business organization with two classes of owners. The limited partner invests in the business but may not exercise control over its operation, in return for protection from liability. The general or managing partner assumes full control of the business operation but can also be held liable for any debts the operation incurs.

LEGALESE

Limited partner: The entity in a limited partnership relationship who is liable only to the extent of his or her investment. Limited partners have no right to manage the partnership.

LEGALESE

General (or managing) partner:

The entity in a limited partnership relationship that makes the management decisions and can be held responsible for all debts and legal claims against the business.

» ANALYZE THE SITUATION 3.1

NICHOLAS KOSTANTY FORMED A limited partnership with his father-in-law, Ray Sweeney, to open an upscale French restaurant in a Midwestern town. Mr. Kostanty was the general partner and owned 75 percent of the business. Mr. Sweeney, with 25 percent ownership, was the limited partner and invested \$100,000. After one year, difficulties in the restaurant's operation caused business to drop off, and Mr. Kostanty called Mr. Sweeney for advice.

After hearing of the difficulties, and concerned with the security of his investment, Mr. Sweeney traveled from Arizona to Indiana to visit the operation. Upon observing the operation for two days, the two partners decided to launch a large and expensive television ad campaign to increase flagging sales. Mr. Sweeney designed the campaign with the help of Seelhoff Advertising and Video, a local advertising agency specializing in television commercials.

Despite an immediate increase in sales, over time, volume continued to decline, and finally, three months after the ad campaign was launched, the restaurant closed its doors. Total debts at the time the restaurant closed equaled \$400,000, with assets of the partnership totaling only \$200,000. Included in the debt was \$150,000 owed to the advertising agency. The agency sought payment directly from Mr. Sweeney. Mr. Sweeney, claiming that his liability was limited to the \$100,000 he had previously invested in the business, refused to pay any additional money. The Seelhoff Advertising Agency sued the limited partnership, as well as Nicholas Kostanty and Ray Sweeney individually.

1. By hiring the advertising agency, did Mr. Sweeney forfeit his limited partner status?
2. Is Mr. Sweeney liable for the outstanding debts of the limited partnership?

LEGALESE

Corporation: A group of individuals granted a charter, legally recognizing them as a separate entity with rights and liabilities distinct from those of its members.

LEGALESE

Shares: Fractional portions of a company in which the owner of the portion has voting rights and rights to a respective fraction of the assets of the company.

C Corporation

A *C corporation*, often referred to simply as a *corporation*, is formed when groups of individuals elect to band together to achieve a common purpose. When they do, the corporation has a legal identity completely separate from that of its individual owners. A corporation is empowered with legal rights that are usually reserved only for individuals, such as the right to sue and be sued, own property, hire employees, or loan and borrow money. Corporations are different from sole proprietorships or partnerships in that it is the corporation itself, rather than the individual owners, that is liable for any debts incurred. This is a powerful advantage. Accordingly, as an operation becomes more complex, and the risk of liability becomes greater, incorporating becomes a sound business practice. Today, many of the major hotel and restaurant companies are incorporated (e.g., Marriott, McDonald's, Hilton, Hyatt, Yum! Brands).

The actual owners of a corporation are called shareholders because they own *shares*, or portions, of the business. Legally, shareholders have the power to

determine a corporation's direction and the way it is managed. In reality, though, in many cases individual shareholders may have little influence on the way a corporation is run. Shareholders elect directors who oversee the business and hire managers for day-to-day operations (many of these directors and managers may be shareholders themselves). A shareholder is not liable for the debts or other obligations of the corporation, except to the extent of any commitment that was made to buy its shares. Shareholders also have a right to participate in the distribution of any residual assets of the corporation if it is ever dissolved, once all liabilities have been paid off.

A C corporation gets its name from Chapter C of the United States Internal Revenue Code (IRC). Although C corporations eliminate individual liability, they also have a significant disadvantage. Profits from a C corporation are taxed twice. The first tax is levied on the profits the corporation earns. After those taxes are paid, the after-tax profits that remain can be distributed to the corporation's shareholders in the form of *dividends*. The individual owners are then required to pay income taxes on those dividends. It is important to note that the corporation must pay taxes on its profits even if those profits are not distributed to the corporation's owners.

Corporations are taxed at different rates from those of individuals, and the taxes they pay may be affected by special rules that allow certain business expenses to be deducted from revenues prior to establishing the corporation's taxable income.

Consider the case of Michelle Rogen, an entrepreneur who wishes to establish a company providing part-time security guards for restaurants and nightclubs. Ms. Rogen has an inheritance of \$1 million that she holds in her name in various bank accounts. She would like to use \$100,000 of her funds to begin her business. Because of her concern for potential liability, Ms. Rogen selects her business structure carefully. A sole proprietorship or a general partnership would not provide any liability protection for her. A limited partnership would also be ineffective because Ms. Rogen, as the business manager, would have to take on the general partner's role, and thus her liability would still be unlimited.

Ms. Rogen selects a C corporation structure, which will limit her liability to only the assets of the corporation. If the company is successful, however, it will pay a corporate tax (at a higher rate than Ms. Rogen would have to pay as an individual on those profits), and then Ms. Rogen must pay her own individual tax on any profits she removes from the business. This double taxation is a powerful disadvantage of the C corporation structure.

C corporations are ordinarily more costly to establish and administer than sole proprietorships and general partnerships, but their ability to limit liability makes them very popular. To establish a corporation, the officers of the business must file "articles of incorporation" with either the secretary of state or a corporate registrar's office in the state in which the business will be incorporated. These articles will disclose the officers and board of directors of the corporation, as well as the number of shares the company is authorized to sell initially.

S Corporation

There is a type of corporation that avoids the double taxation inherent in a C corporation. This is known as an *S corporation*, and it also gets its name from the U.S. tax code. An S corporation is also known as a subchapter S corporation.

The S corporation format makes good sense for many hospitality businesses, such as family-owned operations. There are several requirements for establishing and maintaining an S corporation status:

- There is a limit of no more than 100 shareholders.
- Only one class of stock is issued.
- All shareholders must be U.S. citizens or residents.

LEGALESE

Dividend: A portion of profits received by a shareholder, usually in relation to his or her ownership (shares) of a corporation.

