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Negotiating Hotel Purchase and Sale Transactions: Key Legal Issues for Buyers and Sellers

Drafting Purchase Agreement Closing Contingencies and Reps and Warranties, Navigating Existing Management/Franchise Agreements

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Today's faculty features:

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NEGOTIATING HOTEL PURCHASE AND SALES TRANSACTIONS: KEY LEGAL ISSUES FOR BUYERS AND SELLERS

September 17, 2015 Webinar

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Jonathan Falik is the Founder and Chief Executive Officer of JF Capital Advisors. Jonathan leads the firm's hospitality business, which includes equity and debt placement, asset acquisitions and dispositions, portfolio transactions, JV structuring, asset management, management company and brand evaluation, and strategic and capital markets advisory services.

Jonathan was a Senior Managing Director and the Head of Hospitality Capital Markets at BGC Real Estate Capital Markets. Simultaneously, Jonathan was the Head of Hotel Investment Sales for Newmark Grubb Knight Frank. Previously, Jonathan was a Managing Director and Head of the Lodging and Leisure Investment Banking group at Cantor Fitzgerald & Co.

Prior to joining Cantor Fitzgerald, Jonathan was the founder and CEO of JF Capital Advisors, a lodging advisory and principal investment firm. While at JF Capital, Jonathan led the acquisition or development of 25 hotels with over 5,500 keys and an aggregate cost of approximately $1 billion. Additionally, Jonathan was the CEO of Eagle Hospitality Trust, a 13 hotel-property private REIT. Jonathan has led the sales of single assets and portfolios of 88 hotels for over $2.2 billion of value. Before founding JF Capital in 2004, Jonathan was an investment banker at Bear Stearns in the Gaming, Lodging and Leisure Group. Jonathan began his career as a CPA at Price Waterhouse.

Jonathan has over 20 years of experience in the real estate and lodging sector. He has worked on numerous M&A and financing transactions involving well over 2,000 hotels and over $25 billion of transaction value. Of the $25 billion, $24 billion was completed as an advisor and $1 billion was completed as a principal. He has been actively involved with mergers and acquisitions of public and private companies, portfolio sales and single asset sales, equity financings, high yield financings and mortgage financings. Jonathan has extensive hospitality experience as an agent, advisor, principal, owner, borrower, guarantor, franchisee, lender and asset manager.

Jonathan received a BA in economics with high honors from Rutgers College and an MBA from Columbia Business School with a concentration in Real Estate Finance. Jonathan has been an adjunct professor at NYU's Real Estate Institute and is an active lecturer and panelist at industry events. Additionally, Jonathan sits on the board of the Boutique & Lifestyle Lodging Association.

Tara K. Gorman
Shareholder
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Tara K. Gorman focuses her practice on hotel acquisitions, operations, development and finance, general commercial real estate transactions, including commercial real estate acquisitions and sales, and office retail leasing.

Tara prepares and counsels clients, both domestically and internationally, regarding hotel acquisitions, financing, operations, development and finance, condo-hotels, hotel management agreements, license and branding agreements, restaurant management agreements, water park and casino agreements, real estate finance documents, purchase and sale agreements, property management agreements, corporate formation, business improvement districts, vendor agreements, marketing management agreements, website service agreements, telecommunications license agreements, and commercial office and retail leases. Tara has represented institutional investors such as life insurance companies and pension funds in connection with their real estate investments, as well as governmental and quasi-governmental agencies with respect to their real estate holdings.

Tara is a graduate of University of Maryland, where she received a B.A. and M.B.A. and she holds a J.D. from Georgetown University of Law.

Guy Maisnik
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Guy Maisnik has nearly three decades of commercial real estate transactions with a strong expertise in hotels and finance. He is a partner and Vice Chair of JMBM's Global Hospitality Group®, a senior member of JMBM's Chinese Investment Group, and a partner in the Real Estate Department. Guy advises clients on hospitality transactions, with both a practical business and legal focus, representing buyers, sellers, lenders, opportunity funds, special servicers, REITs and developers in hotel transactions, joint ventures, hotel management and franchise agreements, buying, selling and ground leasing of hotels, complex mixed used development and fractional and timeshare structuring. Guy has also assisted lenders and mezzanine lenders, including EB5 regional centers and investors, with structuring their hotel lending programs and documentation. Guy's practice is equally domestic and foreign, where he advises on matters throughout the United States, Mexico, Canada, South America, Caribbean, Eastern and Western Europe, Australia, Middle East and Asia. Guy also has significant experience in structuring capital raises through Chinese and EB5 investments, and structuring workable condo hotel and resort trust solutions for domestic and foreign buyers and investors. He has been recognized in The Best Lawyers in America®, California Real Estate Journal's Best Real Estate Lawyers, Super Lawyers® for both Real Estate and Business Law, Los Angeles magazine's Top Southern California Lawyers, as well as a Top Real Estate Lawyer in Real Estate Southern California magazine

