HVS

CHAPTER 16

Capital Sources and Financing

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» 16.01 INTRODUCTION

The hotel industry has recovered almost completely from the time in the early 1990s when obtaining any type of financing was difficult. With the renewed success of the hotel industry, lenders are more willing to loan to valid hotel projects. This chapter explores the various financing techniques and sources of capital commonly used in the hotel industry. In addition, this chapter discusses the mortgage loan process and what the hotel developer should consider when obtaining a mortgage.

Exhibit 16-1 indicates the breakdown between various financial institutions that lend to the hotel industry.

Exhibit 16-1 Who Provides Hotel Financing

Source: PKF Consulting. Hospitality Investment Survey (1996)

**Other sources included investment banks, SBA loans, mortgage funds, conduits, and private equity.*

Source	Percentage
Bank	58.0%
Other Source*	36.0
Seller	24.0
Insurance Company	24.0
Pension Fund	18.9
Savings & Loan	3.4

This chapter divides equity and debt sources into the following two categories:

1. Institutions that originate mortgages and maintain portfolios of both mortgages and real estate equities, including:
   - —Commercial banks;
   - —Life insurance companies;
   - —Private credit companies; and
   - —Pension funds.
2. Investment conduits, which are primarily entities that invest in hotel real estate mortgages and passthrough income and gain to investors (both private individuals and institutions), including:
   - —Real estate limited partnerships (RELPs);
   - —Real estate investment trusts (REITs); and
   - —Commercial mortgage-backed securities (CMBS).
3. Mortgage financing, which is how most hotels are financed. Topics covered include:
   - —Types of mortgage loans; and
   - —Obtaining a hotel mortgage.

» 16.02 COMMERCIAL BANKS

Commercial banks have historically played the most significant role in providing financing for the hotel industry. However, they have been hurt by the real estate collapse of hotels during the early 1990s. Commercial banks sold off distressed and foreclosed loans and limited new lending to only the most healthy of hotel developers.

A significant new restraint on future hotel lending by commercial banks and by savings institutions is the Uniform Rule on Real Estate Lending established by the four banking agencies (the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision). The Uniform Rule, issued on December 31, 1992, requires every lender to adopt a written policy establishing appropriate limits and standards for granting real estate loans. Such loans are those secured by mortgages, as well as loans made for financing permanent improvements, whether secured or not.

As a supplement to the Uniform Rule, the agencies simultaneously promulgated a set of guidelines that establish the specific factors banks are expected to consider in establishing real estate (including hotel development) lending policies. Although the guidelines are not mandatory, a lender failing to comply with them invites extra scrutiny from regulators.

A crucial component of the guidelines is the loan-to-value (LTV) limits on real estate loans. The LTV ratio is based not only on the value of the property securing the loan but on the value of any acceptable collateral in addition to the real estate. The guidelines set supervisory LTV limits for various categories of loans as follows:

- For raw land, 65 percent
- For land development loans, 75 percent
- For commercial construction loans, 80 percent
- For improved property, 85 percent

The mere fact that a loan is made within the supervisory LTV limits does not mean it will automatically be deemed sound by a bank examiner. The lending institution must evaluate other credit factors as well, including:

- The capacity of the borrower or the sufficiency of income from the property to service the debt;
- The overall creditworthiness of the borrower;
- The amount of equity invested by the borrower; and
- Any forms of credit enhancement, including guaranties, mortgages, insurance, and additional collateral.

The guidelines also recognize that "exception loans" (those exceeding the supervisory LTV limits) may be appropriate if the credit factors justify the loan. Banks must identify these loans in their records and report all significant exception loans quarterly to their board of directors. As an upper limit, the aggregate amount of all exception loans for commercial loans, agricultural, multifamily, or other residential property (other than one- to four-family homes) may not exceed 30 percent of a bank's total capital.

Several types of loans are excluded from the supervisory LTV limits. These include:

1. Loans renewed, refinanced, or restructured without the advancement of new funds or an increase in the line of credit (except for reasonable closing costs) or in connection with a workout, with or without the advancement of new funds, if the restructuring is consistent with safe and sound banking practices and part of a clearly defined and well-documented program to achieve orderly liquidation of the debt, reduce risk of loss, or maximize recovery of the loan;
2. Loans that facilitate the sale of real estate acquired by the lender in the course of collecting a debt previously contracted in good faith;
3. Loans to be sold promptly after origination, without recourse, to a financially responsible third party; and
4. Loans guaranteed or insured by federal, state, or local governments and a wide range of traditional corporate and business loans not considered true real estate lending, even though such loans might involve real estate collateral or improvements.

» 16.03 LIFE INSURANCE COMPANIES

Life insurance companies have played an important and varied role in hotel development, from providing direct loans for development to participating as equity partners in the ownership of the hotels. Life insurance companies are among the largest financial institutions in the world. Their primary function is to provide financial security to policyholders through life insurance. The premiums collected by the companies are used largely to maintain reserves from which benefits are paid; these reserves constitute enormous capital pools that must be invested for long periods. Because the inflow of funds from premium payments can be predicted with great accuracy, and because fund outflows (upon the death of individual policyholders) can also be estimated with great accuracy, insurance companies are in a position to commit several years in advance to providing loan funds to borrowers and to make long-term commitments of capital.

Because an insurance company's obligations usually are measured in fixed dollars (e.g., the face amount of a life insurance policy), in theory it need not be overly concerned with the depreciation of the dollar through inflation. As a result, insurance companies always have been a major source of fixed-interest mortgages for hotel developers. However, during the period of high inflation that began during the Vietnam War and lasted throughout the 1980s, insurance companies found it necessary to offer a variety of indexed or variable insurance and annuity plans that gave insured persons some hope of hedging against the continued erosion of the dollar. Thus, insurance companies themselves were forced to seek an inflation hedge, resorting to financing techniques such as variable interest rates, equity participation, and other formulas.

Because of their volume of lending and the fact that they are subject to much less regulation than commercial bands and savings institutions, insurance companies have been responsible for many of the creative financing techniques that have surfaced during the past quarter century. Indeed, some insurance companies in the 1980s became virtual partners with developers or property owners by entering into joint ventures and participating loan arrangements that enabled the insurance company to share in any future growth of the property. This trend has all but disappeared following the real estate crash that began in the hotel business in 1987.

Insurance companies are still a significant financing source for the hotel industry. However, they have been reluctant to originate new mortgage money for hotels because of the serious overbuilding that occurred in the early 1990s. With occupancy rates increasing in both 1995 and 1996, it remains to be seen whether insurance companies will once again take the lead in financing of hotel projects.

Insurance companies along with commercial banks are turning with increasing frequency to the purchase of real estate securities rather than whole mortgages.

» 16.04 PRIVATE CREDIT COMPANIES

In the early 1990s, when the traditional financing sources—commercial banks, savings institutions, and insurance companies—were unwilling or unable to provide real estate capital, private credit companies sought to expand their normally small share of the market. Credit companies, often called "lenders of last resort" because of their typically high interest rates and arduous terms, are usually real estate subsidiaries of large industrial companies. They generally peg their lending rates as a float over prime or at a comparable spread. Although credit from these lenders is generally expensive, they have become especially useful in providing the funds needed to acquire underutilized hotel property with appreciation potential.

At the height of real estate financing in the late 1980s, twenty-one major credit companies offered funding programs. The most prominent companies included European, Japanese, and American corporate loan subsidiaries. By the mid-1990s, the picture was quite different. Only a few major credit companies remained active; although they had an abundant supply of funds, they were highly selective. Nevertheless, they were prepared to extend their lending capabilities to a wide range of underwriting alternatives, as is discussed subsequently.

1. *Permanent loans.* Credit companies invade life insurance company and pension fund territory by structuring fixed-rate permanent mortgages, junior debt, and participating debt/equity deals. Unlike other permanent lending sources that loan for ten years or more, credit companies typically structure loans on a shorter term of three to seven years. Credit companies match their yields to their own commercial paper offerings, which are short-term obligations.
2. *Construction loans.* Credit companies are formidable competitors for the banking industry. Although both credit companies and banks use short-term capital that is suitable for funding construction and variable rate loans, credit companies are not governed by federal, state, and local banking regulations. Credit companies are more flexible while having the same financial understanding as banks because of their asset-based lending experience, including corporate lending and paper financing.
3. *Other types of financing.* Although credit companies are known for funding highly aggressive risk-oriented projects, the real estate credit crunch created excellent opportunities for them in conservatively underwritten real estate transactions. For example, credit companies frequently charge rates of as much as 1 and 2 percent of the total transaction amount per year for funding a standby commitment.

Credit companies also fund standby transactions with the expectation of taking a short-term ownership position in the property until the project has an opportunity to stabilize cash flow in a tough market condition. Of course, under all such conditions, credit company pricing reflects risk and reward return.

The credit company's biggest funding advantage over its competitors is its ability to provide commitments for financing on projects before or during cash flow stabilization. Although such lending underwriting involves higher risk, credit companies use a variety of deal structures that enhance the quality and reduce the risk of the total financing package.