LEGALESE

S corporation: A type of business entity that offers liability protection to its owners and is exempt from corporate taxation on its profits. Some restrictions limit the circumstances under which an S corporation can be formed.

- All shareholders must be individuals, trusts, or estates, rather than partnerships or corporations.
- Some types of corporations such as financial institutions, insurance companies, or domestic international sales corporations are not eligible.¹

An S corporation provides the same liability protection offered by a C corporation but must be established with the agreement of all shareholders. This is done by filing a form with the Internal Revenue Service that has been signed by all of the corporation's shareholders, to signify their agreement to elect S status.

In an S corporation, any profits from the business are distributed directly to the shareholders in proportion to their ownership of the corporation. The profits are reported on the individual owners' income tax returns and are taxed at the individuals' taxable rates, which is similar to the favorable taxation treatment of a partnership; however, shareholders also receive the liability protection of a corporation.

It is also important to remember, however, that income from an S corporation is taxable even if it is not distributed to the shareholders. For example, assume two brothers open a microbrewery and select the S corporation structure. Profits from the bar in the first year are \$50,000. The brothers decide they want to use all of the profits from the first year to expand their marketing efforts in the second year. The brothers still, however, must pay individual taxes on the first year's profits in proportion to their ownership in the S corporation.

In addition to filing the S election form with the federal government, in some instances, the state in which the business operates may also require notification. Some states do not recognize the S corporation for state income tax purposes, but do recognize it for liability purposes. Generally speaking, the restrictions on an S corporation make it most suitable for smaller companies, especially those in which the owners are also the employees and managers.

Limited Liability Company (LLC)

The *limited liability company* (LLC) is a form of corporation created under state (rather than federal) law. To fully understand the LLC, let's first recall the disadvantages of the business structures examined so far. If someone starting a new business chooses to establish it as a partnership, it is taxed only once but obligates the owners to part or all of the liability and risk involved in operating the business. A limited partnership is also only taxed once, but the liability of the general partner is unlimited. A corporation offers liability protection but features double taxation and complex administrative regulations. An S corporation could be selected to avoid double taxation, but the restrictions on an S corporation can be significant.

The limited liability company is a fairly new type of entity, created by some states to combine the best features of a corporation with the simplicity of a partnership. Under the typical LLC statute, the members (similar to shareholders in a corporation or partners in a partnership) are all protected from the company's debts, unless they undertake personal responsibility for a debt, such as personally guaranteeing a loan for the business. Thus, a member can serve as the company's owner or manager, yet still protect his or her personal assets from liability.

The LLC is governed by an operating agreement, which is similar to a partnership agreement. It sets the rules for managing the company, as well as the rights and responsibilities of the members.

If formed properly, the Internal Revenue Service will treat the LLC as a partnership for tax purposes; thus, there is no double taxation. However, in some states, the LLC will have to pay state income taxes on its profits. If the LLC is not formed properly or within the guidelines established by the state in which it does business, the IRS may consider the LLC to be a corporation for tax purposes.

Depending on the state in which it does business, the LLC may have to pay a filing fee or an annual registration fee. The LLC has become the preferred type of

LEGALESE

Limited liability company (LLC): A type of business organization that protects the owners from liability for debts incurred by the business, without the need for some of the formal incorporation requirements. The federal government does not tax the profits of LLCs; however, some states do, while others do not.

¹Internal Revenue Service, "S Corporations," www.irs.gov/businesses/small/article/0,,id=98263,00.html. Last reviewed December 15, 2010. Accessed July 2, 2011.

organizational structure in the hospitality industry, particularly for independent operators and many franchisees. Its characteristics and advantages are well suited to hospitality operators who are able to elect such a structure.

Like all organizational structures, the limited liability company should be selected only after seeking the advice of a business attorney and tax advisor.

Another entity is available in most states. Known as the limited liability partnership (LLP), it provides limited liability for its partners, as well as retaining the tax advantages of a general partnership. However, this particular entity is more often used for professional partnerships, such as doctors, lawyers, or engineers, rather than for individuals seeking to enter into a general business operation.

Figure 3.1 summarizes the important differences among the types of organizational structure we have looked at.

| | |
|-----------------------|--|
| | Sole Proprietorships |
| Liability | Unlimited personal liability. |
| Tax Liability | Owner pays. |
| Tax Rate | Individual. |
| To Transfer Ownership | No restrictions. |
| Number of Owners | One. |
| | General Partnerships |
| Liability | Unlimited personal liability. |
| Tax Liability | Partners pay, even if profits are not distributed. |
| Tax Rate | Individual. |
| To Transfer Ownership | Per partnership agreement. |
| Number of Owners | At least two. |
| | Limited Partnerships (LP) |
| Liability | General Partner has no limited liability protection. Limited Partners have limited liability protection unless provided otherwise. |
| Tax Liability | Partners pay, even if profits are not distributed. |
| Tax Rate | Individual. |
| To Transfer Ownership | Per partnership agreement. Generally, an assignee cannot become a limited partner without majority consent. |
| Number of Owners | At least two. |
| | C Corporations |
| Liability | All shareholders have limited liability protection unless otherwise provided. |
| Tax Liability | Corporation taxed on profits, shareholders taxed on dividends. |
| Tax Rate | Corporate rate on profits, individual rate on dividends. |
| To Transfer Ownership | No restrictions for transferring shares. |
| Number of Owners | All shareholders share limited liability. |
| | S Corporations |
| Liability | All shareholders have limited liability protection unless otherwise provided. |

Figure 3.1 Organizational structures summary chart.

Figure 3.1 (Continued)

| | |
|-----------------------|--|
| Tax Liability | Shareholders pay, even if profits are not distributed. |
| Tax Rate | Individual |
| To Transfer Ownership | There are no transfers to an ineligible shareholder. Cannot exceed 75 shareholders. |
| Number of Owners | All shareholders have limited liability. |
| | Limited Liability Companies (LLC) |
| Liability | All members have limited liability protection from the debts of the LLC, unless otherwise provided. Some question exists as to whether states that do not have the LLC form will respect the limited liability of members. |
| Tax Liability | Members pay, even if profits are not distributed. |
| Tax Rate | Individual |
| To Transfer Ownership | Generally, an assignee cannot become a full member without majority consent. |
| Number of Owners | No restrictions, but at least two members to gain partnership level taxation. May be taxable as a corporation if it has more than 500 members. |

3.3 COMMON HOSPITALITY OPERATING STRUCTURES

Now that you understand the manner in which ownership of hospitality operations can be structured, it is equally important to understand the varied manner in which these businesses are managed and operated.

