

## An Online Travel Agency (OTA) Litigation Squeeze Play

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### Summary:

A recent King County summary judgement against Expedia (NASDAQ:EXPE), reportedly the largest consumer class action suit in Washington State history, creates a new front in the growing litigation battles facing the Online Travel Agency (OTA) community. Expedia competitors Priceline (NASDAQ:PCLN), Orbitz (NYSE:OWW), and privately held Sabre's Travelocity potentially risk facing similar claims, although their exposure is somewhat limited relative to Expedia due to lower hotel sales volume and merchant model transaction ratios.

### Analysis:

The King County judgment is significantly different from earlier claims targeting the OTAs. High profile cases, such as the claim filed by the City of Anaheim, focused on the *local taxing jurisdictions* attempting to secure the hotel merchant tax differential from the OTAs. In the Washington State case however, the plaintiffs seek compensation to *consumers* for the hotel merchant tax differential. The suit fundamentally alleges that the tax was collected on a retail basis from consumers, but remitted on a wholesale basis to the hotel (and then passed through to local jurisdictions.) In short, the suit claims the tax amount paid by consumers was overstated by Expedia and the difference should be refunded. Expedia is refuting these claims and appealing the ruling.

In effect, the OTAs are now surrounded by litigants seeking a share of the funds retained on what account for some of their highest margin travel transactions. While an OTA would not be liable for simultaneously paying a higher tax rate to a local jurisdiction and rebate a consumer, having courts decide cases in favor of plaintiffs on opposing sides of the supplier / purchaser spectrum could create considerable confusion, potentially driving higher legal expenses.

At the heart of both cases is how an OTA treats the difference between the retail and wholesale tax basis when the OTA serves as merchant of record for a hotel reservation transacted under the merchant model.

The following hypothetical scenario illustrates the issue:

- A hotel may offer a room at a retail price of \$100. On stand-alone hotel bookings, hotels frequently establish a Best Available Rate (BAR) as the retail price – an amount an OTA may contractually guarantee not to undercut when selling the room to the consumer. This creates price parity between the hotel web site and the OTA web site.
- An OTA may enter into a contract that provides access to the room inventory at a floating 20% discount from the retail price. In this example, the OTA would pay the hotel a net rate of \$80 for the room.

- Local taxing jurisdictions could assess a 10% tax rate on the sale of the hotel room.
- With the OTA serving as merchant of record, travelers pre-pay the OTA for the room, taxes and services fees when the reservation is booked.
- The OTA subsequently pays the hotel the room rate and the associated room tax in a second transaction prior to or immediately following the guest stay.

#### Calculation Examples:

- Retail Transaction: When sold on the hotel web site, the total amount paid by a consumer is \$110 – the \$100 room rate + \$10 room tax (\$100 x 10%).
  - Commissionable Transaction: If transacted by the hotel under a Commission (also called the Agency) Model, the hotel would collect \$110, **pay the tax jurisdictions \$10**, pay the OTA \$20 (\$100 room rate x hypothetical 20% commission) and retain \$80 in room revenue.
- Merchant Transaction: When sold on the OTA web site, the total amount paid by a consumer is at least \$110. The OTA pays the hotel the \$80 room rate + \$8 room tax (\$80 x 10%). The hotel subsequently **pays the tax jurisdictions \$8**. The remaining \$22 is retained as gross margin by the OTA to cover its operating costs and profit.

In this example, the core issue is the treatment of the \$2 difference between the \$10 tax paid by a hotel under a retail (or commissionable) transaction and the \$8 paid under a merchant transaction. The \$2 is effectively the tax rate (10%) applied to the markup amount ( $\$20\% \times \$100 = \$20$ );  $10\% \times \$20 = \$2$ .

In fairness to the OTAs, the merchant tax differential could not be rebated to the consumer as a BAR violation would occur. It would also not be paid to the hotel as the hotel could not rationalize payment of \$10 in tax on \$80 in room revenue as the amount would exceed its effective tax rate. As highlighted by the King County case, no entity should retain funds earmarked as taxes if the taxes are not remitted to the taxation authority. In their cases, the local jurisdictions propose the direct payment of the merchant tax differential directly by the OTA to the taxation jurisdiction. This would be a new transaction that could drive additional accounting and reporting costs for the OTA.

Stand-alone hotel transactions appear to be the most problematic for the OTAs – especially with hotels defining the retail price by enforcing contractual BAR guarantee provisions. This somewhat undermines the OTA argument that merchant transactions have existed for many years without issue. In years past however, the wholesaler, tour operator or travel packager not only served as merchant of record, but also established the retail price. Since the advent of the BAR guarantee, the OTA's role is limited to transaction processing role, with the pricing management role retained by the hotel.

Even more challenging is the calculation process undertaken by the OTAs to arrive at a tax inclusive retail price that matches the tax-inclusive hotel BAR price. It is not possible to gross up a net tax-exclusive rate to match a gross tax inclusive retail price without using the tax rate itself in the formula. Any use of a tax rate as a factor in determining a total price could potentially introduce a liability for any amounts derived from that tax-related calculation.

The good news for OTAs is that multi-component, merchant model package transactions should not be subject to the merchant tax differential. In a package transaction, an OTA may define the retail

package price based on a wide variety of criteria. Additionally, the relative mix of travel component costs and discount levels provided by the component suppliers present a true wholesale cost structure and retail pricing process that is not subject to supplier BAR pricing restrictions.

With locales facing budget deficits, courts may be sympathetic to hearing arguments alleging short-payment of the taxes due. Additionally, courts may be more willing to hearing arguments whether it is appropriate for tax authorities to receive lower tax payment under merchant model transactions, when consumers pay an identical retail price regardless of the transaction model.

Another concern is the sheer number of local taxation jurisdictions – and a wide variety of local tax laws that may or may not apply in each case. Now the OTAs also need to consider the potential number of consumers that could launch class action cases based on precedent if the King County ruling stands. Despite the eventual outcome of these cases, the resources required to mount a successful defense are considerable.

Some OTAs have elected to suspend the sale of hotel rooms in jurisdictions such as Columbus, Georgia or Baltimore, Maryland where litigation is underway. It is questionable whether this approach could be sustained across a potentially growing number of tourist destinations, particularly with major cities in Texas, the State of Florida and the City of Anaheim now engaged in the process.

The bottom line is that OTA margins, already reduced due to competitive reductions in fees for airline flights and expanded low piece guarantee criteria for hotel bookings and packages, will be under further pressure from hotel merchant tax litigation. With the addition of consumer class actions to the existing mix of local tax jurisdiction suits, profit margins on stand-alone hotel bookings are under intense legal scrutiny and increasing legal expenses to support defense against a growing number of cases that are now advancing through the courts.