Credit companies have been highly selected in financing hotel projects. They often demand that the investment returns exceed 20 percent. Hotels require significantly higher debt coverage ratios, often one-and-one half times the debt-service payment. Although they are rare, LTV ratios of as high as 85 percent are available. The higher-risk hotel deals require the borrower to give the lender a significant equity position (often as much as 50 percent or more).

Credit companies are a creative and active force in the real estate market. They have a direct link to the capital markets by their ability to raise capital through selling and guaranteeing commercial paper. As a result, credit companies may capture a larger market share from traditional lending sources in the future years.

» 16.05 PENSION FUNDS

Pension funds are tax-exempt capital funds held by corporations or labor unions (private pension funds) or state and local governments (public pension funds). Their

purpose is to pay retirement benefits to employees or union members. They represent the fastest growing pool of capital in the United States, and they undoubtedly will play a major role in hotel real estate financing in the future.

Only a small percentage of pension fund assets are invested in real estate mortgages or real estate equity. The percentage seems certain to rise, possibly to as much as 10 percent of total assets. The asset and liability structure of pension funds is somewhat similar than that of life insurance companies in that the inflow of funds is continuous and stable and payment obligations are actuarially determinable (i.e., accurate predictions can be made of the payments that must be made in future years). Consequently, pension funds would seem to be a logical source of long-term real estate loans.

However, just when pension funds started to invest significantly in the real estate market, the market crashed in the period between 1987 and 1993. Many pension funds had invested in real estate funds as part of their investment strategy. These funds for the most part were closed-end funds, from which capital could be withdrawn only in limited amounts and at specified times. When real estate values began to decline sharply, the funds had to wait for a considerable period to close their accounts, at which point they suffered significant losses. As a result of these experiences, pension funds are now turning more and more to direct investment in mortgages and real estate equities. The trend to mortgage securitization offers pension funds an easy way to invest in commercial mortgages, while the resurgence of REITSs and the easing of tax limitations on pension fund investment in REITs are making the REITs an ideal intermediary for equity investment.

» 16.06 REAL ESTATE LIMITED PARTNERSHIPS (SYNDICATION)

The limited partnership as a form of ownership of real estate is discussed in Chapter 15. In this chapter, the RELP is viewed as a source of real estate capital because of its primary role in the process known as syndication. In its broadest sense, a syndicate is a group of investors who pool their capital for investment in real estate. A syndicate may be any form of business entity, but by far the most popular format has been the limited partnership, because it represents the best combination of tax benefits and business efficiency.

Real estate syndicates experienced a sustained boom in the years prior to enactment of the Tax Reform Act of 1986 (TRA 1986). However, the TRA 1986, whose fundamental thrust was to minimize the role of taxes in investment decision making, had a major impact on hotel real estate syndication. The use of a RELP to pass losses directly through to investors was reduced almost to the vanishing point by the limitations placed by TRA 1986 on the deductibility of passive losses and the extended recovery (depreciation) period for real estate. The result has been that tax shelter-oriented real estate syndications have essentially been eliminated since passage of TRA 1986. Real estate syndication will remain an important part of the investment scene, but primarily in private rather than in public markets.

[1] Basic Syndication Structures

In a typical real estate syndicate, the investors constitute a single class, with each receiving a pro rata ownership interest in the syndicate for a one-time investment in cash. New investors are not admitted once the syndicate has been formed, and no provision is made for redeeming syndicate interest during the life of the syndicate.

This basic pattern is subject to a number of variations. Perhaps the most common is to create a multiclass syndicate in order to broaden the market for syndicate shares. A multiclass syndication has more than one class of investors, with each class entitled to different investment returns. The idea is to offer investors a range of choices, similar to the choices available to purchasers of securities, who may choose, for example, between bonds, common stock, and preferred stock.

At least three different approaches to the multiclass syndicate can be distinguished; (1) different classes of interest within the same syndicate; (2) land/building split; and (3) equity/loan split.

[2] Specified-Property or Blind-Pool Syndicates

In a specified-property syndicate, the particular property or properties to be acquired is identified in the offering statement and can be evaluated by the investor before he puts up his money. A blind-pool syndicate raises its capital before it has acquired any or less than all of the properties it will eventually own. A single-property syndicate almost always specifies the property to be acquired, although this is not necessarily the case. On the other hand, a multiple-property syndicate may or may not be a blind-pool syndicate, although it usually is.

[3] Master Limited Partnerships

Master limited partnerships (MLPs) are large limited partnerships whose interests are publicly traded, either on a stock exchange or in the over-the-counter market. They are designed to combine the investment advantages of partnerships with the liquidity of corporate stock. The high liquidity of MLP units is achieved through the issuance of depository receipts that can be traded freely.

In most cases, a real estate MLP uses a two-tier arrangement in order to simplify ownership of the underlying real estate assets. The MLP (the investment vehicle) has outside investors as its limited partners and the sponsor as its general partner. The MLP itself becomes a limited partner in a second (operating) partnership that owns the real estate and for which the sponsor also acts as general partner. The TRA 1986 sharply reduced the attractiveness of MLPs for real estate by limiting the use of tax losses from properties to shelter income from active sources. As a result, the MLP has been largely replaced by the real estate investment trust (see IT 16.07). However, some MLPs continue to be traded in the public securities markets, and it is possible that they may come back into favor once again.

» 16.07 REAL ESTATE INVESTMENT TRUSTS

Real estate investment trusts (REITs) as a form of real estate business structure are discussed in Chapter 15. In this chapter the emphasis is on REITs as a source of capital. REITs are playing an important role in the development of hotel property, especially since 1990. The resurgence of REITs can be traced to a number of causes:

1. *High yields.* As a result of the real estate collapse following the passage of TRA 1986, hotel properties suffered price declines ranging from 25 percent to 40 percent in most parts of the country. Many investors began to perceive hotel properties as a much more attractive income vehicle than common

stocks or bonds, which generally were becoming quite expensive. In addition, with interest rates having declined sharply, investors holding funds in money market accounts or CDs were seeing their income return decline sharply.

2. *Institutional demand.* A significant source of new investment in REITs has come from such institutional investors as common stock mutual funds, pension funds, and yield-seeking institutional investors.
3. *Financing source.* In the early 1990s, the traditional sources of real estate financing (thrift institutions, commercial banks, and insurance companies) sharply reduced their lending because of the high volume of distressed and foreclosed loans in their portfolios. Hotel developers, managers, and owners saw REITs as a means of raising new capital from the general market to pay down debt and grow their asset bases. Learning the lesson of previous REIT excesses, the new REIT sponsors structured their offerings on a much more conservative basis.

The resurgence of REITs in the early 1990s largely reflected the public's view of REITs as investments capable of generating high current yields as well as moderate appreciation in value over a period of years. Investors came to understand that cash flow was a more appropriate measure of a REIT's income than the "net income" measure used by business corporations. Cash flow (now known as funds from operations or FFO) disregards the paper write-offs for depreciation and amortization but reflects interest and amortization costs associated with debt financing.

One concern about REITs is whether high yields can be sustained if cash flow declines on underlying hotel assets. This could happen as a result of competition by the many new REITs to acquire desirable properties. The answer to this concern is that REITs can use two types of leverage to maintain or even increase yields: debt leverage and equity leverage.

[1] Debt Leverage

Leveraging yields with debt encompasses traditional mortgage financing as well as various corporate financing techniques. Mortgage financing, while not easily avoidable in the early 1990s, undoubtedly will make a comeback as the hotel market improves and valuations become more stable. A REIT generally must meet the underwriting standards for mortgage financing as a non-REIT borrower of equivalent credit standing and with an equivalent asset portfolio.

REITs do have an advantage over non-REIT borrowers in that their large diversified portfolios enable them to use non-real estate financing techniques as well. For example, a REIT may issue long-term debt in the form of a bond or note that may be sold either to the general public or to private institutional investors. As long as the cost of such debt capital is below the free-and-clear return from the real estate portfolio, the REIT achieves positive (upside) leverage.

Another approach is to issue commercial paper or to use a bank credit. Commercial paper consists of corporate notes having maturities from 5 days to 270 days. The notes can be sold directly by the REIT to the customer-buyer or through a dealer. A bank line of credit will carry a floating rate of interest over prime and may require a compensating balance to be maintained whether the credit is used or not. In both cases, the short-term nature of the borrowing means that interest rates paid by the REIT are likely to be very volatile. This may affect the stability of the yield, an important consideration for public investors.

[2] Equity Leverage

Equity leverage is the process of selling new equity at a premium over the book value (original issue price) of existing equity. To illustrate, assume that a single share issued by a REIT for $10 earns 10 percent ($1 per share) on its original cost. Assume further that investors now are willing to buy this stock at a price-earnings ratio of 20, to yield 5 percent. The result is a market value of $20 per share.

If a second share of stock is then issued by the REIT, it can invest a total of $30 (the initial $10 plus the new $20) and the same 10 percent yield will then earn $3 (or $1.50 per share). The trust has increased earnings per share by 50 percent but also the market value per share by the same amount.

