

SELLING AND BUYING AN EXISTING HOTEL – STRUCTURE OF AN ASSET TRANSACTION

By Albert J. Pucciarelli and Eunice Moon

Albert J. Pucciarelli, formerly Executive Vice President, General Counsel and Secretary of Inter-Continental Hotels & Resorts, is currently Chair of the Hotels and Resorts Practice Group of McElroy, Deutsch, Mulvaney & Carpenter, L.L.P.

Eunice Moon is an associate at the firm of McElroy, Deutsch, Mulvaney & Carpenter, L.L.P. Her practice is concentrated in the area of commercial and real estate transactions.

Those of us engaged in providing legal services to the hotel industry, particularly to developers of 'greenfield' hotel and resort projects, have focused much attention to the peculiar issues involved in developing condo-hotels and branded resort communities. I recently represented the purchaser of an existing branded limited service hotel in the United States and found this project to be a welcomed return to basics. It was a straight forward transaction, structured as an asset sale and purchase, rather than a stock deal, that is, the sale and purchase of the entity that owns the hotel. The Purchase and Sale Agreement ("PSA") was typical for an asset sale and purchase agreement where any business changes hands as an asset sale, and, of course, it contained provisions necessary to address the specific hotel-related aspects of the deal. A review of the PSA and may be useful to you given the frequency of this kind of existing hotel sale and purchase.

Assets or Stock – Liability and Tax Considerations

Why an asset deal as opposed to a stock deal? Typically the seller will favor a stock deal because the shareholders of the owning entity, assuming it is a sole purpose company, will part company with all of the assets as well as all of the liabilities – contractual and otherwise, known and unknown, that constitute the business, except to the extent that the purchaser requires and the selling shareholders are willing to give an indemnification to the purchaser for certain liabilities of the company, such as existing lawsuits, insured and uninsured, that are identified by the seller or discovered by the purchaser in the due diligence exercise. From the purchaser's perspective, the asset purchase is generally preferred for precisely the inverse consideration: unless the purchaser expressly assumes any liabilities of the selling entity, they remain with the seller, with the exception of statutory liability that may "go with" the assets, such as liability for hazardous waste contamination of the land or liability for terminated employees who were not provided with required notice under the "WARN Act".

The stock or asset format is often driven less by these liability considerations than by the tax objectives of the parties.

Generally, in a stock sale the selling shareholders will recognize taxable gain equal to the excess of the sales price over the income tax basis of the stock sold.

However, the purchaser will not be able to “step up” the basis of the corporate assets to reflect the purchase price paid. The purchaser therefore will not be entitled to depreciation and amortization deductions reflecting the purchase price.

In an asset sale, the selling corporation will recognize taxable gain based upon the excess of the sales price over the tax basis of the assets sold, and the purchaser will be entitled to depreciation and amortization deductions, with respect to the purchased assets, based upon the purchase price of the assets. In that case however, (unless the selling corporation is an 80% or more owned subsidiary of a parent corporation, or a subchapter S-corporation) the stockholders of the selling corporation will recognize additional taxable gain upon the liquidation of the selling corporation and the distribution of the after-tax proceeds of the sale.

Often the relative tax advantages and disadvantages to the seller and the purchaser can be dealt with through an adjustment to the purchase price.

Finally, not to be overlooked, is the fact that if certain conditions are met (generally where a parent corporation is selling the stock of an 80% or more owned subsidiary, or where stock of a subchapter S-corporation is being sold) a stock sale may be treated as an asset sale for tax purposes.

Structure of the PSA

Where the seller and purchaser have agreed to go with the asset sale and purchase structure, here is what the PSA typically will provide.

The heading naturally will identify the selling entity and the purchasing entity, and the recitals will usually emphasize to some degree that the purchaser is purchasing “only those assets and assuming only those liabilities as are specifically identified herein”.

Sale and Purchase; Price, Closing

The basic deal terms are usually set out early in the agreement, with the sale and purchase section making reference to the assets to be sold. From the purchaser’s perspective, a generic description may be adequate but a specific listing on a schedule is preferred, and in a limited service hotel where the FF&E is repeated in each room, the listing of all assets – from the land to the lamps – is not overly burdensome. The seller may want to list any assets that are excluded. Receivables arising pre-closing usually are not transferred, and amounts due from guests in occupancy through the closing will either be apportioned at the closing as an adjustment (with purchaser taking the risk of collectibility) or guest may actually be required to check out/check in on the day of the closing. Licenses and permits may be included as assets to be transferred if they are assignable, and contracts to be assumed will be identified. Consumables, such as cleaning supplies and food for the breakfast room, will probably be generically identified, and the quantities will be subject to change to accommodate the ordinary course of business. The

purchaser may be obligated to hire at least enough of the employees to avoid triggering a WARN Act notice. Presumably the purchaser will be willing to do so to assure continuity to the business operations.

