

# Bricks and Sticks and Keys and Flags and Cash Traps: An Introduction to Hotel Transactions

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March 26, 2007

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**LATHAM & WATKINS**

# Types of Hotel Transactions

- Management
- Purchases and Sales
- Financing
- Distressed Hotels
- Development (Not Covered)

# What Is A Hotel?

## Overview of Asset Structure

- Not Just Real Estate
- Very Much an Operating Business
- Totally Different Approach Than an Office Building
- Specialized Contracts and Negotiations
  - Franchise Agreement
  - Management Agreement
- Every Possible Type of Property
- Special Legal Issues
  - Characterization and Transfer of Interests in Assets
  - Licensing (Especially Liquor)
  - Negotiations Between Multiple Players

# Business/Legal Overview: A Few Property Categories

- Contracts
  - License
  - Management
  - Parking
  - Services
  - Supply
- FF&E
- Income Stream
- Intellectual Property
  - Customer Lists and Preferences
  - Name(s) of Hotel (“Flag”)
  - Software
- Inventory
- Leases
  - Restaurants
  - Otherwise Usually Trivial
- Permits
  - Operations
  - Two-Way Radios
- Personal Property
  - Artwork
  - Furniture
  - Liquor
- Resort Amenities
- Shared Operations

# Business/Legal Overview: Liquor Operations and Licensing

- Weird State-Specific
- Essential to Profitability
- Impossible to Pledge (Usually)
- “Tied House” Rules
- Rules About Inventory Ownership
- Rigorous Licensing Procedures (Fingerprinting, Etc.)
- Use of Separate Entity

# Business/Legal Overview: Reserves

- Heavy Reserve Requirements
- FF&E
  - Up to 4% of Gross Revenue, Occasionally 5%
  - 1%, 2%, 3%, 4% for New Hotels
  - Vary By Hotel Type
- Capital Replacement
  - Redo Lobby Every Five or Ten Years
  - Building Renovations
  - Building Systems
- Underreserving Creates False Profitability and Future Disaster

# Management

- Chain Management
- No Name Management
- Self Management

# Two Basic Types of Management Agreement

## *“Eighties”*

- Long-Term
- Hard to Terminate
- Few Performance Standards
- Owner Must Cover Open-Ended Losses and CapEx
- Sometimes “Fee Deferrals” Much Like Prior Mortgage

## *More Modern*

- Shorter Term
- Performance Standards
- Termination Rights
- Budget Approvals
- Capital Requirements as the Price of Tighter Manager Rights



# Leases vs. Management Agreements

## *Leases*

- Interest in Real Estate
- Owner/Landlord Can't Escape via Bankruptcy
- Owners and Lenders Hate Leases

## *Management Agreement*

- Personal Services Contract
- Relatively Easy to Terminate
- Possible Fiduciary Duties for Manager
- Today's Norm

# Management Fees

- Base Fee – 2 to 4%
- Incentive Fee – 10 to 25%
  - Depends on “Profit” Measure
  - Depends on “Priority Return” Deductions
- Chain-Wide Expenses
  - A Big Black Hole
- Reimbursement of “Expenses”
  - Another Big Black Hole
- Reservation Fees
- Consulting Fees
- More Fees
- Guest Loyalty Programs

# Other Major Business Terms

- Operating Expenses
  - Owner Pays All
  - Budget Control
  - Major Expense Approval (If That)
- Standards of Operation
  - Usually Brand Standards
  - Or Comparable Hotels
- Protection
  - Multiple Brands
- Agency vs Independent Contractor
- Hiring Decisions

# Franchise and Brand Names

- Multiple Niches
- Slight Variations in Nightly Rate
- New Brand Names
- Reservation Systems

# License Agreement

- Systemwide Operating Standards
- Often 5 or 10 Years
- Single-Digit Percentage Fees
- Cancellation Penalties
- Best Western (\$/room/year)

# Purchases and Sales

- Again, Identifying All the Assets
- Transfer Documents
- Third-Party Consents
  - Liquor License
  - Franchise
- Accounting and Practical Transition of Operations
  - House Banks
  - Cut-Off Time
  - Inventory
  - Baggage
- “Free of Management”?

# Financing of Hotels

- Security Package
- Cash Controls
- Special Covenants
- Lender-Licenser Relationship
- Lender-Manager Relationship

# Security Package

- Analyze Every Asset
- How Do You Perfect?
  - Example: Federally Registered Service Marks
- Mortgage Collateral
- Hotel Income Issues
  - What's Hotel Revenue?
  - Proposed Uniform Act
- Management and Franchise Agreements
  - Transfer Restrictions
- Amenities, Other Real Estate
- Role of UCC



# Cash Controls

- Owner Has “Sticky Fingers”
- Use of Lockbox
  - Interaction with Management Agreement
- Credit Card Receipts

# Special Covenants

- Preserve License, Franchise, Management Agreements
- Liquor Licensing Compliance
- Reserve Accounts
  - Interaction With Management Agreement
- Additional Financial Reporting
  - Operating Business With Daily Changes in Results

# Lender-Licenser Relationship

- “Cold Comfort” Letter
- A Headache to Negotiate
  - Each Brand Thinks It’s God
- Very Difficult to Assert a Claim
- Traditional Forms of Letter Don’t Even Confirm “No Default Right Now”
  - Recent Litigation

# Lender-Manager Relationship

- “Subordination” of Management Agreement
- “Subordination” Of (At Least Incentive) Fee to Debt Service
- “Nondisturbance” After Foreclosure
- Loan Payments vs Deferred Management Fee
- Reporting and Information
- Control Over Cash and Reserves
- Lender-Manager Agreement Can Be the Most Important and Difficult Document in a Major Hotel Loan Closing

# Hotels in Distress

- Where's the Cash?
- Operating Business – Must Preserve
  - Priority of OpEx vs Debt Service
- Is Our Security Interest Perfected?
  - Wide Range of Assets
  - Air Conditions, Televisions, Laundry Equipment, Telephones (The Missing UCC-1)
- Practical Control Over the Business
  - Electronic Locks
- Treatment of Hotel Revenues
  - 1994 Bankruptcy Amendments
- Quality Control Issues; Loss of License

# A Few Industry Trends

- Cyclical Boom Times as of 2007
- REIT Ownership Special Issues
  - Bad Income
- Litigation Against Managers
- Even Less Hotel Ownership by Brands
- Hotel Services for High-End Apartments
  - Also “Fractional” Interests and Timeshares
  - Condo Craze Cresting
- Relatively Little Distress
  - Except in “Boutique” Hotels
  - Largely Thanks to Low Interest Rates
- Separately Operated Restaurants
- Rate Pressure from the Internet

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(End of Presentation)