Thus, equity leverage may be undertaken at any time at which the market value of a trust's stock commands a premium over original issue price. (If the stock is at a discount from that price, however, the issuance of new stock at that level will *dilute* the original issue price per share owned by existing stockholders.) It follows that the higher a trust's return on book value (original issue price), the greater is its capacity for growth.

Note that the use of debt leverage can achieve the same result as that just described. Suppose the REIT, instead of issuing another share of stock at $20, borrows $25 at 8 percent interest. If the REIT can maintain this 200 basis point (2 percent) spread between its free-and-clear return on assets and the loan interest rate, it will achieve the same 50 percent increase in earnings per share from $1 to $1.50; with the same market yield requirements, its stock will increase from $20 to $30 per share.

» 16.08 COMMERCIAL MORTGAGE-BACKED SECURITIES

Commercial mortgage-backed securities (CMBS) are a major source of debt capital for commercial real estate and the hotel industry in particular. This section provides a brief historical overview of CMBS, which shows why securitization has become a favored method of financing for hotel owner/operators and other commercial property borrowers. It then explains the different roles that investment banks may play in the securitization process, outlines the steps involved in the underwriting and rating processes, and concludes with a focus on recent economic trends in the hotel industry and how these changes influence the industry's relationship with CMBS as an ongoing provider of debt funding.

[1] The Evolution of CMBS

Commercial mortgage-backed securities are bonds or other debt instruments collateralized by loans secured by commercial real estate. CMBS are created by combining loans into pools of $100 million or more and depositing them into a trust that then produces fixed-income securities sold to institutional investors.

Mortgage-backed securities (MBS) have a longer history as a source of debt financing for single-family housing. CMBS evolved from this residential market and arose as a thriving source of debt capital for income-producing property during the real estate recession and savings and loan (S&L) collapse of the early 1990s. (A major difference between MBS and CMBS involves prepayment provisions. Whereas MBS loans are prepayable, mortgages in CMBS are generally locked out from prepayment; consequently, the investor does not have reinvestment exposure.)

The collapse in commercial real estate values triggered a major recapitalization beginning in 1989, when the Resolution Trust Corporation (RTC) was appointed chief

liquidator of S&L loans and real estate owned (REO) properties. The tidal wave of RTC offerings that followed during the next several years created a need to tap into the securities market to bring liquidity to commercial real estate. Investment banks were hired as loan sale advisors, and they consequently beefed up their commercial mortgage departments with real estate professionals who helped underwrite and dispose of the RTC offerings, incorporating mortgage securities structuring technology learned from the residential mortgage arena. Independent rating agencies at the same time increased their commitment to this emerging market by standardizing the underwriting criteria by property type, which was incorporated into the sizing of debt proceeds and the structuring of the underlying CMBS pools. This RTC-driven market was mainly functioning as an agency, or "best efforts" business, yet a small group of investors were earning an arbitrage by acting as a principal, purchasing RTC loans and selling them as rated and non-rated securities independently.

By the end of 1992, the RTC had disposed of approximately $11.6 billion of commercial real estate assets financed by CMBS, while the industry's traditional lenders (S&Ls, commercial banks, and life insurance companies) were experiencing unprecedented loan losses. This prompted these conventional lenders to move away from direct lending on commercial real estate. Instead, they bought long-term Treasury securities, enjoying a favorable spread between short-term and long-term rates (the Federal Reserve lowered short-term Treasury securities 200 basis points during this period).

Concurrently, stricter commercial real estate lending regulations were imposed by the Federal government. These restrictions led to larger loan loss reserve requirements and provided another impetus for traditional lenders to shift capital away from direct lending to buying CMBS—a natural for life companies that were already familiar with commercial real estate as collateral.

A dramatic transformation of commercial real estate finance was in full swing in 1993. In addition to the change in the role of traditional lenders—who were quickly becoming the largest buyers of CMBS—property owners were also changing the ways in which they raised equity, forming real estate investment trusts (REITs) and other capital markets vehicles to recapitalize their portfolios while issuing CMBS for leverage. Many borrowers looked to Wall Street to provide debt capital and issue single-borrower, multi-class transactions using sophisticated underwriting and structuring techniques.

By mid-year 1993, the RTC had securitized nearly $14 billion in performing commercial mortgages. This liquidation forced the markets to confront the issues of securitization. The establishment of underwriting standards, rating criteria, valuation techniques, and more standardized structures paved the way for further growth in CMBS and allowed the private sector to take the helm from the RTC and become the dominant issuer of CMBS.

Since that pivotal year, CMBS issuance has grown to reach approximately the $100 billion mark for total issuance. As the market matures, it has encompassed a broader group of both issuers and property types. In a 1994 study on income property securitization, Kenneth Leventhal & Co. pointed out that the market will continue to be influenced by interest rate fluctuations, competition from other lending sources, underlying real estate market conditions, regulatory changes, and information technology developments.

Despite such variables, the CMBS market has nonetheless witnessed increased efficiencies, including better availability and analysis of information to investors, improved reporting from servicers, better performance monitoring by rating agencies, and further standardization of transactions. All of these are becoming more uniform in terms of both structure and collateral, according to Duff & Phelps, a rating agency, which reported in early 1996 that such increased consistency translates into lower capital costs for borrowers. Another sign of the CMBS market's underlying strength

was that in 1995, CMBS substantially outperformed corporate bonds at a time when spreads were largely unchanged.

[2] Roles of Investment Banks in CMBS

Investment banks that represent borrowers in a CMBS transaction act in either a best efforts or a principal capacity. This distinction has important implications for borrowers in terms of allocation of risks.

Some securities firms do not commit capital to transactions, but rather act in a financial advisory and/or brokerage capacity to borrowers and investors. Such firms are said to act on a "best efforts" basis. They assist in structuring the transaction and brokering the rated certificate classes to investors. After the certificates have been rated and sold, the borrower is funded from the proceeds of the sale. In such a best efforts transaction, the borrower does not know the rate or amount of debt proceeds to be received until the securities have been sold, and the borrower assumes all of the risks involved in the transaction, including:

- The risk that the transaction can be rated.
- The risk of what rating each class of certificates will be assigned (i.e., the amount of certificates that receive high ratings versus those that receive low ratings).
- The risk that the certificate classes, including the unrated classes, can be sold, and assuming that the classes can be sold, the risk of at what spread to Treasuries (i.e., price) each class of certificates can be sold.
- The risk regarding how long a period of time it will take to consummate the transaction. (The pricing and funding of a principal transaction typically takes between 60 and 90 days, while a best efforts placement can be expected to take between seven months and one year.)
- The risk that interest rates will increase during the processing period for the transaction. (In a best efforts placement, since there is uncertainty as to whether and when the transaction will close, it is not possible for the borrower to effectively hedge this risk.)
- The risk of assuming all costs of the transaction, regardless of whether it is consummated.

While a best efforts transaction may result in lower costs to the borrower, the foregoing risks make it clear that any savings over a principal transaction can be lost by interest rate movements and unfavorable rating agency treatment during the securitization process.

In a principal transaction, the investment bank/lender makes a permanent mortgage loan to the borrower, who is funded at the inception of the transaction. The aforementioned risks involved in a best efforts placement are assumed by the lender, who shepherds the loan through the rating and securitization process.

This distinction was particularly important from 1993 to 1995, when traditional lenders (who had always provided certainty of funding) remained on the sidelines. At that time, investment banks such as Bear Steams, CS First Boston, Lehman Brothers, and Morgan Stanley were accustomed to acting as an agent on CMBS because of their experience at working with the RTC, but they were reluctant to risk their own capital. As conventional lenders returned to aggressive lending again in 1995, more Wall Street firms did begin to act as principal.

[3] Underwriting Criteria for Hotel Property Loans

Despite their better economic performance after the early 1990s, hotels did not derive any immediate capital benefit from CMBS, because rating agencies and bond buyers (many of which were former hotel lenders with unpleasant memories) were hesitant to put capital back into the sector. Gradually, though, CMBS investors have developed greater comfort with hotel collateral.

Each segment of the hotel industry—resort, full-service, limited service, or extended stay—has its own unique characteristics that need to be examined in the context of underwriting. What follows is an overview of general underwriting criteria for the structuring of securitizable hotel loans.

In general, hotels are underwritten to ascertain a stabilized net operating income (N01) from a trailing twelve-month cash flow to determine supportable debt proceeds at different debt service coverage ratios (DSCRs). N01 equals the actual net income of the properties before interest, depreciation and income taxes for the trailing twelvemonth period adjusted if necessary to cap the growth of departmental profit and occupancy. In addition, N01 takes into account all of the various operating expense line items to make sure they are consistent with historical and market performance. The underwriter evaluates the performance of the property over the previous five years to look for consistency while researching demand and supply characteristics of the market to essentially "mark the property to market." After a stabilized N01 has been determined, debt proceeds and pricing can be determined by applying a pricing matrix based on DSCRs at various proceeds levels with different amortization schedules. The price of a hotel loan or the all-in rate is based on a spread over the yield on the ten-year or fifteen-year Treasury security. Pricing varies by the quality of the collateral, but the most favorable pricing is generally given to loans with the highest DSCR.