The purchase price will be established and a schedule for payment thereof, typically a deposit upon execution of the PSA, to be held in escrow, and the balance due at closing. If the seller is providing financing by taking back a note, this will of course be so stated. Adjustment on the price may be allowed for guests in occupancy at the closing (credit seller for the pre-closing nights) or consumables on hand on the closing (credit or debit seller depending upon the change since the inventory at the time the PSA is signed).

The closing date will be established, albeit subject to change as may be necessary to accommodate the purchaser's time requirement to obtain financing and the assignment of existing contracts to be assumed or replacement contracts, and generally to satisfy other pre-closing conditions.

Condition of the Assets; Due Diligence

The seller will want to emphasize that all assets are being sold "as is, where is, in existing condition" and disclaim all warranties or any liability whatsoever for the condition of the assets. The purchaser, therefore, must undertake a thorough due diligence effort, learning as much as possible about the land, the tangible and intangible assets, and generally learning as much as possible about what is being purchased. This due diligence effort requires the seller's full cooperation, access to the premises and all records of the business, including the financial statements covering operations, and access at least to some employees for their insights into the business.

The seller may be reluctant to give the purchaser access to more than what is available in the seller's selling prospectus, if any, before the seller has the purchaser contractually bound to some extent to the basic deal terms, and the purchaser may be unwilling to expend much time or effort in due diligence until the purchaser knows that it has a binding agreement with the seller or at least some period of exclusivity during which no other purchase offers will be accepted.

An alternative to pre-contract due diligence is to provide a period post-execution of the PSA, perhaps thirty days, during which the seller will provide and the purchaser will review all relevant information about the hotel and during which the purchaser will have limited access to the property to conduct tests and inspections, and possibly employee interviews. The seller will be obligated to cooperate and the purchaser will be bound to confidentiality. If the purchaser is not satisfied, and generally "for any reason" will be allowed at this early juncture, the deposit will be refunded and all bets are off. The seller may require some level of forfeiture of the deposit if only to avoid the purchaser's using the due diligence inspection opportunity as a "free look" into the seller's business, with no serious intention of proceeding. The negotiation of the PSA before the inspection, with the time and legal fees attendant thereto, may also serve to deter the not-serious purchaser.

Seller and Purchaser Covenants, Positive and Negative; Conduct of the Business Pre-Closing

The seller and the purchaser will each covenant to the other to cooperate and to make at least a good faith effort to cause all conditions to the closing to be satisfied.

The purchaser obtaining the franchisor's consent to an assignment of the franchise or a new franchise agreement is likely to be a key condition to the purchaser's obligation to close the purchase. The seller must covenant to provide its cooperation to the purchaser in obtaining an assignment of the franchise agreement or a new franchise agreement. The purchaser must covenant to do what is necessary, such as applying to the franchisor for the assignment or a new franchise, including possibly agreeing to a capital improvement program for the hotel.

The seller will be required to conduct the business of the hotel in the ordinary course and to preserve the hotel's good will and will be prohibited from making commitments that are unusual – i.e., outside the ordinary course of business - not on commercial terms or not arms-length, such as unusual procurement obligations or reservations for periods post-closing that are made at other-than-normal rates. The seller will not be permitted to make any capital expenditure commitments to the franchisor that will survive the closing, at least not without the purchaser's prior consent.

Representations and Warranties; Remedies

The seller's representations and warranties in any sale are critical because a) they tend to smoke out information that only the seller is in a position to know, b) they provide a basis for the purchaser to decline to close if they are discovered to be inaccurate or incomplete, and c) they provide, although usually only to a limited extent, the basis for a claim by the purchaser after the closing if they are discovered to be inaccurate or incomplete after the purchaser has been "in possession" of the property for some time following the closing.

The seller's representations should include the typical representations contained in standard asset and/or real estate sale agreement, such as the following:

- a) the seller's due authorization and good standing,
- b) the seller's authority to execute the PSA and to consummate the sale, in accordance with the terms thereof;
- c) the seller's execution of the PSA does not and will not violate any other contracts, covenants, or agreements to which seller is a party or may be bound;
- d) the seller's compliance with zoning and other applicable laws governing use and occupancy of the property;
- e) all permits are in full force and effect and there are no material violations thereof;

- f) whether the seller is conveying good, marketable and insurable title; and
- g) the extent of the seller's knowledge concerning the following issues:
 - the presence of hazardous substances affecting the assets or of violations in environmental laws, either currently or in the past;
 - insurance violations;
 - status of special assessment levies or roll back taxes;
 - condemnation proceedings or commitments to dedicate or grant any portion of the property to a third party resulting in a restriction, expense or obligation to the property;
 - any litigation, action, investigation or proceeding, including pending or threatened, relating to the assets or the transactions contemplated under the agreement;
 - the existence of liens resulting from work performed on the premises.