Owner-Operator

Assume that you wished to start your own restaurant. If you proceeded to do so, it is very likely that, regardless of the organizational structure you select, you will also want to manage your restaurant. If you do select an *owner-operator* structure, you would join the ranks of literally thousands of hospitality businesses operated under this model.

Owner-operators may own a single small business or they may own multiunit facilities in several geographic areas. In many cases, the owner-operator structure is used by families that pass restaurants or lodging facilities on to new generations of hospitality managers. In fact, most towns and cities are home to one or more “family-run” businesses that have served their communities for multiple generations.

The actual organizational structures used by owner-operators may vary from single proprietorship to various forms of partnerships and corporations. As the independent owner-operator of your own business, you will have complete freedom to implement any policies, procedures, and products you feel are appropriate. Drawbacks, however, include the possible insufficiency of marketing influence or public recognition, reduced purchasing power, and a lack of operational support (something that business owners without a lot of experience may find valuable or

LEGALESE

Owner-operator: A type of operating structure in which the owners of a business are directly responsible for its day-to-day operation. Also known, in some cases, as an “independent.”

necessary). In many cases, independent business operators who start businesses experience markedly lower expenditures on both initial investment and promotion than do some other operational structures; however, their long-term survival rate is typically lower than with some other operational structures.

Franchise

When customers see facilities with well-established business names such as Hilton, Big Boy, Subway, Marriott, and the like, they may assume that the company that owns these businesses is also its operator. In fact, however, in most cases, the owners of these businesses are not owner operators, but rather, they have elected to enter into a *franchise* relationship.

According to the International Franchise Association, a franchise exists when one party allows another to use its name, logo, and system of business to generate sales and profits. One of the earliest franchisors was the Singer Sewing Machine Company, which set up dealers shortly after the Civil War to sell and repair its sewing machines. McDonald's is a present-day classic example of how, without tremendous personal wealth, an entrepreneur named Ray Kroc could take an idea and quickly spread it coast to coast, then around the world. Many companies turn to franchising as a system for expansion because they can do so rapidly with a minimum amount of capital and with the assistance of top-notch operators. However, in return, the company must be willing to share its revenues with those operators.

In a franchise operating structure, the actual owner of a hospitality facility (the *franchisee*) agrees to operate that facility in a specific manner in exchange for the franchise. A franchise can take many forms, but, as stated previously, it is generally the right to use the name, trademark, and procedures established by the *franchisor* for the sale of a product or service in a specific geographic area.

In a typical franchise operating structure, an owner gives up part of his or her freedom to make operational decisions in exchange for the franchisor's expertise and the marketing power of the franchisor's brand name. The owner of a doughnut franchise, for example, gives up the right to make doughnuts according to any recipe she

LEGALESE

Franchise: A contract between a parent company (franchisor) and an operating company (franchisee) to allow the franchisee to run a business with the brand name of the parent company, as long as the terms of the contract concerning methods of operation are followed.

LEGALESE

Franchisee: The person or business that has purchased and/or received a franchise.

LEGALESE

Franchisor: The person or business that has sold and/or granted a franchise.

» ANALYZE THE SITUATION 3.2

AFTER FIVE YEARS OF effort, you develop a unique style of roasting pork that is extremely popular in your hometown. You own and operate five units called Porkies that sell this product. Each unit costs \$175,000 to develop. Total sales of each unit average \$600,000, with a net profit margin of 10 percent per unit.

A friend of yours discusses your success with you and suggests the possibility of opening five new stores in his or her hometown. Your friend wants to know what you would charge to sell your recipe and your standard operating procedure (SOP) manual, as well as the use of the name Porkies.

1. How would you determine a fair price for your experience?
2. If your friend is successful, causing the name of Porkies to be even better known, thus resulting in greater demand for franchises, should your friend share in future revenue from franchise sales?
3. What are the ethical issues at play here?

LEGALESE

Licensing agreement: A legal document that details the specifics of a license.

LEGALESE

Licensor: One who grants a license.

LEGALESE

License: Legal permission to do a certain thing or operate in a certain way.

LEGALESE

Licensee: One who is granted a license.

chooses but gains the national recognition of a well-known “name” for her doughnut products. The use of the franchise as an operating structure is extremely common in the hospitality industry.

If a business owner elects to operate a franchise, he or she can gain the marketing support of an established trademarked name; credibility with potential investors, lenders, customers, and vendors; and, in many cases, assistance with operational problems that are encountered. Of course, these advantages come with a price. Typically, the franchisor will charge the franchisee an initial fee, plus a percentage of gross revenue. In addition, both parties will sign a legal agreement, which outlines the duties and responsibilities of both the franchisor and franchisee. This franchise agreement is often referred to as a *licensing agreement*, because the franchise company (*licensor*) is granting the right, or *license*, to operate as one of its franchisees (*licensee*).

The operating agreement requirements and other legal aspects of buying and utilizing the franchise operating structure are complex. In Chapter 5, “Significant Hospitality Contracts,” we will look closely at those mandatory disclosures and arrangements that relate to franchising. Here, what is important to remember is that operating a business as a franchise is simply one of several operating structures available to a business owner.

The primary advantage to buying a franchise is that doing so allows a business’s owners to acquire a brand name with regional or national recognition. In many cases, affiliation with a strong brand name will increase a business’s sales and thus its profitability. However, the charges for using the name of the franchisor’s brand increase as the perceived quality of the brand name increases. The total fees paid by the business owner to the brand owners are related to the strength of the brand name and the revenue that the name will likely bring. Although the fees related to a franchise agreement are sometimes negotiable, they will, on average, equal 3 to 15 percent of a business’s gross sales revenue.