[4] Role of the Rating Agencies in CMBS

Independent rating agencies (i.e., Standard & Poor's Corporation, Moody's Investors Service, Inc., Fitch Investors Service Inc., Duff & Phelps, and others) assign ratings on debt and other securitized transactions with regard to the capacity of an issuer to meet its debt obligations in a variety of economic circumstances. Higher ratings come from the issuer's ability to make interest and principal payments under severe economic conditions.

The four highest ratings categories—Triple A, Double A, Single A, and Triple B— represent what is referred to as "investment grade" CMBS. A typical CMBS issue is divided into several classes by payment priority with each class receiving a separate rating.

The rating agencies have been careful to establish very conservative criteria for rating CMBS—in most cases, the result of in-depth studies of historical loan performance data (e.g., American Council of Life Insurance (ACLI) loan performance data and the Russell-NCREIF property performance indices). Through such studies, the agencies have sought to identify loan characteristics that influence performance and to establish reasonable assumptions regarding defaults and losses resulting from foreclosures. While such studies provide the basic framework for the rating process, the agencies adjust their expectations according to the unique characteristics of each transaction, especially those that most influence real estate performance.

Rating agencies review the economics for the property type that collateralizes the loans in a CMBS pool the same way that they consider the economics of the industry in which a borrowing company belongs when rating a corporate debt transaction.

Hotels are generally considered to be the most risky type of commercial property—clearly different from other sectors in that they provide services to short-term guests with revenues coming largely from room rents as well as such extras as restau-

rants and meeting rooms, especially at luxury hotels. Small increases in occupancy rates or room prices go a long way toward improving profitability because of considerable fixed costs. Yet unlike other income-producing properties, hotels do have increased expenses as occupancy increases; therefore, maximizing occupancy does not always equal maximizing long-term profits.

Because the performance of hotels depends largely on the active management of operations, the rating agencies place particular emphasis on the quality of property management teams. Well-managed properties with competitive positions in their regions present attractive collateral for commercial mortgages.

[5] Outlook for the Hotel industry as a Component of CMBS

Smith Travel Research reported that 1995 was the most profitable year in the lodging industry, and as of mid-year 1996, hotel fundamentals remain strong. Industry occupancies for 1995 were at a 10-year high, averaging 65.5%, and room rate increases continued to outpace inflation in 1996, leading to further improvement in industry profits and operating margins. Revenue is expected to grow at slightly under 7 percent, with an operating leverage of 67 percent, meaning that 67 cents of every dollar earned is profit.

As profits continue to rise substantially, the hotel investment market is witnessing accelerated activity. Although this has fueled a rise in hotel values, it is still less expensive to buy rather than build, although the margin continues to narrow. In 1996, hotels in most segments could be purchased for approximately 80 percent of replacement costs, up from 1995 levels of 50 to 70 percent, according to HVS International.

Combine that with forecasts of historically high hotel profits in the next two years, and it is obvious why the industry is in an expansion mode. Construction starts are up, concentrated mostly in the limited service sectors, such as extended stay hotels. Many hoteliers have recently announced plans to expand their sets of offerings and markets, and some industry experts report expectations of overbuilding in the economy segment within the next few years. This may cause some concern that the hotel market is once again heading toward an overbuilt bust reminiscent of the 1980s. The pessimism may be largely unfounded, however, as several basic market characteristics are, thankfully, very different now. Some examples:

- Demographics are heading in the right direction for continued hotel demand. A robust level of business travel as well as a steady growth in leisure travel are both expected to continue as baby boomers reach middle age.
- Most new hotel construction is concentrated in the budget and extended-stay segments, which has been undersupplied and should be able to accommodate new supply in balance with rapidly growing demands. Meanwhile, the full-service sector has the advantage of essentially no new supply coming on board.
- The possibility of some oversupply on the horizon is offset by lower leverage ratios and, inherent in the CMBS process, the stricter underwriting criteria that come from rating agency review—a marked difference from the lending attributes of past periods of excess.

The health of the hotel industry at large combined with the ability of the CMBS market to better scrutinize funding requests and make more rational lending decisions should ensure that CMBS lenders remain committed to providing hotels with a viable borrowing option. This will allow hotel owner/operators to continue to take advantage of reasonable acquisition and expansion opportunities and eliminate overleveraging in their existing debt, which in many cases is based on higher interest rates or overinflated values of the past.

» 16.09 MORTGAGE FINANCING

Hotel owners use a wide variety of mortgage loans to structure a financing package that meets their objectives. The following sections discuss the various types of loans typically employed in hotel financing.

[1] Construction Loans

A construction loan is a short-term loan made during the period in which a project is under construction. The moneys from a construction loan are disbursed over the development period for amounts determined by the actual progress of construction. Interest is typically tied to a floating rate (usually prime), exceeding this rate by one to three points. Most construction loans call for interest only. Personal guarantees, as well as completion bonds, are normally required by construction lenders. Construction loans are paid off when the project is completed and the hotel opens. The lender that provides the permanent financing after the construction loan has been paid off is called the take-out lender.

[2] Construction and Mini-Permanent Loans

When a lender provides both the construction financing and a short-term permanent loan (two to five years), the arrangement is called a construction and mini-permanent loan. The terms of the construction segment of the loan are similar to those of normal construction loans. The mini-perm often has a fixed interest rate rather than a floating rate, and it may have an amortization. The advantage of construction and mini-perm financing is that the borrower does not have to find a permanent take-out lender, which can be difficult to locate for a new hotel without an operating history. Once the hotel has been operating for two to four years and has an established track record, the borrower is better able to attract a long-term permanent lender at more favorable terms.

[3] Permanent Loans

A permanent loan is obtained after the term of a construction or mini-permanent loan that are used to pay off the previous lender. Sometimes sufficient funds remain to allow the equity investors to remove some capital. The permanent loan carries either a fixed or floating interest rate and amortization over a twenty- to thirty-year term. The length of the loan typically extends for five to twenty years, depending on the lender. Most permanent loans made on stable hotels with established earnings do not require personal guarantees. If they do, the borrower can generally negotiate removal of the guarantee when a certain debt coverage has been achieved.

[4] Term or Bullet Loans

If a construction lender does not want to provide a mini-permanent loan after the construction has been completed, the borrower can line up a term or bullet loan as the take-out. By using this type of loan until the property establishes a track record, the borrower is better able to obtain more favorable terms on a long-term permanent loan.

The terms of a bullet loan are similar to construction financing—it carries a floating interest rate of one to three points over prime, has little or no amortization, and personal guarantees are sometimes required.

[5] Accrual and Zero Coupon Financing

An accrual loan is a mortgage where all or part of the interest accrues and is not paid until some point in the future—sometimes at the maturity of the loan. This structure reduces the amount of the debt service that has to be paid and assist hotels during initial start-up years when there is usually insufficient cash flow to cover debt service.

» 16.10 OBTAINING A HOTEL MORTGAGE

Obtaining mortgage financing for a hotel venture is probably the most critical step in both the hotel development and the acquisition process. Since mortgage debt generally represents the largest source of cash invested in a hotel transaction, finding a mortgage lender is a make-or-break issue. Without a lender, the contemplated transaction will usually die.

Lenders, realizing this great power, are often difficult to approach. Coupled with the fact that most mortgage lenders do not make hotel loans, finding suitable financing can be difficult.

The key to obtaining hotel financing is to put together a transaction that clearly shows excellent financial potential and low investment risk. It must be presented to the lender in a highly professional manner so that the opportunity stands out from all the other submissions.

The following steps are involved in obtaining a hotel mortgage:

1. Determine how to approach the lender.
2. Put together a mortgage submission.
3. Negotiate the important terms.
4. Submit an application.
5. Obtain a commitment.
6. Fulfill the terms of the commitment.
7. Close the loan.

[1] Approaching the Lender

The first step in obtaining a hotel mortgage is to determine whether to retain the services of a mortgage broker or to attempt the process alone. A mortgage broker's services can cost between 1 percent and 3 percent of the amount borrowed. While this might seem expensive, it may be worth the expense, since the transaction cannot be completed unless sufficient financing is secured. For new hotel owners without a lengthy track record of successful projects, the services of a hotel mortgage broker can be invaluable. Owners with extensive experience in the hotel industry and good financing contacts are better able to successfully complete the process without a broker. In any event, contacts are vitally important, and the proper introduction to the right person and the right lenders will give a project the necessary initial attention.