1. SELLER REPRESENTATIONS AND WARRANTIES IN THE PURCHASE AND SALE AGREEMENT

Representations and Warranties

Representations and warranties are statements of fact and assurances made by the parties

- They are usually the longest part of the acquisition agreement and can take a significant amount of time to negotiate

- The Buyer's goal: Comprehensive representations and warranties; valuable source of information from the basis for a damage claim post closing

- Seller wants to give as few representations and warranties to limit post closing liability

Negotiated Issues In Purchase Agreements - Seller's Representations and Warranties – Due Diligence Period:

Seller's Perspective:

- Wants as short a time as possible before deposit is non-refundable
- Concern with Buyer talking to GM, engineers and employees in case Buyer doesn't buy hotel
- Does not want to be obligated to pay off any encumbrances in case Buyer finds something unexpected that Seller may want the right to walk away
- Wants protection of access agreement and insurance
- Doesn't want to authorize Phase II environmental reports unless know more information
- Wants to disclose all information in data room
- Doesn't plan to fix anything raised in title objection/survey objection letter
- Wants confirmation that franchisor will approve of Buyer or Buyer pay penalty of termination of franchise agreements

Buyer's Perspective:

- Understanding the Buyer's goals
- Properly describing the hotel and related assets being purchased
- Wants to ensure sufficient time to perform due diligence
- Wants free reign to investigate all physical, legal and operating conditions to understand the hotel's true value and shortcomings
- Ensure that the hotel is financeable, including Seller's payoff of all monetary encumbrances
- Obtain key estoppel certificates
- Need to understand the value in the existing hotel management agreement
- Understanding the franchise agreement and impact

Negotiated Issues In Purchase Agreements - Sellers Representations and Warranties

Seller's Perspective

- Limit representations and warranties and limit liability
- Limit knowledge to very few people, usually hotel general manager
- Wants Buyer to rely on Buyer's own due diligence
- Does not want to spend resources to determine ability to terminate service contracts or other agreements; wants Buyer to assume or pay termination fee
- Wants to give extremely limited environmental representations
- Prefer to provide no representations on compliance with existing laws or financials
- Discuss floor and caps for liability; survival period and ability to enforce

Buyer's Perspective

- Wants as many representations and warranties as possible to provide better understanding of the Property
- Better used as a checklist than an insurance policy
- Does not want to assume all service contracts and want Seller to pay any termination fee
- Wants assurances that Seller has delivered all documents and data
- Desirous of a low floor and for the liability to go back to the first dollar, a high cap, and a post-closing escrow, holdback, letter of credit or creditworthy guarantor

Negotiated Issues In Purchase Agreements – Seller's Covenants

Seller's Perspective

- Willing to run business normally but does not want Buyer interference in case Buyer does not complete the purchase
- Does not want it to be a condition precedent to Closing to obtain tenant estoppels. May be willing to give a Seller estoppel instead

Buyer's Perspective

- Doesn't want Seller to enter into new leases or contracts
- Doesn't want Seller to make tax appeals or anything that can affect hotel value in the future
- Doesn't want Seller to sell any FF&E, OS&E or inventory
- Wants Seller's cooperation in the transition of permits and liquor licenses
- Doesn't want to inherit any pre-closing tax responsibilities

Negotiated Issues In Purchase Agreements - Conditions Precedents to Closing

Seller's Perspective

- Wants as few condition precedents as possible
- Does not want a financing contingency
- Does not want a franchise contingency
- Does not want a liquor license contingency
- Does not want a manager contingency

Buyer's Perspective

- Wants to make sure no major litigation or change in property
- Wants to make sure can obtain clean ALTA title policy (typically in the United States only)
- Wants to make sure Seller's satisfied its obligations under the purchase agreement
- Wants to ensure financing, franchise, management and liquor licenses are in place

