

Hotels 201: Legal and Business Issues in the Purchase and Sale of Hotels - What You Don't Know Can Hurt You

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This is the second of a three-part series on the business and legal issues that arise in developing and owning hotels. In the first podcast, “[Hotels 101](#),” attorneys Dan Weede and David Adams discussed

the basic legal and business issues unique to developing and owning hotels, including the brand's impact on creating and maintaining the hotel's value; the roles of various agreements in hotel deals, specifically the management agreement; franchise and loan agreements; and the basic metrics used to evaluate a hotel's financial performance. In this podcast, Dan and David discuss some of the more important issues in a hotel purchase and sale agreement, with a particular focus on the legal rights investors need to properly evaluate a hotel acquisition.

David: Why is a purchase and sale agreement for a hotel acquisition so different from a contract to purchase other property types? Dan: That's a great question and one that I get a lot. Hotels differ from other property classes in three or four key ways: First, as an investment, they are really hybrid real estate projects/operating businesses. Second, hotel revenue comes in daily, not monthly. Third, hotels are much more service and labor intensive than other property classes. Fourth, the importance of the brand, or the flag, to the value of the real estate is much more important in hotels than in other classes of real estate. These differences, and the way you perform "due diligence" on them, are what make a hotel contract different. **Q: Let's start with "due diligence."**

What are some "due diligence" methods you would advise a buyer to perform in connection with a purchase contract to properly evaluate a potential hotel? A: Due diligence is simply making sure you get what you think you're going to get. It's accomplished through some or all of the following: (i) representations and warranties from the seller, (ii) your physical inspection of the property, (iii) inspecting and reviewing the hotel's books and records, and (iv) various conditions to closing negotiated in the contract. **Q: That's a great list. Let's start with the first point you mentioned,**

representations and warranties. What are some typical reps and warranties a purchaser would want to have in its purchase and sale agreement? A: Well, I'm not sure there's such thing as a "typical" rep and warranty, but there are ones that are commonly negotiated. So, a seller will want to limit its representation, in general, to only those matters it thinks the buyer cannot reasonably ascertain for itself. Sellers will typically want to limit and qualify the reps they do give to "materiality," their actual knowledge, usually time duration and, typically, cap the damages that can result from any untrue representations. Buyers will push for broad and comprehensive representations and warranties, even if they plan to perform full due diligence on the hotel themselves. The basic representations and warranties should define the types of property, such as real property, personal property, and the intellectual property that's being sold with assurances from the seller that, to its knowledge, the seller owns those rights and can convey them free of monetary encumbrances in other lanes. The buyer will also want to see representations and warranties and schedules of the various material leases, service contracts, and the licenses that will affect the hotel. Now, as we discussed in our last podcast, two of the most critical documents that affect a hotel's value and operations are the franchise and management agreements. Therefore, if the hotel is "encumbered" by management or "encumbered" by franchise, the buyer will

want appropriate representations and warranties regarding those agreements so that it can understand those agreements' impact on the property's value. The purchaser will also want to see a list of all service contracts, as well as have the right to review and reject service contracts it thinks are above-market or otherwise undesirable. **Q:**

Thanks, Dan. The second thing you recommended was a physical inspection of the property. What are some physical inspections a prospective purchaser would want the right to conduct?

A: The buyer typically conducts standard due diligence regarding title and survey, and physical condition of the property, including the zoning status and the environmental status. The buyer will typically want to conduct a full review of the agreements that affect the property, including important licenses, such as the liquor license, and will want to review the management agreements, as we discussed – the franchise agreement and, importantly, any offsite parking agreements or reciprocal easement agreements that may affect the property. Much of the physical due diligence is now performed by various third-party vendors and is contained in (i) property condition reports (PCRs), (ii) environmental site assessments (ESAs), and (iii) property zoning reports (PZR). If a buyer plans to “reposition” or “rebrand” the hotel, it will also want a hotel feasibility study that supports those plans. One more note about franchise agreements for a hotel: Franchise agreements are personal to the owner and cannot be, typically, assigned to a buyer. The buyer will need to enter into a new franchise agreement with the brand. As a condition to entering into a new franchise agreement, most brands require that the new owner complete a property improvement plan, or PIP. PIPs can add significantly to the overall hotel acquisition costs so it's critical that, as part of its due diligence, the new owner fully understands and accounts for PIP costs in its economic forecasts for the hotel.

Q: That's a great segue to my next question, which is on the inspection of the hotel's books and records. How extensive a review of the hotel's books and records should a prospective purchaser want the right to conduct?

A: A buyer will want to review (i) the hotel's financial information, including annual audited profit and loss statements, typically, for the last three to five years and the current year to date, (ii) the audited balance sheet for the last three to five years, (iii) occupancy and average daily rate for the last three years, (iv) capital expenditures for the same time period, with current projections for those expenditures, (v) the important service contracts and leases, the franchise agreement, the license agreement, important permits, any union agreements, (vi) a list of future reservations and bookings, (vii) important inspection reports that might deal with health, fire, the building, or elevators, (viii) and a current list of employees, including, typically, name, position, salary, and benefits.

Q: That's a great list. And, as I should've asked when we were talking about reps and warranties: What are some important covenants a buyer would want a seller to agree to in a purchase and sale agreement?

A: Buyers typically want the sellers to continue to operate the property (or cause its manager to continue to operate the property) in the same manner as prior to executing the contract. This

includes maintaining proper inventories, keeping all existing service contracts, and not entering into any new service agreements without the buyer's consent. If the buyer wants to retain the existing hotel manager it will also want to ensure that its key employees remain at the hotel. **Q: Thanks, Dan. So, we've gone all the way through the due diligence process. Let's talk about actually closing on the acquisition. What are some important closing conditions that a buyer would want the seller to commit to?**

A: Well, this is one of the more highly negotiated parts of any purchase and sale agreement. Common closing conditions that buyers and sellers agree to typically surround: (i) title and the title company specifically being willing to issue a standard title policy at closing, (ii) that there's no material litigation that might affect the property or the transaction, and (iii) neither party has defaulted under the purchase and sale agreement. Those are fairly uncontroversial. The non-standard, or more highly-negotiated, conditions a buyer will typically want to request, and sellers will typically want to resist, deal with (i) financing, or having a financing contingency, (ii) the franchise, (iii) liquor license, (iv) management agreement contingencies, and (v) WARN Act contingencies. Now, we don't have enough time to go into the WARN Act, but the it relates to important litigation that affects mass employee layoffs or firings. If you don't know what you're doing, the WARN Act trip you up in a transaction. Buyers frequently request a condition for anything they believe is critical to the hotel's operation. And, of course, as I said, sellers resist these conditions to closing and want to ensure that the buyer is using its best efforts to obtain everything we just discussed — its financing, franchising, liquor license, and that it get all of this in a timely manner. That's all I have for this brief overview of hotel purchase and sale agreements. While the issues we discussed today are common to most hotel deals, the ultimate resolution is as varied as the properties themselves. Finally, be mindful that it's very important to understand the other party's motivations in any transaction. If you hope to get what you want, you must understand what the other party wants. Frequently, both parties can get what they want and need if they just take the time to understand each other. That's what we call a classic win-win situation — and that's what we shoot for.

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