[2] Compiling a Mortgage Submission

A mortgage submission is a package of information that describes the hotel investment, the financing requirement, and the structure of the contemplated transaction. It should provide the lender with sufficient information to generate interest in pursuing the mortgage. As with the overall process, the mortgage submission should be complete and have a professional appearance. The information a lender looks for in a mortgage submission includes the following:

- Description of the hotel project and contemplated transaction.
- Description of loan and requested terms.
- Resumes and financial statements of owners.
- Economic market study and appraisal.
- Owner's projection of income and expense.
- Description of management company experience and operating ability.
- Operator's projection of income and expense.
- Rendering or photograph of the property, including an aerial photo of the site with appropriate maps, plans, and legal description.
- Architectural plans and specifications.
- Estimate of all project costs—particularly if the hotel is to be constructed or will undergo a major renovation.
- Identification of project team, including architect, interior designer, and contractor.
- Copies of all major contracts—management contract, franchise agreement, ground lease, and tenant leases.

[3] Negotiating the Terms

Once the lender shows interest in the contemplated project, the important mortgage terms are negotiated, including the following:

- Interest—rate, fixed or floating
- Term
- Amortization schedule
- Prepayment
- Personal guarantees
- Accrual facility
- Commitment and closing fees
- Timing

[4] Submitting a Mortgage Application

When the borrower and the lender have agreed on the terms of the loan, a mortgage application is submitted. A mortgage application formalizes the information generally provided in the mortgage submission.

[5] Obtaining a Mortgage Commitment

Once the loan has been approved by the lender, the lender issues a mortgage commitment, which describes the loan and its terms. The commitment may also contain a request for additional information as well as contingencies. Normal contingencies in a mortgage commitment include (1) an appraisal showing that all the property has a specified minimum value; (2) a satisfactory title report; (3) a survey guaranteed to the lender; (5) an engineering report showing a sound structure and equipment; and (6) satisfactory credit reports for the principals.

The borrower is usually required to sign the commitment letter and return it to the lender with a nonrefundable commitment fee of between 1.5 percent and 3 percent of the amount borrowed.

[6] Fulfilling the Terms of the Commitment

The bank's commitment letter generally states that the borrower must provide additional information (e.g., appraisals, studies, and certified financial statements) and fulfill certain obligations (e.g., subordinating the management contract, obtaining rights under the franchise, and transferring the liquor license). These must be completed before a specified date or prior to closing the loan.

[7] Closing the Loan

When the borrower has complied with all the provisions of the commitment and the transaction has reached its culmination, the loan is ready to close. At this point the borrower and the lender (and the seller if appropriate) meet and exchange and sign the necessary documents, and the moneys borrowed are exchanged.

HVS

CHAPTER 17

Buying, Selling, and Exchanging Hotel Properties

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» 17.01 PURCHASE OR SALE OF HOTEL PROPERTIES

Because the purchase or sale of a hotel property is basically the opposite sides of the same coin, when discussing purchases or sales, investors should realize that the motivation for one party will usually be a factor for the other party as well. There are no easy answers when a hotel owner should sell a property. Many factors play into the decision to sell a property. What will the future hold? Is the market expanding or contracting? How much competition is coming on line in the next few years? Will supply be expanding or contracting? All these questions need to be guessed at as best as the seller can in making his determination to sell or not. Of course the buyer is doing the same type of analyzing and is hoping that he may be able to buy at an opportune time and thus increase his overall value.

The seller motivation is always on the mind of the buyer. Some of the more common reasons for selling a hotel property include:

1. *Change of corporate policy.* Many large conglomerates may feel a particular hotel chain or group of hotels no longer fit within their corporate strategy.
2. *Need the money.* Many property owners borrowed so much money on the hotel's value that the property has a difficult time servicing the debt load. Of course this puts the buyer who has this information in a very strong position. For example, the Asian crisis has forced many foreign-owned hotels to be put up for sale because the corporate owners are in need of capital.
3. *Changes in perceived future market values.* Many hotel owners wish to get out because they see a peak in values that they feel will not be duplicated again in the near future.
4. *Retirement of key personnel.* Many hotel owners simply wish to get out of the business because there is no one to take over the business.
5. *Declining depreciation and other tax shelter aspects of the property which results in more taxable income being attributable to the owner.* The owner may wish to capitalize on lower capital gains rates.
6. *Changing neighborhood.* The owner may realize that new competition is coming into town and may wish to sell out before the information is generally known or that a key reason for travelers to visit the location is in jeopardy of leaving.

These are just some of the more common methods that motivate an owner. The buyer needs to beware of any or all possible motives for the sale of the properties. This is why an indispensable part of any purchase is for the buyer to ascertain as realistic as possible the true value of the hotel that he is about to purchase.

[1] General Legal Requirements to a Real Estate Contract

When a hotel is purchased, the key instrument in the purchase is the sales contract or agreement of sale. This document spells out in great detail the rights and obligations of the parties during the contract period. It also will detail the manner in which the party will eventually be transferred.

Since real estate contracts need to be in writing in order to be enforceable, the sales contract is the essential agreement of exchange of promises which makes the sales transaction enforceable under law. Once the document has been signed, it is enforceable on both parties unless both parties assent to the changes. Throughout our legal history it has been well established that contracts must contain certain provisions in order to be enforceable.

° *Mutual agreement.* A basic requirement of any contract is that the parties have a "meeting of the minds." Mutual agreement is met when one party makes an offer and the other party accepts that offer.

• Any offer must meet certain well-accepted rules in order to be considered a valid offer. The offer must (1) be definite and certain; (2) define the precise subject matter of the proposed contract; and (3) be communicated by the one making the offer to the recipient of the offer.

• Once the recipient receives the offer it remains open and capable of being accepted until (1) it expires by its own terms; (2) the recipient rejects the offer;

or (3) the person making the offer revokes it before the recipient accepts. The offer is also canceled by the destruction of the hotel property or by circumstances that make the contract illegal.

• The recipient accepts the offer only when his deed or words clearly indicate acceptance of the terms of the offer. An acceptance must (1) be positive and unequivocal; (2) conform precisely to the terms of the offer; and (3) be communicated to the person making the offer within the permissible time period.

• Any counteroffer is considered a new offer and the above-mentioned criteria then is applied as if the contract is being offered for the first time. The parties may go through several counteroffers until final acceptance or rejection has taken place.

° *Reality of assent.* The assent of a party is real when it is given freely and with full knowledge of the circumstance affecting the agreement. When assent is not freely given, the contract may not be valid depending on the cause. The four such causes are fraud, mistake, duress, and undue influence.

• Fraud is the intentional misrepresentation of a material fact in order to induce another to part with something of value. It clearly indicates there must be a misrepresentation of a fact, not merely an opinion. The misrepresentation also must be significant and substantial, and it must be made with the intention that the other party rely on it to his detriment.

• Mistake is a difficult concept to apply to invalidate a contract. Generally, only mistakes of fact can invalidate a contract, and only if the mistake is material and the other party should have realized a mistake was being made.

• Duress occurs when one of the parties uses threats or coercion to obtain consent.

• Undue influence is when a party in a confidential relationship uses improper or excessive persuasion to obtain a consent.

° *Legal capacity to contract.* Each party must have the legal capacity to enter into valid legal contract. Legal capacity means the ability to reason and understand the significance of an agreement.

• Minors (children under the age of 18 or 21, depending upon the particular state) lack legal capacity to enter into a contract for the purchase of real estate. Any contract that the minor should make on real estate can be disaffirmed on reaching the age of majority. This type of contract is called voidable because it is considered to be valid until the minor takes steps to disaffirm his obligations.

• Persons found to be insane, incompetent, and at times, intoxicated at the time the contract was entered into may be held to lack the legal capacity to contract.

° *Consideration.* Contracts cannot be enforced unless consideration has passed between the parties. This is a fundamental requirement of all contracts. Consideration includes promises and actions that can include anything that constitutes a benefit to the promisor (the one whom makes the promise) or detriment to the promisee (the one to whom the promise is made). The law does not look at the adequacy of the consideration but merely whether consideration was actually bargained for.

° *Legality of the transaction.* A contract will be enforceable only if the purpose of the contract is legal. A contract to buy or sell a hotel property for an illegal purpose (e.g., gambling in a state that bars this activity) would be void and unenforceable.

° *Contract in writing.* Finally, real estate contracts must be in writing in order to be enforceable. This requirement originally was imposed by an English statute, the Statute of Frauds, enacted in 1677. Its purpose was to prevent many fraudulent claims that were based on alleged oral promises or agreements. All states recognize the writing requirement and apply them to all transactions involving the sale and purchase of real estate and all leases of real property that exceed a specified time period (usually one year).

The Statute of Frauds will be satisfied so long as the person against whom the contract is sought to be enforced has signed it. It is not necessary that the person seeking to enforce the contract has signed it. Generally, the writing must contain the following information:

1. The identity of the parties
2. The identification of the property of the contract
3. The consideration

The writing need not be designated a contract. Any written memorandum will suffice to satisfy the statute, provided it contains the requisite information.

Appendix 2, Sample Clauses for Hotel Purchase and Sale Agreement, contains an excellent checklist of what is included in most hotel sale agreements. Below is a summary of that checklist and some considerations that the buyer and seller may want to ensure are included in the contract.

