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A Landmark Decision: The Stouffer Valley Forge Hotel

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Abstract

The information presented in this article is derived from the testimony and exhibits offered in connection with the trial of Auger, et a1 v. The Stouffer Corporation, et al., Civil Action No. 93-2529, which took place in the United States District Court for the Eastern District of Pennsylvania. The authors of this article served as expert consultants and expert witnesses to the plaintiff

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by
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This landmark decision involves a cautionary tale of a management company which didn't know enough about the marketplace, didn't commission the necessary research, didn't permit the local management to prevail in positioning strategy, didn't provide flexibility on rates and pricing, and didn't follow the basic precepts of yield management and revenue maximization. The management company tried to impose a four-star market position on a three-star hotel by fiat. The market wouldn't pay the rates necessary to support the luxury levels and amenities that Stouffer provided. Despite all the evidence over a five-year period, Stouffer insisted on a four-star operation, resulting in the loss of the hotel by the owner to foreclosure by the lender.

On August 8, 1994, a landmark decision was reached by a jury in the U.S. District Court for the Eastern District of Pennsylvania, resulting in a verdict as follows:

- for the plaintiff as to their claims against defendants, the Stouffer Hotel Company and the Stouffer Corporation, for tortious breach of contract, gross negligence, misrepresentation, and breach of fiduciary duty.
- for the plaintiff as to their remaining claims against the Stouffer Hotel Management Company for tortious breach of contract and misrepresentation.
- for the defendant, Stouffer Hotel Management Corporation, as to the plaintiff's claim for breach of contract.

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Story Begins in 1987

In 1987, the Auger family, through its affiliate, U.S. Penn Hotel Associates, purchased the Stouffer Valley Forge Hotel in King of Prussia, Pennsylvania, from the Stouffer Hotel Company for $25 million. At the time, the Augers' decision to purchase the hotel seemed sensible. It was then the market leader in terms of rates, profitability, and stability.

Stouffer retained responsibility for the management of the hotel and received management and other fees during the life of the agreement. In order to cancel the agreement, which had a 20-year term and provided Stouffer with the option to extend, the Augers were required to pay Stouffer a termination fee of as much as $8 million.

In November 1992, after five years of ownership, the lender foreclosed on the hotel because it no longer produced a cash flow sufficient to pay the mortgage. During the period they owned the hotel, the Augers received virtually no return on their investment despite the fact that they committed significant resources to improvements of the hotel's physical plant. Indeed, during this 64-month period, the hotel went from making a $653,000 profit in 1987 to losing $1.4 million in the year the bank foreclosed, 1992.

In contrast, during this same period Stouffer collected more than $3.5 million in management fees, marketing fees, reservation fees, and assessments for national advertising. Under Stouffer's management, the hotel lost 61 percent of its individual guests in four market segments. This deterioration occurred despite the fact that consumer demand in these same market segments grew by 34 percent during this same period of time. Moreover, although the Valley Forge hotel market experienced some ups and downs, it proved to be relatively stable over the long term. Indeed, the occupancy and average rate of the hotel's direct competitors was virtually unchanged from 1987 to 1993. However, during the same period of time, the Stouffer hotel's overall occupancy declined by 21 percent. Thus, whereas the hotel was the market leader in 1987, with an occupancy advantage of six points, it had fallen to a position at the bottom of the market with occupancy of 10 points below the market.

Market research showed that four of the hotel's direct competitors improved their occupancy relative to the market. In contrast, four other hotels fared poorly by comparison to the market. Interestingly, each of the four hotels that fared well adopted prices that were consistent with the value they offered to consumers. Conversely, each of the four hotels that fared poorly had increased its rates to the point that there was a significant disparity between the price charged and the value offered. Though it was the market leader in 1987, the Stouffer Hotel performed worse than any of its direct competitors during the period it was managed by Stouffer for the Augers' account.

A variety of factors were tested to determine the cause of this precipitous decline in the hotel's performance. This testing was done through the use of a variety of well-established marketing techniques, including several in-depth surveys designed to reveal the reasons for the defection of the Stouffer's guests. Using Tourist Bureau data, the occupancy and rate history of all hotels in the area were analyzed. From this data the market was mathematically modeled. The results were conclusive: Every hotel that offered rates lower than its perceived quality gained in occupancy, while those who charged more than their relative quality ranking lost occupancy and market share.