Negotiated Issues In Purchase Agreements - Transaction Costs

Seller’s Perspective

- Wants to determine the amount of purchase price allocated to goodwill
- If Seller is paying a portion of the transfer tax or title insurance, want to determine purchase price allocation
- Wants to prorate the date of closing and do reconciliation 90-360 days after
- Would like to sell accounts receivable
- Need to negotiate who pays for Property Improvement Plans, title insurance, franchise fees, transfer and recordation taxes

Buyer’s Perspective

- Wants to use the lender’s evaluation of allocation of purchase price which typically is different than Seller’s valuation
- Wants to ensure all costs, reserves and security deposits are properly accounted for
- Wants to buy liquor (if legal to do so) at cost
- Wants clean slate for all employees; does not want to inherit any pre-closing responsibilities (accrued benefits) – beware of or unfunded pension liabilities and multi-employer plans

Negotiated Issues In Purchase Agreements - Casualty and Condemnation

Seller's Perspective

- Wants to assign insurance and condemnation proceeds and close
- If a portfolio deal, may be stuck with one property or make it an all or nothing deal

Buyer's Perspective

- Wants to make sure the insurance and condemnation proceeds plus Seller's insurance proceeds are sufficient
- May not want the hassle of having to rebuild a damaged property
- If portfolio deal, have ability to kick out a property significant sunk costs and may want to close on other properties

Negotiated Issues In Purchase Agreements – Default Prior to Closing

Seller's Perspective

- If Seller defaults, wants to limit damages. Give Buyer the choice to close or specific performance
- If Buyer defaults, Seller may want its remedy to be the security deposit and legal fees

Buyer's Perspective

- If Seller defaults, Buyer wants Seller to cure the default or reduce the purchase price to compensate for the default
- Wants ability to terminate and have cost covered if default is material
- If Buyer defaults, Buyer wants Seller's sole remedy to be the security deposit

Negotiated Issues In Purchase Agreements – Default After Closing

Seller's Perspective

- If Seller defaults, Seller wants to limit it damages with a floor and cap on damages. Typical cap is 2%-5% of purchase price. Issue whether damages go to the first dollar or the first dollar after the floor. Wants a short survival period
- If Buyer defaults, Seller can sue Buyer for damages because Buyer will be a creditworthy entity since it owns the hotel

Buyer's Perspective

- If Seller defaults, Buyer wants a creditworthy entity for recovery of damages
- Buyer wants guaranties, letters of credit or post-closing escrows
- Buyer wants a survival period of 12-24 months
- Buyer wants to extend the survival period if it files a claim during the survival period

Due Diligence – What Can Go Wrong?

- **Third Party Reports** - Title, survey, zoning, environmental reports, property condition reports
- **Liquor License** – Transitional Liquor License Agreements vs. Condition to Closing
- **Parking** – What if not sufficient – restriping, off-site parking, reciprocal easements with adjacent property owners to share garage?
- **Condemnation** – Can potential condemnation impact signage or hotel entrances?
- **Reciprocal Easements/Air Rights** – What happens if hotel is on the third floor and there is a casualty, and first floor owner does not rebuild; how would rebuilding occur?
- **Study Period** – Wants Seller to be obligated to release or discharge monetary encumbrances
- **Estoppels** – Ground lease and parking issues
- **Liability Assumption** – What liabilities are being assumed?
- **PIP** – Have PIP issues resolved prior to end of the due diligence period

Representations and Warranties – How to Protect Ones Interest

- **Remedies for Breach** – Minimum Threshold and Cap; Need Creditworthy Entity or Escrow from which collections possible post-closing
- **Seller's knowledge and duty to investigate** – How realistic?
- **Hotel Service Contracts** – Obtain copies of all hotel contracts – what is and is not binding? What is and what is not assignable?
- **Financial Statements** – How does Buyer know they are accurate?
- **Compliance with Brand Standards** – Does the hotel comply with brand standards? What will it cost?
- **Vouchers/Gift Certificates** – Unexpired vouchers, gift certificates or other promotional materials
- **Guest Room Personal Property** – OSE and Supplies: What needs to be replaced and supplemented?