When negotiating hotel transactions, the following additional representations should be included to account for the sale of the business aspect of the transaction:

- a) whether the consent or authority of third parties is required to execute the sale agreement and to consummate the sale, other than those required under a franchise agreement or contract relating to the ownership and operation of the hotel;
- b) disclosure of all material contracts, including leases, relating to the ownership and operation of the hotel, whether these contracts are complete, in full force and effect, and the existence of a material default by any of the parties under these contracts;
- c) the existence of employment agreements, collective bargaining agreements, or pensions, retirement or profit sharing plans covering any of the employees of the hotel; and
- d) the seller's compliance with its franchise agreement.

The purchaser's representations are usually more perfunctory and generally cover due authorization and the ability to close. For any representation and/or warranty that is made by a purchaser or seller, that party will attempt to carve out as many exceptions to each statement by making them "subject to" certain facts or conditions or based on a certain level of "knowledge," in an attempt to limit any potential misrepresentation or potential liability.

Each party will make its representations as of the time of execution of the PSA and then repeat them again at the closing to establish that they have not changed, or disclose how they may have changed, between the execution of the PSA and the closing. If a representation is discovered to be or subsequently disclosed as inaccurate or incomplete prior to the closing, the purchaser typically has the option of either a) terminating the PSA and receiving a return of the deposit together with possible reimbursement of its costs, or b) waiving the defect and proceeding to the closing. For example, the seller has represented that there are no pending lawsuits or claims that may

give rise to a lawsuit, and before the closing discovers that the general manager had received an angry letter from a guest about abusive treatment from an employee that has caused emotional distress. The seller must disclose this newly discovered claim to the purchaser before the closing and the purchaser may decide, given that the claim is against the selling entity (as the employer of the offending employee) rather than the purchasing entity, to waive the “breach” of the prior representation and to proceed to closing, but, possibly, not without requiring that the seller provide a specific indemnification for this claim.

If a breach of a representation is discovered after the closing, the purchaser may have recourse against the seller. The seller will try to limit post-closing claims by amount—either singular claims that exceed an amount or, for aggregate claims, a higher amount that caps the total exposure—and by time—in requiring that the claim be asserted in some brief period of time, such as six months, following the closing or be time barred. The seller will also try to make representations “to seller’s knowledge” thereby requiring the purchaser to prove not only that the representation was inaccurate or incomplete, but that the seller knew it to be so. In addition, post-closing, a dissolved seller may be judgment proof, and thus a purchaser may want to have a hold-back of some amount of the purchase price to cover these post-closing claims.

Conditions Precedent to Closing

The parties each will have the right not to close the sale and purchase if certain conditions to closing are not satisfied notwithstanding each party’s good faith effort to cause the conditions to be satisfied. These include the typical conditions that the other party not be in breach of any of its covenants and that its representations remain accurate as of the closing (and that each party provide an officer’s certificate to that effect). In addition, the purchaser may condition its obligation to close on obtaining necessary financing and an assignment of the existing or the grant of a new franchise agreement.

Indemnification Obligations

Each party will typically agree to indemnify the other for claims arising during its period of ownership of the assets. The indemnification may be limited as to time and aggregate amount.

Remedies

The purchase and sale of existing hotels is a combination of a real estate and personal property transfer as well as the transfer of an existing business. The well-crafted PSA should ultimately balance the conflicting interests of the seller who typically is looking for a sale that is certain and does not involve lingering liabilities and of the purchaser who is looking for maximum disclosure and a remedy after the closing for any misrepresentations or failures to disclose.

As a real estate transaction, most states will enforce the PSA by the reciprocal equitable remedy of specific performance. The parties may and sometimes do contract out of the remedy. The seller's remedy if the purchaser fails to close may be limited to the purchaser's forfeiture of the deposit. The purchaser's remedy if the seller is found to have breached a representation before the closing may be limited to either termination of the SPA with a return of the down payment and possibly reimbursement of expenses, or the purchaser may waive the breach and close. The seller should try to preserve the remedy of specific performance where the purchaser, after all conditions to its obligations to purchase simply refuses to close the purchase unless the down payment that will be forfeited is sufficient to avoid the purchaser's having used the SPA as merely an "option" agreement in exchange for the deposit forfeiture. The purchaser should try to preserve the remedy of specific performance where the seller, after all conditions to its obligation to sell simply refuses to close the sale, otherwise the purchaser is subject to the possibility that the seller has found another buyer who will pay a higher price.

Miscellaneous

The PSA will of course include the "usual" miscellaneous provisions, such as a notice provision, a governing law provision, an arbitration requirement, and the like.

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