In addition to increased sales levels, affiliation with a brand affects the ability of a business’s owner to secure financing. When owners seek financing from banks or other lending institutions, they often find that these lenders will look more favorably on those businesses that elect this operating structure than those that do not. Additional advantages, depending on the franchisor selected, may include assistance with on-site training, advice on purchasing items for sale, and reduced operating costs resulting from vendors who give brand operators preferred pricing.

The greatest advantage to a franchisor of entering into a franchise agreement with a business owner is the increase in fee payments to the brand that will result from the agreement. Like all businesses, franchise companies desire growth. The greater the number of businesses that operate under a single brand name, the greater, in general, the value of the name—and, thus, the fees that can be charged for using that name. In addition, each additional business that affiliates with a brand helps to pay for the fixed overhead of operating that brand. Therefore, additional properties operating under the same brand name result in greater profits for the franchise company.

For a business owner, there are also disadvantages associated with purchasing a franchise. Although there is no question that consumers often prefer the consistency associated with buying a franchised product or service, the manager of such a facility may be hampered by franchisor rules and regulations that do not take into account local needs and tastes. For example, having grits on a breakfast menu may make tremendous sense for an operation in a southern state but may make no sense at all for the same type of unit in the Northeastern portion of the United States. If a franchisor is not sensitive to the needs of local clientele, the franchisee may have a difficult time achieving success.

Local conditions can affect more than menu items. Returning to the example of McDonald’s as a franchise model, in his book *Grinding It Out*, Ray Kroc speaks of the difficulties he encountered persuading the McDonald brothers to allow the

modifications he required to adjust his building design from one that was successful in California to one that could survive the frigid winters of Illinois.² The best franchisors allow their franchisees to make adjustments for local conditions, while maintaining the integrity of the franchise concept. Thus, business owners who select this operating structure should be very familiar with the operating procedures of their franchisors.

Management Contracts

In many cases, those who own a business are not the same individuals as those who want to manage a business. Either these nonoperating business owners can hire individual managers to operate their businesses, or, if they desire, they can select a *management company* to do so. When they do, they will enter into a *management contract* with the chosen management company.

In some cases, investors who are not experienced in hospitality management simply elect to hire a qualified company to run their businesses. In other cases, the owners of a business have absolutely no interest in managing or even in the continued ownership of it. For example, assume that a bank has loaned money to a restaurant owner to start a business. The owner opens the restaurant but, over time, fails to make the required loan repayments. As a result, the bank is forced to repossess the business. In a case such as this, the bank, which is now the restaurant's owner, will likely close it, or, if it feels it is best, seek a company to manage the restaurant until it is put up for sale and purchased by a new owner.

The hotel industry, because it is cyclical, sometimes experiences falling occupancy rates and revenues. Sometimes these cycles result in properties that fall into receivership and lenders who face the consequence of becoming involuntary owners. In cases such as these, effectively managing a hotel may simply mean optimizing the property's value while offering it for sale.

Interestingly, the operating relationship that exists when a hotel owner signs a management contract with a hotel management company is very different from that of a restaurant owner who does not wish to operate the restaurant. Typically, in the restaurant business, the owner of a restaurant who elects not to operate it, but wishes to continue ownership, will often lease the space to another restaurateur. In that situation, the business entity that leases the restaurant pays the restaurant's owner an agreed amount and assumes responsibility for all the expenses associated with operating the business. If the restaurant makes money, the benefit goes to the person(s) who leased the space. If the restaurant loses money, the same person(s) is (are) responsible for the loss.

Unlike the restaurant business, in most cases, hotel owners find they cannot lease their properties to management companies. Rather, it is the management company that receives a predetermined monthly fee from the hotel's owners in exchange for operating the property, and it is the owners who assume a passive position regarding operating decisions, while at the same time assuming responsibility for all operating expenses, and debt service. The fees charged by management companies to operate a hotel vary, but commonly range between 1 and 5 percent of the hotel's monthly revenue. Thus, regardless of the hotel's operating performance, the management company is paid the fee for its services and the hotel's owners receive the profits (if any) after all expenses are paid. Just as the legal agreements, governing franchises can be complex, so too can be those related to management contracts and leases. As a result, these also will be examined in more detail in Chapter 5.

LEGALESE

Management company:

An entity that, for a fee, assumes responsibility for the day-to-day operation of a business.

LEGALESE

Management contract:

The legal agreement that defines the responsibilities of a business owner and the management company chosen to operate the owner's business.

²Ray Kroc, *Grinding It Out: The Making of McDonald's* (Chicago: Contemporary Books, 1977).

REITs

LEGALESE

REIT: Short for “real estate investment trust,” a very special form of business structure in which the owners of a business are generally prohibited from operating it.

Some ownership and operating structures are quite unique. One of these is the real estate investment trust (*REIT*). A REIT is a form of business ownership that, in many cases, expressly forbids the owner of a business from operating it. Thus, for example, an individual REIT could own 300 hotels but not be allowed to serve a customer breakfast in any of them!

As a REIT, a company can own hotel properties but in most cases must lease them to operating companies. A real estate investment trust is a private or public corporation (or trust) that enjoys special status under the U.S. tax code. That status allows the REIT to pay no corporate income tax as long as its activities meet statutory tests that restrict its business to certain commercial real estate activities. Most states honor this federal treatment and, as a result, also do not require REITs to pay state income tax.

The REIT is a popular ownership model for hotels because the Real Estate Investment Trust Act of 1960 set up three key provisions when it created REITs:

1. Owners that operate as REITs pay no tax on corporate income.
2. In order to get that tax break, REITs must pay out at least 90 to 95 percent of every dollar in income to their shareholders in the form of dividends.
3. Companies can pass the tax savings from the dividend deduction on to shareholders, making REITs an attractive investment.

Although the details of how a REIT is established (there are actually several varieties of REIT) are beyond the scope of this text, it is important for hospitality managers to understand that, especially in the lodging industry, the REIT is a common business structure.

LEGALESE

Condominium: A multiple-unit complex (i.e., hotel, apartment house, office building), the units of which are individually owned with each owner receiving a recordable deed to the individual unit purchased, including the right to sell that unit and sharing in joint ownership of all common grounds, hallways, and on-site facilities.