Seller Covenants

- **Inventory** Inventory remains adequately stocked, and maintain linens and bath towels at least at a 2.5 PAR level for all suites or rooms

- **Consent Rights** Wants consent rights for anything that could benefit/hurt hotel including rights relating to Adjacent Property Owner’s parcel if Adjacent Property Owner’s deed restrictions benefit hotel

- **Hotel Contracts** Need to be in ordinary course of business or Buyer wants consent rights

- **Hotel Manager** If retaining the same hotel manager (unlikely unless an encumbered asset), will want to ensure best/key employees remain at the hotel for least one year from closing

Remedies: Distinguish between Pre-Closing and Post-Closing Remedies

- **Pre-Closing Seller Default** – Why specific performance is so important; create post-closing escrow for repairs (unlikely); use Purchase Price to pay all monetary encumbrances at Closing

- **Post-Closing Seller Default** – Bucket and/or Cap on damages, escrow arrangement, guaranty or letter of credit. Want access to post-closing escrowed funds to breaches in reps/warranties/covenants and for prorations

Representations and Warranties

Seller can limit the representations and warranties in the following ways:

- **Materiality:** Qualify a representation or warranty by what is material or what might cause a material adverse effect
- **Knowledge:** Qualify a representation or warranty by what a party knows or should know
- **Scope:** Limit a representation or warranty to certain material. For example, the representation or warranty may be limited to the materials identified in the data room
- **Time:** Make a representation or warranty as of a specified date or time or with respect to a particular period
- **Disclosure schedules:** Limit a representation or warranty by reference to the detailed disclosure schedules

Types of Representations and Warranties

- **About the Seller:** Seller qualifications
- **About the Purchase Agreement:** Valid and no conflicts
- **No condemnation**: No anticipated governmental interference
- **No litigation**: No buyer wants to purchase a lawsuit
- **No violations of law**: Be realistic about how much a Seller needs to represent about the hotel's compliance with law
- **Environmental conditions**: Buyer does not want environmental problems
- **Ground and space leases**: List all the leases and obtain estoppels
- **Conveyance free of all liens**: Confirm all liens and encumbrances
- **Contracts/management agreement/franchise agreement**: Confirm whether the hotel is encumbered by a hotel management agreement and franchise agreement
- **Financial and operating statements**: Confirm accuracy of hotel financial records
- **No right of first refusal/rights to purchase or lease**: Ensure no third party rights to purchase or lease

Types of Representations and Warranties

- **Taxes**. Ensure Seller has paid all taxes and assessments
- **Maintenance and No Defects**: Confirmation of proper maintenance and the existence of defects
- **ERISA**: If Buyer or Seller, directly or through a management company, is contributing to a pension plan that is subject to ERISA, then the details of the plan(s) may be provided as part of a tailored representation and warranty
- **Money Laundering/Terrorist List**: Assurances that a party is not on any governmental list related to money laundering (e.g. OFAC) and is not the subject of a criminal investigation relating to money laundering. Note: This statement is more important with respect to Buyer, as Buyer is providing the funds for the purchase
- **No Undisclosed Liabilities Representation:** This representation protects Buyer against unknown liabilities by shifting the risk of unknown liabilities to Seller

Pre-closing Breach of Representations and Warranties

The Seller’s representations and warranties can have significant value

- The purchase and sale agreement typically includes closing conditions in favor of the Buyer which, if not satisfied, will provide the Buyer with the opportunity to terminate the agreement and receive a refund of its earnest money deposit

- These closing conditions almost always include a statement that the Seller must have performed its covenants under the agreement and that the Seller’s representations and warranties must be true and correct (typically both when made and as of the closing date)

- Depending on the knowledge qualifier used in the representations and warranties section and the wording of Buyer’s conditions to closing, the Seller’s representations and warranties may be true and correct even if inaccurate

Post-closing Breach of Representations and Warranties

It is not unusual for a purchase agreement to provide that any breach of a Seller representation or warranty known by a Buyer prior to closing is waived if the Buyer elects to proceed to close escrow rather than terminate the purchase agreement

Purchase agreements often include limited Seller representations and warranties, and minimal recourse if a breach is discovered, particularly in overcoming the hurdles of enforcement

Bucket and Cap:

- The Seller will often negotiate for a “bucket” (i.e., a dollar amount below which Seller will have no liability for a breach of its representations and warranties)

- This may be documented as a threshold above which Seller will have liability for the entire claim or a deductible above which Seller will begin to have liability

  - (Obviously, the former is preferable if you are the Buyer!) and a “cap” (i.e., a maximum liability for such breach)

- This will sometimes mean that the Buyer will have no recourse for “small” claims (even if the Seller breached its representations and warranties) and will have limited recourse for larger claims

- This sort of arrangement may remove much of the incentive of the Seller to carefully review its files and its statements, and therefore, the Buyer should carefully consider the implications of agreeing to this provision