Guests Left Because of High Rates

Survey results indicated that the hotel provided high quality service, and that guests found the facilities to be more than satisfactory. However, the vast majority of past guests who no longer stayed at the hotel left because of the high rates charged.

Interviews were conducted with the general manager and other senior managers at the hotel regarding the rationale for Stouffer's pricing philosophy, as well as their efforts and experience with rate adjustments. Stouffer's on-site management team said that their repeated requests to cut rates had been rejected by Stouffer's senior management. Stouffer's senior executives also canceled several historically successful and critical promotions, thereby making the situation even worse. Moreover, the on-site management team also reported that Stouffer insisted that the vast majority of the hotel's advertising budget, which was paid for by the Augers, be spent on national advertising campaigns which promoted Stouffer's luxury image, but which were not appropriate for the Stouffer Valley Forge Hotel.

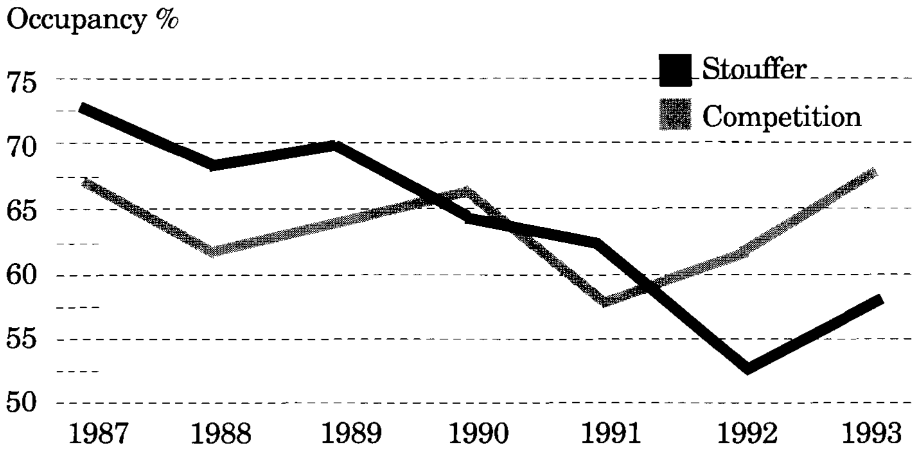
The general manager should have been permitted to manage and operate the hotel in accordance with his local analysis and recommendations, rather than the dictates of Stouffer's senior management. Had this occurred, the hotel would have enjoyed the success realized by some of its competitors. Moreover, had the hotel been managed and operated in a reasonable fashion, the owners would not have lost the hotel through foreclosure.

From 1987 until 1993 the Stouffer Valley Forge Hotel lost 21 percent of its annual guests. During this same period of time, the hotel's competitors enjoyed a 45 percent increase in rooms occupied each year. Moreover, the Stouffer Hotel also lost 10 percent of its yearly revenue while competitors actually gained 43 percent in average dollar revenues.

Economy May Have Hurt Hotel

Stouffer took the position that two factors were responsible for the hotel's failure: weak national economy and insufficient market demand. Economic factors directly affect the hospitality industry, as they do all major industries. However, market research shows that Valley Forge is fortunate in that most of its industry is concentrated in the pharmaceutical business which did not suffer from the recession to the same degree as many other industries. The major demand generators in the area are Smith Kline Beecham Corporation, Rhone Plulence Rorer, Shared Medical Systems, Inc., Merck and Company, Inc., Main

Exhibit 1
Stouffer Occupancy vs. Competition



Source: Smith Travel Research

Stouffer Went From Market Leader to Follower

Line Health, Inc., Rohm and Haas Company, U.S. Healthcare, Inc., and Wyeth Ayerst Laboratories. There is relatively little defense, military, or major banking, all of which were heavily hurt by the recession.

The demand for hotel rooms for both the Stouffer Hotel and its competitors in the area grew in every year except 1991, the year of the Gulf War. Furthermore, over the six-year period from 1987 to 1993, room demand among the hotel's competitors in Valley Forge grew from $32 million to $45 million, or an increase of 43.3 percent. Similarly, during the same period, the revenue growth generated by consumers of competitive hotel rooms grew on the average at a rate of more than 10 percent per year.