Condo Hotels

An increasingly popular hotel structure, and thus an increasingly common hotel organizational/operating structure, is the *condominium* or “condo” hotel (sometimes also referred to as a mixed-use property).

In 2005, Smith Travel Research reported that there were 227 condo hotel projects in the development pipeline, representing more than 93,000 units (rooms); a number of hotel rooms close to the average annual supply of new rooms built in a “normal” year.³ As of March 2006, condo hotel rooms made up nearly 20 percent of the hotel rooms under development in the United States. Given the latest economic downturn, the development of condos has slowed dramatically, along with the entire hotel development industry. Unfortunately, there is not universal agreement on the definition of a condo hotel. A “condo” hotel can refer to many types of hotel operating structures, ranging from a traditional hotel with residential condominiums next door, or on the top few floors, to properties where some or all of the hotel rooms have actually been turned into condominiums and are then sold to individual owner/investors. These owners may own their condominium units entirely, or they may have purchased *fractional ownership*.

Condo hotels differ from traditional condominium complexes in that, in a condo hotel, owners who are not staying in their units on a given night have the option of placing the unit in a rental “pool.” Under such a pooled rental program, the condo owner’s unit is sold as a traditional hotel unit. Revenue from the sale is then shared, according to a previously agreed upon formula, between the unit’s owner and the entity responsible for administering the rental program.

LEGALESE

Fractional ownership:

A purchase arrangement in which a condominium owner purchases the use of his or her unit for a portion (fraction) of a year. The fraction may be defined in terms of the number of days per year (e.g., 30, 60, etc.) or very specific days and/or months (e.g., January 1 through March 31). Individual units purchased under such an arrangement are commonly known as fractionals.

³“The Condo Hotel Boom,” *Global Hospitality Advisor* (January 2006), p. 1. Available at www.jmbm.com/.../lookup/...=/GHG%20Advisor%20Jan%202006%20.pdf. Accessed July 2, 2011.

It is easiest to understand the increased popularity of condo hotels when they are viewed from the perspective of the hotel's developer. In contrast to a traditional hotel developer who normally faces many years of operation before a significant return on capital can be expected, a condo hotel developer expects to sell some or all of the guestrooms constructed to individual unit owners prior to, or immediately upon, completion of the hotel. As a result, the condo hotel developer is able to realize significant financial returns several years earlier than the developer of a traditional hotel is. As well, construction loans for condominiums are often less expensive and easier to obtain than traditional hotel construction loans. In summary, the condo hotel developer expects, and thus far has been achieving, higher rates of return than those rates achievable by traditional hotel development.

In completed condo hotel projects, the business operating structure employed typically takes one of two forms. In the first, the project's developer retains ownership of, and typically manages, the revenue generating areas such as restaurants, lounge, meeting space and the like. In such an arrangement, the operating structure employed may be that of an owner-operator, a management contract, or even a franchise. In the second case, all of the hotel's commercial areas are turned over to and operated by a *condominium homeowners' association (CHOA)*.

Although CHOAs are usually elected in a democratic manner, it may also be true that the condo owners elected simply are not experienced in hotel operations management. This is true for both revenue-generating areas such as room rental and restaurant and bar operations, and the basic maintenance of the facility.

Figure 3.2 is a partial list of some of the non-revenue-generating areas of a condo facility for which a CHOA would typically be responsible. From the information in

LEGALESE

Condominium homeowners' association (CHOA): A group of condo owners, elected by all of the condo owners in a project, to interpret, develop, and implement the policies and procedures required to effectively manage their condominium complex.

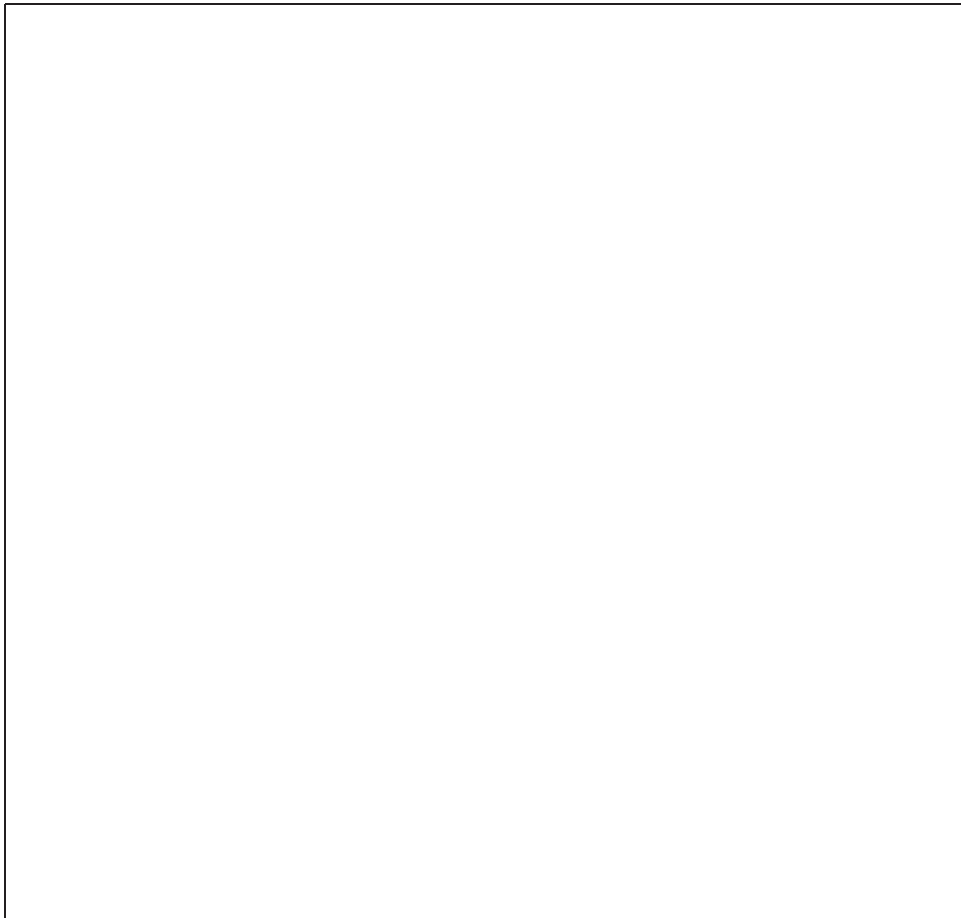


Figure 3.2 Typical responsibilities of a CHOA.

that list, it is easy to see that inexperienced members of a CHOA would face many challenges in effectively operating a condo hotel. Despite that fact, however, the CHOA is increasingly common. With current development trends, it will continue to be an increasingly prevalent form of hospitality operating structure.