[2] General Provisions of a Sales Contract

[a] Real and Personal Property Being Sold

A contract for the purchase and sale of a hotel should accurately describe the property to be conveyed and also the personal property to be included in the conveyance. The description may be by street address, full legal description, or reference to a public map; by plat attached to documents or schedules; or by some combination of these. Regardless of the method used, however, unless the description burnishes

the means of determining with reasonable certainty the property intended to be conveyed, the contract is unenforceable.

Sources for the description of the hotel would include current surveys, copies of the seller's warranty deed or title policy, and current title reports or binders. If a current, accurate description is not available or if the parties contemplate that a survey will be made before the closing, it is advisable to provide that the description that will be used at the closing be based on the survey.

All descriptions of property should be independently verified by the purchaser. Also, if rights of access or other rights affecting adjoining property are important to the use and enjoyment of the property being purchased, those rights should be specifically included. Where appropriate, clauses may be included to cover such items as air rights, rights in adjoining streets, easements, and leaseholds.

[b] Business Assets Being Sold

Some of the most important assets of the hotel will be the right to operate the property through various government permits. If a government license or permit has already been issued for the property, the seller will want assurances that the seller will transfer these valuable rights. Success in obtaining a license (e.g., gaming license) or in obtaining the transfer of an existing license may be essential to the right of the purchaser to conduct or continue the conduct of the hospitality business located thereon. For this reason, contracts for the sale of hotel properties frequently contain provisions concerning the seller's duty to keep necessary licenses or permits (e.g., liquor license) in force and cooperate with the purchaser in obtaining the transfer of a license or permit to him.

[c] Closing

The closing is the final meeting of the parties at which the instruments necessary for conveying title to the premises and to the personal property from the seller to the purchaser occur. It is also when the consideration from the purchaser to the seller takes place. Also at the closing, the final documents are signed and delivered, expenses are apportioned, income from the property is prorated, and all closing adjustments are made.

[d] Purchase Price

The purchase price for the hotel must be readily ascertained from the sales contract or be calculated with a degree of certainty. Often, the contract will provide certain clauses that make the final purchase price unknown, but the price will be able to be ascertained by closing, thus meeting the requirement of certainty.

The contract should specify how payment of the purchase price shall be made; any down payments or earnest money payments that are required; and the method, medium, and time of payment.

[i] **Adjustment of purchase price.** Often the total purchase price will only be determined after a final audit of the property. The contract should specifically spell out what items will be used in adjusting the purchase price. For instance, liquor inventory at the time of closing would be an adjustment to the final purchase price.

[ii] **Allocation of price among different assets.** Although not required by law, the parties should consider allocating the purchase price of the hotel among the various assets. The reasonable allocation of purchase price among assets is an excellent method of avoiding trouble with the IRS over the value placed on personal property vs. real property. Of course, the seller would like as much as is reasonable, allocation of purchase price to real property for capital gain treatment and less to personal property, which would be taxed as ordinary income. The buyer has the opposite needs and wants, and therefore a goodfaith allocation is usually acceptable to the IRS.

[iii] **Allocation of price between land and buildings.** In order to maximize depreciation deductions, purchase price needs to be allocated to the building as opposed to land which is not a depreciable asset.

The Treasury regulations require that when nondepreciable and depreciable properties, such as land and building or improvements, are acquired together for lump sum, the acquisition cost must be allocated on the basis of the respective values of the land and the building or other improvements on the land. The Treasury regulations do not state how the respective values are to be ascertained. One way is to use a professional appraisal; other ways are to base the allocation on the relative values placed on the land and building by the local tax assessor or on the buyer's own information resulting from his personal familiarity with the area in which the property is located. Still another method is for the buyer to evaluate the buildings situated on the land from the investment point of view by capitalizing its cash flow. This may produce a particularly favorable allocation in the case of a hotel which is old is a very profitable one.

[e] Earnest Money

Almost all major hotel sales require that the buyer put a substantial down payment or earnest deposit to show good faith in the purchase of the property. This good-faith deposit will be held in escrow during the period between the signing of the sales contract and the closing on the property (transfer or title). Also, in complex hotel sales there may be substantial performance clauses in which the buyer or seller may place funds in an escrow, in which case the escrow deposit is used as a security for the performance under the agreement.

An escrow deposit may be in cash, securities, promissory notes, letter of credit, or such other device that the parties agree will suffice as to proper value. Cash deposit is the most common method for securing a down payment. The cash deposit will be credited against the purchase price of the hotel and paid over to the seller at the closing, unless the purchaser has committed a breach of contract. Often the deposit is returned to the buyer if the sale is not consummated due to some other reason than a breach of contract.

Most escrow agents in the sale of hotel properties are brokers, attorneys, title companies, financial institutions, or escrow companies. The escrow agent by law must follow the specific instructions agreed to by the parties concerning his custody and disposition of the funds entrusted to his care. The law puts an escrow agent in a fiduciary bound duty to act according to the dictates of the escrow agreement. His duties should be strictly ministered, limited to the safekeeping of the funds in a separate, properly identified, interest-bearing account, and paying over the funds at the proper time and place to the proper person when required to do so under the terms of the escrow arrangement.

Often when the contract for sale requires the purchaser to make the deposit as security for his performance, the seller may insist on a provision declaring that the sum placed in escrow shall constitute liquidated damages if the purchaser subsequently defaults or breaches the contract. The purchaser, on the other hand, may in-

sist on placing provisions in the sales contract that if certain contingencies are not met or that if the seller defaults in his performance, the escrow deposit is to be returned to him.

[f] Due Diligence

Usually in the purchase of a hotel property a prudent purchaser will insist that the seller expressly warrant the condition of the property, but also insist in the sales contract to the right to physically inspect the hotel and its record prior to closing. The purchaser should place in the sales contract a provision that if the condition of the hotel proves to be unsatisfactory or not as warranted or represented by the seller, the purchaser has the right to rescind or cancel the contract.

The purchaser will also want to insist that all existing leases and tenancies be disclosed in the contract. The purchaser will also want to put in the contract that the seller continue to perform any service and repair arrangements with the tenants until title passes to the purchaser.

Anytime that the purchaser is given the right to enter upon the premises and inspect the property before title is transferred to him, the seller should insist on the right to be indemnified or held harmless by the purchaser against any and all losses, damages, or claims arising out the purchaser's entry and activities on the premises. The seller should also require that the tests the purchaser conducts in the course of the inspection are at the purchaser's sole cost and expense.

If there are major physical problems with the hotel, the seller could be held liable to third parties after the sale of the property unless the purchaser hides and/or fails to disclose the dangerous or defective condition to the seller. Therefore, the purchaser should require provisions in the contract offering him protection against defective conditions existing at the hotel.

The purchaser's protective provisions may take several different forms. For instance, he may require the seller to fix the problems before closing will take place. The buyer could insist that the seller place in escrow sufficient funds as security against his performance of the necessary work within a specified time after closing.

The seller may want the contract to afford him the option to cancel the contract and return the purchaser's earnest money if the cost of remedying the offending conditions or securing the violations exceeds a specified amount.

[g] Terms of Purchase Financing

[i] **Third-party financing.** Most hotels usually involve some type of mortgage financing in order for the purchaser to buy the hotel. Because the loan authorization process is often a very lengthy affair, the sales contract is made contingent on, or subject to the purchaser's procurement of a mortgage loan commitment meeting specified requirements. Some of the more common requirements for a loan include interest rate, amount, and duration.

Another important clause in the sales contract is the amount of time that the purchaser will have in order apply for and to procure a loan commitment. The parties may agree that the purchaser's procurement of the loan commitment within the required time and containing the required terms shall be a condition precedent to the obligation of either party to perform, or that the purchaser's failure to obtain the required mortgage loan commitment within the allotted time may be grounds for rescission or cancellation of the contract.

The sales contract should provide for a refund to the purchaser of the sums paid by him to the seller where the contract is canceled for failure to obtain the necessary

financing within the required time; if the seller is entitled to his costs, the contract should clearly state exactly what he is entitled to.

[ii] **Purchase-money financing.** Often the seller will be willing to help finance in whole, or in part, the purchase price of the hotel property by extending a purchase-money loan to the buyer secured by a mortgage, land contract, or deed in trust on the property sold. The most frequent use of the purchase-money loan will be as a second mortgage on the hotel property. Under these conditions, the purchase-money loan will be used to fill the gap between the purchase price of the property and the aggregate of the purchaser's cash investment and the proceeds of the existing outside-mortgage loan.

Sellers frequently enter purchase-money financing arrangements with their buyers on smaller hotel properties where financing of any kind is difficult to obtain or in times of high interest rates, which make the purchase of a hotel prohibitively expensive. Many sellers may prefer to enter into purchase-money financing because it will . generate interest income for the seller.

It is important that any purchase-money mortgage loan arrangement be reflected in the sales contract and the material details of the mortgage, land contract, or deed of trust including the property that secures the obligation. Some of the more important details include the amount of the loan, the loan term, the debt service payments, and the interest rate.