A survey of individual corporate travelers to Valley Forge in the summer of 1992 revealed that 38 percent of the companies had requested a reduction in travel expenses. Moreover, virtually all corporate meeting planners were under pressure to reduce costs, and most companies actually cut attendance at group functions held during 1991. This made most travelers very sensitive to price and, where they could afford higher rates, they tended to choose the best hotel for the same price.

Therefore, from 1987 to 1993 the economic conditions in Valley Forge actually were favorable for the hospitality industry. Indeed, the market experienced a growth in demand of 43 percent during the period in question. Therefore, the financial failure of the Stouffer Hotel was not caused by the general weakness of the U.S. economy.

Market Supply and Demand Was Factor

During 1987, Marriott opened a Courtyard Hotel and Guest Quarters opened a suites-only hotel in the Valley Forge area. The opening of these hotels did not directly affect the Stouffer Hotel, which was able to increase its occupancy to 72.5 percent (up 1.4 points), and to increase its average rate by $3.57 (to $84.51). Indeed, the hotel achieved a record profit of $653,000 in 1987. This record-breaking performance was accomplished by adding over 2,000 occupied room nights by individual travelers at rates of more than $100 per night.

However, in 1988, with the opening of an additional Courtyard, a new Hilton and several limited service hotels (Residence Inn, Days Inn, Hampton Inn, and Lodging Unlimited), the Stouffer Hotel began to lose occupancy. Though Stouffer added 2,700 group room nights, it lost 5,400 non-group room nights, for a net loss of 3.9 percent in occupancy. In spite of this declining occupancy, the Stouffer Hotel almost achieved its 1987 profits by raising its prices (groups up $2.10 and non-groups up $3.16) and by cutting some costs.

The opening of the six hotels during these two years had only a modest impact on the Stouffer Hotel because the lower-priced and limited service hotels did not compete directly with Stouffer.

In the 1989-1991 period, Sheraton opened an attractive 160-room hotel in the Valley Forge area. Marriott also opened a full service hotel in nearby Conshohocken and three additional low-priced hotels, Hampton, McIntosh, and Summerfield Suites, started operation. However, these later hotels, which offered rooms from $39 to 65, did not impact the Stouffer, which was offering rooms at over $100 per night.

It is interesting to note that, of the four hotels that performed poorly, three — the Stouffer, Sheraton Plaza, and the Great Valley Hilton — actually raised prices, rather than lowering them during the time others were cutting prices. The only hotel to fare poorly and reduce its prices was the Hilton in Valley Forge, which still appeared to be overpriced after the discounts, compared to its quality.

Based on market research, it was determined that Stouffer priced rooms for individuals $32 above Marriott, which had a very strong Frequent Guest Program. Naturally, this disparity led many customers to prefer the Marriott. Similarly, the Guest Quarters offered a suite of rooms for under $90, as compared to a standard single room offered by Stouffer at $125. Thus, it is not surprising that Stouffer lost most of its individual guests during the years the hotel was owned by the Augers. Stouffer simply would not allow the local management of the hotel to lower its prices as necessary, even to retain its long-time customers who were happy with the facility. Hence, the Stouffer's loss of business was neither a function of the weak economy, nor of depressed occupancy in the market.

Rather, the financial collapse was caused by Stouffer's mismanagement, as demonstrated primarily by their adamant unwillingness to adjust prices when better quality hotels were available at lower rates.

The Competition Did Better Than Stouffer

Four of Stouffer's individual segments — rack, corporate individual, package, and preferred corporate — declined from 1987 to 1993 by 61 percent, while the competition actually had more individual segment guests in 1993 than in 1987.

Corporate individuals are adults who are offered a rate better than transient guests because they tend to travel frequently, averaging about six trips to a particular hotel each year. Normally, corporate rates should not vary widely because variable rates tend to alienate regular customers. Nevertheless, Stouffer introduced a pricing system whereby rates were raised and lowered daily, or even hourly, in an effort to optimize revenue. However, as the general manager of the Stouffer Hotel properly recognized, "This pricing for corporations confused and alienated customers." Stouffer's lost about 68 percent of its corporate individuals by pricing a single room at more than the competition was charging for a suite.

Stouffer raised prices from $115 in 1988 to $127 in 1992, while competitors reduced their prices. Stouffer's prices increased by $12 on average when suite prices during the same period were reduced by an average $15. If Stouffer simply held its prices, rather than raise them, and then lowered them to $98 to meet competition in 1992, the hotel would have been priced consistently with its quality and could have remained competitive. Instead, by adopting a pricing philosophy that was contrary to the market, Stouffer embarked on a reckless strategy that was destined to sacrifice occupancy and profits in this important market segment.