3.4 THE AGENCY RELATIONSHIP

As you have learned, the ownership of hospitality businesses can be maintained utilizing a variety of organizational structures. As well, these businesses are managed under a variety of operating structures. Sole proprietorships, partnerships, and corporations are all subject to the federal and state laws governing employer–employee relationships.

It is also true that owner-operators, franchisors, franchisees, and management companies are subject to the laws governing employer–employee relationships. This is important to understand because the conduct of a business’s employees, regardless of organizational or operating structure, will directly affect the liability (or potential liability) of a business. Hospitality owners need to keep laws regarding employee relationships in mind when deciding on an organizational or operating structure for their business, and then choose the structure that will best allow them to absorb any liabilities incurred by the employees of the organization.

In the United States, regardless of the business structure selected, the relationship between businesses and their hired help usually takes the form of one of three concepts:

1. Master–servant
2. Agent–principal
3. Independent contractor

Figure 3.3 summarizes the characteristics of each relationship.

The Master–Servant Relationship

Returning to the previous example of John Graves, the man who wanted to begin his own restaurant, we can examine these relationships and the special rights and responsibilities they involve. It is highly unlikely that John will be able to operate his new restaurant entirely by himself. John would more than likely need to hire bartenders, wait staff, and kitchen help. When he hires people to fill these positions, he is creating a master–servant relationship: John is the master and his employees are the servants. Traditionally, in the law, the term *servant* was used to describe employees who performed manual labor. They were not generally in a position to act and/or make decisions on behalf of the master or employer when dealing with third parties. The master–servant relationship implies that the employee is under the direct control of the employer, and since the employers are presumed to be in control of their employees, employers are generally held responsible for the behavior of the employees when they are working. To illustrate, assume that a groundskeeper was directly hired by John to maintain the grassy areas, parking lots, and landscaping around his restaurant. This employee would likely be assigned a variety of groundskeeping tasks, including cutting grass. Assume further that, while mowing, the worker inadvertently ran the mower over a rock, and that the rock was discharged, with great force, into the parking lot where it struck the side of a parked car, resulting in significant damage to that customer’s car. John, as this groundskeeper’s employer,

| Relationship | Characteristics |
|---------------------------------|--|
| Master-servant | Also known as the employer-employee relationship, where the servant is the employee whose performance is controlled by the employer. |
| Agent-principal | An agent is empowered to act on behalf of or for the principal, with some degree of personal discretion, and the principal is ordinarily responsible for the conduct and obligations undertaken by the agent. |
| Employer-independent contractor | The employer has very little control, if any, over the conduct of the independent contractor; accordingly, the independent contractor is not an employee and usually not an agent (however, one could hire an independent contractor specifically to be an agent, such as a real estate agent or an attorney). |

Figure 3.3 Three types of employer–employee relationships.

will be directly responsible for the actions of this employee and the damage he or she has caused.

The Agent–Principal Relationship

John could also hire someone to act as his general manager. In this instance, some of the general manager’s work might be under the direct control of John, but the general manager might also be empowered to make decisions on behalf of the restaurant, and to enter into contracts on behalf of the restaurant. When employees act on behalf of the *principal*, they are usually referred to as *agents* of the principal. Agents have a fiduciary duty (responsibility) to act in the best interests of the principal. In this instance, the agent would be the general manager, and the principal would be John and his restaurant business. In general, a contract is used to specify the specific terms of a principal–agent relationship.

In many cases, the distinction between the agent–principal relationship and the master–servant is quite blurred. As empowerment becomes more widespread in hospitality workplaces, this distinction may fade altogether. Servants who are given more discretion and more authority will be more frequently categorized as agents. The distinction becomes important when you are trying to assess the responsibility of the employer for the acts of the employee. For example, assume that a restaurant customer becomes violently ill from food poisoning that is later linked to unsanitary practices by a kitchen employee in John’s restaurant. If the relationship is considered a master–servant relationship, John could be held legally responsible for the guest’s injuries under the concept of *respondeat superior*.

LEGALESE

Principal: Employer, the person hiring and directing employees (agents) to perform his/her/its business.

LEGALESE

Agent: A person authorized to act for or to represent another, usually referred to as the principal.

LEGALESE

Respondeat superior: Literally; “let the master respond,” a legal theory that holds the employer (master) responsible for the acts of the employee.

In this example, the servant in the master–servant relationship does not have the ability to speak on behalf of John or the restaurant, and thus will not be considered an agent. However, if the servant did have independent decision-making capabilities, then the employee could be classified as an agent. In the agent–principal relationship, the principal is ordinarily responsible for the behavior of the agent, as well as for any significant, or even insignificant, promises or obligations undertaken by the agent on behalf of John or the restaurant. Thus, if the general manager of the restaurant (the agent) enters into a long-term contract to purchase meat from a particular purveyor, John and the restaurant will be responsible for fulfilling the obligations undertaken by the contract (assuming that the contract is in proper form, as discussed in Chapter 4, “Contract Basics.”

LEGALESE

Fiduciary responsibility: The requirement that agents act in the best interest of their principals.

Because principals are held responsible for the actions of their agents, agents have a *fiduciary responsibility* to act in the best interest of their principals.

The agent generally has five duties:

1. *Utmost care:* The agent is bound to a very high standard to ensure the maximum protection of the principal’s interest.
2. *Integrity:* The agent must act with fidelity and honesty.
3. *Honesty and duty of full disclosure:* The agent must make honest and full disclosure of all facts that could influence in any way the principal’s decisions, actions, or willingness to follow the advice of the agent.
4. *Loyalty:* The agent is obligated to refrain from acquiring any interest adverse to that of a principal without full and complete disclosure of all material facts and obtaining the principal’s informed consent. This precludes the agent from personally benefiting from secret profits, competing with the principal, or obtaining an advantage from the agency for personal benefit of any kind.
5. *Duty of good faith:* The agent must act with total truthfulness, absolute integrity, and total fidelity to the principal’s interest.