If the purchase-money mortgage is to be junior to an existing mortgage on the property, the contract should so state; and if it is to be subordinate to a new mortgage on the hotel property in favor of an outside lender, the contract should clearly state that fact. Finally, the sales contract should state whether the purchase-money loan is to be a recourse or a nonrecourse obligation; that is, whether the purchaser is to be personally liable for the loan or whether the seller's sole remedy in case of default is to proceed against the property.

[iii] **Existing mortgage.** Often there is an existing mortgage that is in existence at the sale of hotel property. The contract should spell out whether the hotel is to be purchased subject to an existing mortgage. If the buyer takes the property subject to an existing mortgage, the parties understand that the mortgage will not be satisfied by the seller by the time the title is transferred to the seller (closing). Instead, the purchaser will be responsible after the closing to make the mortgage payments under the original terms of the mortgage document.

Of course, any purchaser who takes subject to an existing mortgage should realize that the financial institution still maintains a lien on the hotel property and can foreclose and sell the property if the purchaser defaults on future mortgage payments. However, because he is not personally liable for the mortgage obligation, he cannot be held personally liable for the deficiency if the proceeds of the foreclosure sale are not sufficient to satisfy the balance due under the mortgage obligation plus intuits and costs. Instead, the mortgage holder (mortgagee) must look to the original seller (mortgagor) to recoup the deficiency, assuming that the mortgage obligation is a recourse obligation.

Another type of existing mortgage arrangement is when the purchaser assumes an existing mortgage. Rather than merely taking the title subject to the mortgage where the purchaser assumes a mortgage on the property, he undertakes personal liability for payment of the existing mortgage indebtedness. If the seller was personally liable to the mortgagee or the mortgage obligation before the sale, he remains personally liable after the sale even though the purchaser assumes the mortgage, unless the assumption of the mortgage obligations by purchaser is accompanied by a novation (new contract). Thus, if the holder of the mortgage agrees to substitute the personal liability of the purchaser for that of the seller (in other words, if the mortgage holder agrees to a novation), the seller remains personally liable and, in most juris-

dictions, the purchaser is also personally liable to the mortgage holder. If the seller becomes liable to pay any part of the mortgage debt, he is entitled to reimbursement from the purchaser since, as between them, the purchaser is primarily liable.

Today, however, many mortgage agreements carry a due-on-sale clause under which the mortgagee may accelerate the mortgage debt so that it becomes immediately payable in the event that the property is sold by the mortgagor. If such payment is forthcoming and the sale takes place, the mortgagee may proceed to its remedies under the mortgage. That is to force the payoff of the mortgage and force the purchaser to secure a second mortgage at supposedly a higher interest rate.

Finally, if there is a mortgage on the property, the purchaser should request before purchasing the hotel a duly executed estoppel certificate, statement, or letter from the mortgagee that states all the current particulars with respect to the mortgage, including the interest rate, balance due, and that there has been no default under the mortgage. The party executing the estoppel certificate cannot later claim that the facts stated are different, since the statement was issued with intention that it be relied on by the purchaser, and the purchaser bought the property with reliance on it.

[h] Title Commitment and Survey

It is very important that the seller be able to convey title to the purchaser. If the seller can not convey good title, he will want provisions in their agreement so as not to be liable to the purchaser or to cure the defects of title regardless of the cost to him. The purchaser, for his part, will want assurance that the seller will be obligated to convey a good title when the closing date arrives. Within this framework, the parties may agree that the purchaser shall either accept, without abatement of the purchase price, such title as the seller can convey, or terminate the agreement and receive a refund of his earnest money deposit. Another option is to require the seller to remove, at his own expense, any and all defects of title that are subject to removal regardless of cost.

A contract that specifies that a marketable title is required refers to a title that (1) is free from liens or encumbrances except those specifically set forth in the contract; (2) discloses no serious defects; (3) does not depend for its validity on doubtful questions of law or fact; and (4) will not expose the purchaser to the hazard of litigation. In addition, the title should be such that a reasonable, well-informed, and prudent person acting on business principles with full knowledge of the facts and their legal significance would be willing to accept with the assurance that he, in turn, will be able to sell or mortgage the property at fair value.

The following examples have been ruled to render title unmarketable:

- A reasonable hazard of litigation
- Title acquired by adverse possession
- An outstanding right in a third person that interferes with the use or transfer of the property or subjects the property to an obligation, leases, liens of any tax assessment, or water charge
- Debts of decedents or a reasonable possibility of their existence
- Easements
- Outstanding mineral and oil rights

Regardless of the agreement reached by the parties, with respect to defects of title, the purchaser will want to include a provision that if the sellers inability to convey good title results from his own acts or omissions, he will be considered to be in default under the contract and will continue to be liable to the purchaser for any damages resulting therefrom.

One way to avoid many problems with title questions is for the purchaser to acquire a title insurance policy. The purchaser will still insist that the seller fix defects of title where the condition of the title is unsatisfactory, and that if title defects are not rectified, the purchaser should have the right or option to terminate the contract.

Although the title insurance does not cure a defective title, it does, however, protect the buyer against loss as a result of defects and encumbrances that are not specifically expected from the insurance coverage. In this regard, it is important for the purchaser to understand the legal implications of the endorsements to the title insurance policy and the exception contained therein.

A title insurance policy ensures against loss or damage to the insured by reason or defects, liens, or other encumbrances on his title that are not specifically excepted from, or excluded by, the policy. The policy does not cure a defective title; if the defect is such as to render the title unmarketable, title insurance will not render the title marketable.

In most jurisdictions, all title policies cover losses or costs arising from defects disclosed by the pubic records; defects not disclosed by the public records; the costs of defending title, whether justified or not; and mistakes of the title examiner, whether errors, omissions, or mistakes or judgment.

The purchaser will also insist that within a given number of days after the signing of the sales contract, a current survey of the property be prepared by a licensed surveyor.

Surveys, on the other hand, give the purchaser a description of the property by describing the property by metes and bounds and show the gross number of acres as well as the number of "net acres." The survey will also show all existing easements, rights-of-way, alleys, streets, and roads, and any encroachments upon the property.

[i] Seller's Representations and Warranties

A warranty may be distinguished from a representation in that a warranty is a promise that is given contemporaneously with, and as part of, the contract, while a representation is of an existing fact and usually precedes and induces the contract. All hotel sales unless prearranged sales between related parties should have warranties as part of the sales contract. In the case of a breach of warranty, the contract remains binding, but the opposite party may sue for damages by reason of the breach. On a false material representation, however, the opposite party may elect to avoid the contract and recover the entire price paid or he may affirm the contract and sue for damages.

Representations and warranties may be expressed or implied. For this reason, the contract may include provisions that the seller makes no representations or warranties, whether express or implied, and that the purchaser is not relying on any representation or warranties made by the seller. Alternatively, the contract may state that no representations or warranties should be made or relied on other than those expressly stated in the contract as being made.

The specific representations and warranties that the parties will want to insist on depend on the situation of the parties and the nature of the transaction and the property. However, basic representations and warranties such as marketability of title or that no condemnation proceeding is pending, should be considered to be fundamental in any contract for the sale of the real estate.

[i] **Building and zoning regulations.** Of critical importance to the purchaser is that any use of the hotel property comply with proper building and zoning ordinances. It is important for the purchaser to make sure that he puts in the right protective language in the contract even if he is accepting the hotel "as is." The purchaser's worse nightmare is to purchase a hotel property that he cannot use or develop for the purposes or in the manner contemplated.

In order to protect himself, the purchaser should place a clause which makes the sale conditional on obtaining the required zoning change or accommodation. A contract so conditioned should clearly state who will be responsible for the approval and expenses of any zoning changes or accommodations required. As a general rule, the purchaser will want the option to rescind the contract and have the down payment or earnest deposit returned to him if the zoning change or accommodation cannot be obtained.

The purchaser should also be concerned about building violations such as violations of regulations adopted by local or state governmental entities concerning the construction, design, quality, use, occupancy, and maintenance of the hotel.

The purchaser should be assured that an existing hotel structure meets all the current government building codes and regulations. Depending on the severity of the violations, the parties can most likely negotiate any compliance measures needed to bring the hotel up to code.

[ii] **Franchise agreements.** Any franchise agreements need to be examined; generally, approval is needed to transfer to a new owner. See Chapter 18, Hotel Franchises, for a complete discussion of the hotel franchise process.

[j] Closing Documents and Procedure

[i] **Title deeds.** A deed to real property is a written instrument by which title to the property is conveyed by the owner (grantor) to the buyer (the grantee). A deed is not valid as between the grantor and the grantee unless it is delivered to and accepted by or on behalf of the grantee and it also meets the following requirements.