Accordingly, had Stouffer simply adopted prices that were fair and appropriate for the market, the hotel's volume of corporate individuals would have acted just like the market: lost volume in 1991 and recovered in 1992, with gains in 1993. Had Stouffer priced this segment properly, it could have expected results consistent with those of the market as a whole in each year. In this one segment alone, the revenue losses caused by inappropriate overpricing were $2.3 million (the lost volume in room nights multiplied by the fair price, less the amount which would have been lost by discounting the price paid by the fewer number of corporate guests who paid the higher price charge by Stouffer).

Most of Package Sales Were Lost

Market research revealed that Stouffer also lost about 78 percent of its package sales during the same period as it suffered dramatic losses in the number of corporate individual guests. In 1988, Stouffer canceled the "Family Summers" as well as the AAA Program and replaced these successful programs with Breakations, its own unsuccessful creation. The extraordinary decline in package sales between 1987 and 1992 was caused by Stouffer's overpricing and by its decision to cancel historically successful programs. Keeping the AAA program, coupled with an average price for this segment of $65 rather than $80, would have allowed the hotel to maintain its previous volume in package sales. The resulting loss was over 20,000 room nights and roughly $1.6 million in lost revenue. When adjusted to take into account the reduced volume of the package sales, Stouffer was able to achieve at an unfair price; the net loss in room department revenue for this segment alone was $1.5 million.

Principal competitors of the Stouffer Hotel were two Marriotts, the Courtyard and Marriott Conshohocken; two Guest Quarters in Plymouth Meeting and Wayne; two Hiltons in Great Valley and Valley Forge; one Holiday Inn; and two Sheratons, the Valley Forge Sheraton and the Sheraton Plaza. Demand increased for the Stouffer Hotel and its competitors every year but 1991, the year of the Gulf War. During this same period of time, new hotels were being built, increasing significantly the room supply in the Valley Forge area.

Hotel occupancy at Valley Forge was depressed in 1988 and again in 1991, but in each case the occupancy recovered once the market had time to absorb the new additions to the supply of hotel rooms. Therefore, Stouffer's loss of 20 percent of its occupancy during the period from 1987-1993 was not caused by any long term depression of occupancy in Valley Forge. Indeed, there simply was no overall depression of occupancy in the area.

Occupancy Declined for Five Years

The Stouffer Hotel showed occupancy declines over the 1987-1992 period, but experienced its worst decline in 1992. During that year, the Stouffer Hotel declined by 15.4 occupancy points from 1991. During this same period, the occupancy of the hotel's competitors decreased by only 2 percent. Three hotels — the Sheraton, the Holiday Inn, and the Courtyard — performed about equal to the market. Moreover, four hotels actually outperformed the market: the Marriott, the two Guest Quarters, and the new Sheraton. All these new hotels used reduced prices to gain customers. Moreover, the two Guest Quarters cut prices as much as $14 and $16 per night to hold customers and gain new ones. Similarly, the Sheraton offered much lower prices and a better Frequent Guest Program than the Stouffer Hotel.

Four hotels fared significantly worse than the market average — the two Hiltons, the Sheraton Plaza, and the Stouffer Hotel (whose performance was, by far, the very worst in the market).

Rack rates are the highest posted rates, set at Stouffer headquarters, and not by the on-site management team at the hotel. In 1991, Stouffer charged its non-corporate guests prices as high as $159.94, higher than any rates surveyed among 35 hotels in the region (except luxury hotels in downtown Philadelphia).

Stouffer lost 86 percent of its rack business from 1987 until 1992. Moreover, the general manager again concluded that a reduction in price from $140 to $120 would have doubled the hotel's business in this very lucrative market segment. Unfortunately, Stouffer refused to permit this sensible price reduction. The loss due to improper pricing in this segment is calculated to be 10,900 room nights over the five-year period from 1987 to 1992. Stouffer's insistence on an artificially high price accounted for a net loss of $1.2 million in rack rate room revenue.