Because of the master–servant and agent–principal relationships, it is very important that hospitality operators carefully select and train their employees. If you, as a hospitality owner or manager, are responsible for selecting employees who will represent or make decisions on behalf of your operation, you must trust the decision-making capability of those individuals, as well as their integrity to act in the best interests of the operation when they are making decisions and/or entering into contracts.

In Chapters 7, “Legally Selecting Employees,” and 8, “Legally Managing Employees,” you will learn how to properly select and manage employees under current federal and state employment laws, and see some ways that you can minimize the risk of liability by using effective employee selection and training techniques.

The Independent Contractor

Back to John. From time to time, he may also need to hire individuals or other companies to come in and perform specialized tasks that are outside the day-to-day operations of his restaurant. For instance, he may need to repaint the exterior walls of the building that houses the restaurant. John could hire an individual painter or a company that provides painting services. This type of relationship would involve an *independent contractor* relationship.

Usually, employers are not liable for the behavior of independent contractors, and independent contractors cannot ordinarily bind employers to obligations that they have made. The general rule is that the more control that the worker retains,

LEGALESE

Independent contractor: A person or entity that contracts with another to perform a particular task but whose work is not directed or controlled by the hiring party.

» ANALYZE THE SITUATION 3.3

THE GREAT FOX WATERPARK and Resort, located in the Wisconsin Dells area of Wisconsin, has received an invoice from Lion Distributing of Reisterstown, Maryland. The invoice is for ten cases of pool chemicals delivered to the resort two weeks ago. The invoice states Mr. Mark Bell, the resort's head lifeguard, ordered the chemicals. The price on the invoice is three times the normal price paid for chemicals of this type (which are normally purchased from a local vendor).

When questioned by the hotel's accounting office about the purchase, Mr. Bell states that all he recalls is that he was working one day and received a telephone call in which the caller asked for the "right" shipping address for the resort. The confirmation of address was needed, the caller maintained, because an office mix-up had resulted in some shipments of products purchased by its customers being misdelivered. Mr. Bell provided the caller with the hotel's correct shipping address.

Despite the obvious overcharge, the vendor refuses to accept the shipment back, claiming Mr. Bell, as an agent of the resort, had authorized the purchase of the chemicals. The vendor threatens a lawsuit if their invoice is not paid. Upon investigation, it is determined that one of the ten cases of product has, at this time, already been used.

1. Assume that Mr. Bell did not ordinarily purchase pool chemicals for the resort. Is the resort responsible for paying the invoice?
2. Assume that Mr. Bell did in fact ordinarily purchase pool chemicals for the resort. Is the resort then responsible for paying the invoice?
3. What steps would you suggest that the resort's owners take to prevent being victimized by potential invoice frauds of this type?

- Degree of control or direction over the worker: The greater control, the higher probability that it is an employer-employee relationship.
- The workers' investment in the enterprises: Does the worker provide his or her own tools and materials, or are they provided by the employer? If provided by the worker, that is evidence of an independent contractor.
- Opportunity for profit and loss: Employees are ordinarily guaranteed a wage, whereas an independent contractor, such as a painter, usually bids a job for a set amount and then has to perform the job efficiently to make a profit.
- Permanency of the work relationship: Most employees have a permanent, consistent relationship, full- or part-time with one employer; independent contractors work with many different employers and usually on a random basis.
- Are the workers' services an integral part of the employer's operation? A plumber that comes in every few months is not an integral component of the day-to-day operations; dishwashers, servers, front desk clerks, housekeepers are integral components.

Figure 3.4 Methods of assessing employer liability.

the more likely that the worker will be characterized as an independent contractor. Figure 3.4 displays some of the characteristics utilized by courts and government agencies to help determine whether a specific relationship is one of an employer–employee (master–servant) or that of an employer–independent contractor.

To illustrate the importance of understanding the differences in employer–employee relationships, return to the previous lawn-mowing example. This time, however, assume that John hired a lawn service company to care for the grass around his restaurant. In this case, John’s relationship with the lawn service company would be that of an employer–independent contractor. As a result, if an employee of the lawn service company inflicted the same damage to a customer’s car that was described



INTERNATIONAL SNAPSHOT

A Comparative Overview of Business Entities in the Hotel Industry

UNITED STATES

Traditional hotels in the United States operate as a variety of entities under a variety of models. Most often, they take the forms of corporations or limited liability companies rather than partnerships.

Limited liability companies offer added protection for officers and directors above that of a normal corporation. Among these entities, there are both publicly traded companies, such as Hilton, and privately held companies, such as Hyatt.

There is a greater variety among the operation structures of the various hotels. The major distinction can be drawn between a traditional hotel model and a condo hotel model. Traditional hotels have many different forms of management and franchise agreements, but all follow the basic model that there is one central owner for the entire property. Condo hotels, which have become significantly more popular in recent years, have many units owned by many people but typically managed by one entity. A third group has made a greater footprint in the market recently, the hybrid hotel, where some units are condos, typically full-time residences, and the remainder is traditional hotel rooms. Both the W Hotels and Ritz-Carlton Hotels have properties with this new hybrid structure.

CHINA

I. Rapid Growth in the Hotel Industry

As China prepared for the impending 2008 Summer Olympic Games in Beijing, its hotel industry

experienced tremendous growth. Traditional hotels are, in light of China’s breakneck economic development, in the fast lane for expansion. According to the “2006 Chinese Traditional Hotel Research Report” compiled by the National Development and Reform Commission of China, the number of traditional hotels exceeded 600 by the end of 2005.

In comparison, development of condo style hotels does not enjoy the same level of fast pace. Because of the lack of clear private ownership laws and regulation with respect to condo style hotel units, buyers are faced with greater risks. However, Chinese condo hotel buyers might be more receptive to the risks of condo style hotel units, given the fact that the Private Property Law went into effect in October 2007.

II. Business Entities in the Hotel Industry

Most hotels in China are organized under the Company Law of People’s Republic of China.