Closing Conditions

If there is a period time between signing and closing, each party requires the other to fulfill certain conditions before the transaction closes

- Usually there are conditions that both parties must satisfy and conditions that only bind one of the parties
- If a condition of a party is not satisfied, that party is typically not required to close the transaction until the condition is satisfied
- A party may waive its own closing condition

Name of Closing Condition Provision

Bring-down of representations and warranties
The bring-down of representations and warranties provides the Buyer with the right to walk away from the deal if any of the Seller's representations are inaccurate. The Buyer and the Seller often negotiate on what date the representations and warranties must be accurate

Stand-alone material adverse effect (MAE) condition
The stand-alone MAE condition gives the Buyer the right to walk away from the transaction if there has been a MAE between signing and the closing

2. CLOSING CONTINGENCIES IN THE PURCHASE AND SALE AGREEMENT

What unique issues involved in the purchase of a hotel property must be included in the closing contingencies of the purchase and sale agreement?

Hotels are operating service businesses residing on real estate. They have the following unique transaction related issues:

- WARN Act
- Collective Bargaining Agreements
- Liquor Licenses
- Franchise / License Agreements
- Lender / Servicer Approvals
- Employee Issues
- Operating Agreements and Contracts
- Proprietary Systems – Electronic and Operational
- Proprietary Data
- FF&E, OS&E and Inventories

WARN Act

- Laws requiring advance notice to employees in the event of a substantial termination of employees
- May not be applicable if all or substantially all employees are being re-hired by the new owner or manager

Collective Bargaining Agreements

- Union contracts will likely need to be assigned and assumed by the new manager
- May require payouts to employees for unused sick days, vacation days, or other benefits

Liquor Licenses

- Buyer or its operator will apply for a new liquor license but may need an interim agreement from the existing license holder
- It is often difficult or time consuming to obtain the new license and may require the new management agreement to be finalized before starting the process
- Often, liquor cannot be sold as part of the purchase price

Franchise / License Agreements

- Generally, franchise / license agreements cannot be assumed, assigned, or transferred
- Will have termination or liquidated damages provisions
- May have key money loan that needs to be repaid
- Will require a PIP (Property Improvement Plan) for new owner and assess timing and cost
- Will require certain proprietary systems, signage and logoed items
- Changing franchise affiliations can be costly

Lender / Servicer Approvals

- May require lender approvals or special servicer approvals to assume the loans

Employee Issues

- Employees may be terminated and re-hired
- Employee personal files may not be made available to the new owner / operator
- Issue with the timing of communicating new hiring / employment offers
- May have to pay out accumulated vacation days, sick days, and other accrued benefits
- Employees may resign during the sales process

Operating Agreements and Contracts

- Need to evaluate which agreements and contracts can be assigned, and if there are any assignment costs or fees

Proprietary Systems – Electronic and Operational

- Some of the proprietary systems are property of the brands and can't remain in place on change of brand
- Some of the data is proprietary to the brand

Proprietary Data

- Access to historical operations history, client files, and financial data is important

FF&E, OS&E and Inventories

- Acquiring the existing FF&E, OS&E, and Inventories is critical

3. VETTING THE HOTEL MANAGEMENT OR FRANCHISE AGREEMENT

Key Issues – Management Agreements

- Base Fees
- Incentive Fees
- Performance Standards
- Notice Periods
- Cooperation on sale / termination
- Termination Fees
- Employee Communication

Key Issues in Reviewing a Management Agreement

- Employees are usually employees of the Management Company and **NOT** of the Owner or the Hotel
- If the employees are union, so that there is a Collective Bargaining Agreement, then it will be difficult to reduce any positions, or to change / reduce seniority and benefits
- States have different requirements with regards to payouts of unused vacations days and personal days
- May or may not contain provisions allowing for communications with and interviews of Executive Committee Members and employees
- May have cooperation provisions on transfer to a new manager
- Fees: Termination fees, closing fees
- Ownership of Information: Who owns files, data, etc…
- SNDA with Lender: Will provide for manager to continue to manage

Key Issues – Franchise Agreements

Existing Agreement

- Termination Provisions
- Liquidated Damages
- Key Money
- Right of First Offer or Right of First Refusal
- Area of Protection

Key Issues – Franchise Agreements

New Agreements

- Fees, Fee Reductions
- Termination Provisions
- Liquidated Damages
- Key Money
- Right of First Offer and Right of First Refusal
- Area of Protection
- Guaranties
- Property Improvement Plan

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