Preferred rates are locally negotiated rates for large companies which send many employees to a hotel. Stouffer Valley Forge had worked hard over the years to develop this segment because these guests tend to be very loyal. In 1987, just after Stouffer sold the hotel to the Auger family, they directed the general manager to discontinue the preferred rate to many of its best customers.

The general manager reported "..in 1987 I was told I could only offer preferred rates to 12 companies, regardless of lost business. I lost 10,000 room nights, between this decision and the rate optimization program." Obviously, the corporate mandate to eliminate reduced rates for all but 12 of the hotel's preferred customers antagonized the companies that were discontinued. Prices were increased just when new hotels were offering better values.

Two Groups Are Surveyed

Two separate surveys were conducted to confirm the reasons for the hotel's loss of business. The first group included 20 meeting planners who had used the hotel in the past but had either not returned or had reduced their usage and the second, 50 individual former guests who had not used the hotel in the 12-month period prior to the survey.

The meeting planners were asked to rate the important features of the Stouffer Hotel as compared to other hotels in the area. A rating of 1 would be considered excellent or outstanding, rating of 2, above average or superior, and a rating of 3, average. Table 1 shows the scores given to the hotel.

Meeting planners who had not returned to Stouffer rated the hotel generally superior to the competition, and the hotel's staff and sales groups were rated close to outstanding. As one meeting planner said, "The reason I chose the Stouffer was because of the sales group." The hotel received an overall rating between superior and outstanding. Hence, the primary reason for the discontinued use of the hotel was overpricing.

Meeting planners were asked about Stouffer's group pricing, when compared to the competition. They responded with the following opinions: very high, 19 percent; high, 29 percent; and average, 52 percent. Almost half (48 percent) of the meeting planners found Stouffer's prices to be higher than average when compared to competition. What is most interesting is that all of the meeting planners interviewed who continued to use the hotel (albeit less often than they used to) found the hotel's prices to be "high."

Respondents were then asked how important it was to use a "Stouffer" when having a meeting. More than three quarters of those surveyed (76 percent) found it was "not important," compared to 24 percent who found it "important."

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Table 1
Opinions of Meeting Planners

	Past meeting planners who had not returned	Current meeting planners who had reduced business
Quality of food	1.8	2.3
Quality of service	1.8	2.3
Quality of sleeping rooms	2.0	2.3
Quality of meeting rooms	1.7	2.4
Quality of facility (bldg & grounds)	1.7	3.0
Quality of staff	1.4	1.7
Quality of sales group	1.3	1.6
Overall rating of hotel	1.6	2.6

Meeting planners were next asked to identify the other hotels they were using in the Valley Forge area. They listed the following: Sheraton, 30 percent; Hilton, 22 percent; Marriott, 22 percent; Guest Quarters, 11 percent; and others, 15 percent. All of the hotels identified were rated better by the Stouffer on-site management team and offered relatively lower prices.

Higher Prices Rate as Significant Factor

The survey of the hotel's lost business reports indicated that, during the 12 months preceding this market research, the hotel lost approximately 6,000 room nights of potential group business that was not due to a lack of available sleeping or meeting rooms. The following reasons were given for this lost business: rate too high, 69 percent; preferred competition, 23 percent; and other, 8 percent.

Many of the meeting planners surveyed named the Marriott as their alternative hotel. Even more significant is that all of those surveyed who mentioned the Marriott also said that the lack of a nationally negotiated contract rate was one of the reasons for their decision to use the Stouffer Hotel less or not at all. Nationally negotiated contracts typically provide that a hotel chain will offer attractive rates to a major company if all of its employees will use the hotel chain should rooms be available.

When asked what it would take to get them to use the Stouffer for their future meetings, all but one of the meeting planners surveyed said "lower price." Other reasons for not using the hotel were individual guests charged at different prices, no dining variety like Hilton's Kobe Steak, poor sales material, no printed menu, hotel not up to grade, poor decor, not Grade A, company management insists on other hotel, Stouffer will not negotiate national rates, and cannot use Stouffer again because we have a nationally negotiated rate.

The last comment was the most common single reason given for not using the hotel.

Individual Guests Were Surveyed

The survey of 50 past guests who had not returned to the hotel was designed to determine the reasons for their failure to return, the factors that would motivate them to use the Stouffer Hotel whenever they were in the Valley Forge area, and perceived quality of the hotel in comparison to other hotels in the area.