The Company Law became effective on January 1, 2006, governing two types of business entities: limited liability companies and joint stock companies.

Currently, no foreigners are permitted to invest directly through joint stock companies, and their direct investments are required to be operated via the vehicle of limited liability companies. As reported by the China Franchise and Chain Store Association, 74 percent of the growth of the leading traditional hotel brands in China is achieved through direct operation, and franchised traditional hotels are less than 1 percent of all franchises in China.

Provided by John Vernon, Partner with VernonGoodrich, LLP
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earlier, it would be the lawn service, not John's restaurant, that would be liable for repairing the damages to the customer's vehicle.

Chapters 9 through 13 examine the different types of circumstances under which hospitality operations may be held liable in a court of law, and identify some preventive measures that managers can take to minimize the risk of litigation. Although we strive throughout this book to emphasize managerial practices that will promote safe and legal operations (and prevent the possibility of a lawsuit), accidents or misunderstandings will invariably occur, and at those times, a well-chosen business structure may provide the hospitality owner with a higher degree of protection against liability than one that was poorly chosen.

WHAT WOULD YOU DO?

Assume that you are responsible for approving commercial loans at a bank where you are the senior lending official. You are approached by two

hospitality management college graduates, each with three years' management experience acquired after they completed their studies. They are seeking a loan slightly in excess of \$1 million to establish a restaurant in the community. The funds will be used to lease land, facilities, and equipment, as well as for renovation, inventory, salaries, and other start-up costs.

Write an essay that answers the following questions:

1. Will the organizational structure selected by the partners have an impact on your decision to extend the loan?
2. Will the operating structure selected by the partners have an impact on your decision to extend the loan?
3. What other factors would influence your decision?
4. Would it make a difference to you if the partners were requesting the loan to complete a franchise agreement with an established and successful franchisor?
5. What additional information might you request if the partners were seeking the loan to operate as an independent restaurant? Would it matter if the loan were for an existing restaurant, as opposed to a new start-up?

To see how a court views the legal relationship between a franchisor and a franchisee, consider the case of *Allen v. Greenville Hotel Partners, Inc.* 409 F.Supp 2d 672 (D.S.C. 2006).

FACTUAL SUMMARY

Multiple guests suffered severe injuries by a fire started by an arsonist while they were staying at a Comfort Inn hotel. The Plaintiffs brought suit for personal injuries and wrongful deaths against Choice Hotels (Choice), the franchisor, and against Comfort Inn, the franchisee.

QUESTION FOR THE COURT

The question for the court was whether the franchise agreement between Choice Hotels, the franchisor, and Comfort Inn, the franchisee, was such that it gave Choice a right to control the day-to-day operations of the Comfort Inn. If Choice was held to have a right to control over Comfort Inn's operations, then it could be held vicariously liable for injuries suffered by patrons and guests due to Comfort Inn's negligence. If Choice had no right to control, then liability for Comfort Inn's negligence would not be appropriate. The Plaintiffs claimed that Choice had been negligent for failing to provide proper security and fire protection for the Comfort Inn, and Choice had

THE HOSPITALITY INDUSTRY IN COURT

the right to control the daily operations of the Comfort Inn because the franchise agreement gave Choice a right to enforce trademark standards designed to maintain uniform appearance and service throughout the Choice Hotel chain.

DECISION

The court ruled in favor of Choice, holding that Choice did not control Comfort Inn's daily operation or security and fire systems. The rules and regulations provided in the franchise agreement were a way to ensure a similar experience in all Comfort Inns, and therefore maintain the public goodwill of the Choice franchise. The court held that this regulation in the agreement was not enough to show Choice's control over the operations of the Comfort Inn, nor did it specifically control the hotel security and fire systems, which were the specific causes of the injuries in this case. Thus, Choice was not found liable for Comfort Inn's negligence.

MESSAGE TO MANAGEMENT

Franchisors need to be cautious when considering the extent of control over the franchised operations in the franchise agreement.

WHAT DID YOU LEARN IN THIS CHAPTER?

Establishing the appropriate business structure for a hospitality operation is a decision that requires owners or managers to consider the amount of liability risk they are willing to absorb, the willingness to pay taxes on the operation's profits, and the degree of control they wish to exercise over the business. There are a variety of business structures to choose from, each offering different benefits to the business operator. Your business may not fit within the parameters established for particular structures, so your choices may be limited.

However you choose to operate your business, you will rely on others to represent the interests of your business. To varying degrees, you will be responsible for their decisions and acts. Determining the types of employees and agents that will be needed for your business operation, and the degree of control they will have, is an important liability consideration that must be factored into your choice of an organizational structure.

RAPID REVIEW

After you have studied this chapter, you should be prepared to:

1. Identify those organizational structures that result in paying income taxes based on distributed, as compared to earned, profits. Explain the advantages of each approach.
2. Identify those operating structures that affect the amount of control an owner has over the day-to-day operations of a business. Explain the advantages and limitations of each structure.
3. Explain the phrase *respondeat superior*; in terms of liability and business structure. Describe a real situation in which the phrase takes on meaning.
4. Compose a letter to a potential lender addressing only the issue of why the organizational and business structures you have selected for your new business group make it advantageous for the lender to grant you the loan you have requested.
5. State the defining characteristics of six types of organizational structures used in the hospitality industry as they relate to:
 - Taxes
 - Liability
 - Financing
 - Transfer of ownership

6. Explain the concept of fiduciary responsibility and ethics as they relate to the general manager of a hospitality operation.
 7. Describe the two primary operating structures utilized by condo hotels.
 8. Discuss the concept of a franchise as it relates to reducing an owner's risk of failing in a business.
 9. Identify the best organizational structure and operational structure for the business you would most like to own, and explain why they would be best.
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Assume that the decision has been made to start a new chain of sub-type sandwich shops. Assume also that investor funding is available to construct five such stores.

1. Divide the group into six teams.
2. Three of the teams are responsible for suggesting possible organizational structures for the chain. Each team should discuss the advantages and disadvantages of the structure they suggest.
3. The remaining three teams are responsible for choosing possible operational structures for the chain. Each team should discuss the advantages and disadvantages of the structure they suggest.

TEAM ACTIVITY