Respondents were almost equally split between those who traveled frequently to Valley Forge and those who seldom visited the area: frequently, 43 percent; seldom, 47 percent; and not any more, 10 percent. Of those surveyed 56 percent had chosen to use another hotel in the future, and did not plan to return to the Stouffer Hotel. Those surveyed were about evenly divided between the Marriott, the Hilton, and the Sheraton, with slightly fewer guests choosing the Guest Quarters and the Holiday Inn.

Other than price, the following reasons were given by those surveyed for their selection of competitive hotels: Marriott, Honored Guest Program; Hilton, friendly attitude and restaurant; Sheraton, generally pleased with the hotel and staff; Guest Quarters, liked the suites (at Stouffer's single room price); and Holiday Inn, better price and nearer the King of Prussia Mall.

Individuals who stayed at the Stouffer Hotel with either a government or group rate were removed from the sample to obtain a better reflection of those who paid a normal individually-negotiated rate. Not one respondent felt that the Stouffer offered good value with respect to rate. The respondents' attitudes toward Stouffer's pricing are as follows: very expensive, 12 percent; expensive, 53 percent; competitive rates, 35 percent; good value, none; and excellent value, none.

Thus, when the quality of the Stouffer Hotel was compared to the other hotels in the area, the majority of those surveyed (65 percent) felt that the Stouffer Hotel was overpriced.

Factors Other Than Price Rank Higher

Not a single person surveyed found the hotel's location to be "poor," and most found the service quality "superior" to other hotels. Room comfort and food quality were both about evenly split between "superior" and "equal to the competition." See Table 2.

Survey results showed that 37 percent of individual respondents tend to use a Stouffer hotel whenever they can, and 54 percent report that they use Stouffer rarely or not at all any more. However, the survey results also suggested that, even among those who often use a Stouffer hotel, there was some reluctance to use the Stouffer Valley Forge Hotel. Two guest comments are indicative of this reaction: "Tried the Valley Forge Stouffer because of my past experience at the Battle Creek Stouffer, but found the Valley Forge Stouffer too expensive," and "I stayed at Stouffer [Valley Forge] expecting it to be like other

Table 2
Guest Opinions of Hotel

	Superior	Equal to Competition	Poor
Location	56%	44%	0%
Service quality	59%	36%	5%
Room comfort	50%	45%	5%
Food quality	47%	53%	

Stouffers; but it wasn't. It was not really satisfactory."

These comments reflect the general attitude of guests who are experienced with Stouffer hotels and resorts. That is, the Valley Forge property is not of the same quality as many of the Stouffer properties, but it demanded high prices that were appropriate for more luxurious hotels. For seven out of eight respondents, "lower prices" or having a "better frequent guest program" would be a reason to come back to the Stouffer Hotel: lower prices, 55 percent; better frequent guest program, 30 percent; better facilities (indoor pool, etc.), 10 percent; and other, 5 percent.

On August 14, 1995, Federal Judge Charles R. Weiner vacated the jury's decision against the Stouffer Hotel Management Corp. to pay $7.85 million to the former owners of the Stouffer Valley Forge Hotel near Philadelphia.

The suit arose out of SHMC's operation of the Valley Forge Hotel, pursuant to a management agreement with U.S. Penn. The case was tried to a jury in a bifurcated trial. In the initial liability phase, the jury found in favor of the plaintiffs on all claims submitted, with the notable exception of their breach of contract claim against Stouffer Hotel Management Corporation.

In the subsequent damages trial, the same jury awarded the plaintiffs compensatory damages of $4.2 million against Stouffer Hotel Management Corporation, $2 million against the Stouffer Company, and $650,000 against the Stouffer Corporation. In addition, the jury warded $1 million in punitive damages against Stouffer Hotel Management Corporation.

In granting the defendant's motion for a new trial, the judge said that his decision "turns entirely upon an interpretation of Pennsylvania law...." After careful review, the judge concluded that "the jury's inconsistent verdict finding no breach of contract by the Stouffer Hotel Management Corp. But tortious breach" by the Stouffer Hotel Company and Stouffer Corporation cannot be left undisturbed. Hence, a new trial.

Stanley Turkel, a New York based hotel consultant, advises hotel owners, investors, and lending institutions on all aspects of hotel acquisition, disposition, marketing and operations, and **Russell O. Stewart** specializes in hotel turnaround situations with client hotels Sheraton, Omni, Choice, and Westin.