- Each grantor must be identified and he must be a competent adult. While there must be a valid consideration that is set forth in the deed, the actual consideration need not be set forth and nominal consideration may be stated.
- A deed must contain language (e.g., "grant and convey") that shows that the property is being conveyed and the property conveyed must be sufficiently described to identify it.
- A deed must be signed by the grantor, and under the statutes of some states, the signature must be witnessed and/or notarized. Generally, a deed must be delivered by the grantor to the grantee and, unless delivered, it is invalid and ineffective to transfer title. The grantee must be in existence at the time the deed is delivered.

Deeds are of several different types; the key distinction among them is related to the precise responsibilities that the grantor assumes in connection with the conveyance. These responsibilities are called warranties, A warranty combines a representation that a certain state of facts is true and the responsibility to make good any damages if the facts turn out to be otherwise.

- *General warranty deed.* This deed includes the broadest warranties by the grantor and so would be most preferred by the grantee. In fact, it is the most common method of transferring title in this country. A warranty deed usually contains four basic covenants:

1. The covenant of seisen, by which the grantor represents that he in fact owns the property
2. The covenant of the right to convey

3. The covenant against encumbrances, that is, a representation that no claims exist against the property other than those specified in the deed or contract
4. The covenant of quiet enjoyment, by which the grantor represent that no person with superior right to the property can interfere with the grantee's use or possession of the property

° *Special warranty deed.* This is exactly the same as a general warranty deed with one important distinction. The grantor will be liable for the breach of his warranty only if the cause arose through the grantor's own act or during his period of ownership. The grantor thus disclaims any responsibility for defects that arose before he became the owner.

° *Bargin or sale deed.* This type of deed conveys title to property just as effectively as either kind of warranty deed but contains no covenants. Thus, it is also known as a deed without convenants.

° *Quitclaim deed.* While this deed, too, can effectively convey title, it is normally used as a means of surrendering a claim to property that may or may not be valid. In effect, the grantor under a quitclaim deed says "I don't know if I own this property, but if I do, I convey to you whatever rights I may have." This type of deed often is used to correct an error made in an earlier conveyance.

[ii] **Closings.** At the time of the closing, the seller will bring all the necessary documents necessary for the title to pass. This should include the deed to the property, and any documentary stamps that may be required will be attached to the deed at that time or immediately before recordation. The seller will also have with him any leases that pertain to the property. He will also bring the insurance policies covering the property (e.g., fire and extended coverage), certificates of occupancy, and all required government inspection documents.

The seller will also bring with him receipted bills for real estate taxes, water and sewer charges, and any other items as to which adjustments will be made at the closing. He may also bring a contract with the labor union representing the hotel workers.

In addition, the seller will have a bill of sale covering personalty ready for delivery to the buyer.

At the closing, the buyer will be ready to deliver a certified check for the approximate amount that will be due from him. While the adjustments are often approximated in advance of closing, they are computed accurately and finally, and often paid by check executed at the closing. The seller will want to obtain an owner's estoppel certificate from the purchaser if a purchase-money mortgage or deed of trust is to be assigned at the time title closes.

As already indicated, the adjustments are made at the closing, and the deed, any mortgages, release of mortgages, or other liens, the check or checks for the purchase price and the adjustments, and other documents are turned over to the attorneys for the parties or the title insurance company to be held until the deed and other documents are recorded. Recordation normally takes place as soon as possible after the closing.

[k] Brokerage Commissions

Most hotel sales will involve a broker who brought the parties together. The sales contract should identify the broker; the party who is responsible for the payment of the brokerage commission; and the amount, time, and manner in which payment is to be made.

Generally, the seller will be responsible for payment of the brokerage commissions although the parties can agree otherwise. Assuming the seller is responsible for the brokerage commission, he will want to provide that the commission will not be payable unless and until the contract is closed and that it will not be payable if certain circumstances prevent the contract from being closed (e.g., purchaser unable to obtain financing). The brokerage contract is an important document in a hotel transaction and should be analyzed carefully before signing.

[I] Miscellaneous Provisions

Although the discussion of the sales contract has been extensive, there are still many areas that the parties need to be aware exist although their discussion in detail is beyond the scope of this text.

1. Eminent domain and risk of loss
2. Assignment, successors, and heirs
3. Binding arbitration and other legal means of settling disputes
4. Controlling law

» 17.02 HOTEL BROKERS

This section discusses the importance of hiring a professional broker when selling a hotel.

[1] Creating a Story

Two of the most important factors in achieving the optimum price for a hotel are creating a competitive environment for that hotel and creating a "story." Every hotel has a story that describes its upside potential and opportunities for improvement. The better the hotel's upside potential, the greater the price the market will be willing to pay. Determining and understanding a hotel's highest and best use is the foundation of that hotel's story.

A hotel achieving only an 80 percent RevPAR penetration for its market may or may not be performing at its optimum potential; a hotel achieving a 130 percent RevPAR penetration, however, may or may not be achieving its RevPAR potential. No two hotels are the same physically or financially; none have identical market-demand generators or barriers to entry. Being able to reconcile all of the foregoing variables and accurately determine the weight that should be given to each is the difference between selling a hotel below market or selling a hotel above market. A professional hotel broker with an extensive transaction track record should provide great insight in sorting out the variables.

The story must be credible and intellectually defensible. If it consists of only "pie in the sky" projections, it will do more damage than good. A credible story, by contrast, places the foregoing variables in their proper perspective and can mean the difference of several million dollars in value. For example, consider a 300-room commercial hotel that recently sold at an enhanced price because of a competitive market. This hotel was in a city that had experienced the shutdown of a large military base, which had been the largest single provider of room nights to the city. The ini-

tial response of many to this loss of a major room-night generator was that it would hurt the hotel's future performance. However, it did not work out that way.

The military is lower-rated business than other commercial or leisure segments. This particular city ran a high annual city-wide occupancy. There were many days throughout the year in which tourist or commercial travelers who wanted to visit the city were unable to because of the lack of available rooms. With the absence of the military business, this city now can accommodate this latent or unaccommodated demand. As a result, occupancies remain the same as before the base closing, but average rates have grown significantly. Because the creators of the story of this hotel understood that the loss of the military base would ultimately be to the hotel's benefit, the price was enhanced.

[2] Negotiating From Strength

A strong negotiating position is critical if a seller is to achieve the optimum proceeds from a hotel sale. The seller can lose proceeds from a sale in two ways if he attempts to market the hotel himself. First, purchasers discount the valid strong points made by a seller. If the seller describes the demand generators for a hotel as growing significantly over the next several years, a buyer will not only disregard this potential, but will argue, convincing himself, that the hotel's price should be based solely on the hotel's historic performance.

The second risk the seller runs by marketing a hotel himself is that the buyer will detect any weakness in the seller's position. When a seller pushes a buyer for a decision, the purchaser often perceives this as anxiety and may negotiate a lower price than the purchaser was willing to pay. On the contrary, if a professional hotel broker pushes a purchaser for a decision, the purchaser may perceive the time being of the essence in order to beat the market. This perception and concern on the part of the purchaser may yield a price higher than the purchaser wanted to pay.

[3] Capital

Another method a professional hotel broker uses to achieve the highest possible price is to be a steady source of capital. An intermediary should be in constant contact with the lowest-cost capital sources and the most creative financing techniques. Consider the following example, wherein the capital helps achieve a higher price.

A buyer perceives that a hotel will produce a $5,300,000 net operating income during its first year of ownership. This purchaser has a source of financing for 70 percent of the acquisition price at an interest rate of 9 percent and an amortization schedule of twenty years, and the purchaser is seeking a 12 percent first-year return on equity. The buyer determines that it can pay a purchase price of $47,500,000 for this hotel. A 70 percent loan is equal to $33,250,000 and the equity required is $14,215,000. Using the foregoing interest rate and amortization schedule, the annual debt service is $3,589,907. The resulting cash flow after debt service is $1,710,093. If the $1,710,093 is divided into the equity investment of $14,215,000, the resulting cash-on-cash return is 12 percent.

If the professional hotel broker is able to source a 70 percent first mortgage at an 8 percent interest rate for 70 percent of the purchase price, the purchaser can then pay $50,000,000 for the same hotel, producing the same income stream and still yielding a 12 percent return on capital.

Mezzanine financing is another case in which the capital can create value, giving the seller a higher price and the purchaser a higher return. This form of debt is

subordinate to first-mortgage financing. It may or may not be secured by a second mortgage on the real estate. The cost of mezzanine financing is significantly higher than first-mortgage financing because of its higher-risk position; however, the cost is lower than market equity returns and occupies a priority position ahead of the purchaser's equity.

Assume that a purchaser is acquiring a hotel that is a turnaround opportunity. Although the hotel is currently producing a $500,000 net operating income, the purchaser believes that if the hotel had $5,000,000 invested in renovation and the franchise were changed, the stabilized cash flow of the hotel would be $2,000,000. The purchaser wants a 20 percent cash-on-cash return on his equity. Assume that the first mortgage is 70 percent of loan-to-cost at a debt constant of 10 percent. On the basis of a $2,000,000 stabilized net operating income, the purchaser could pay a purchase price of $10,384,615. That price plus the $5,000,000 renovation makes the total investment $15,384,615. The first mortgage is 70 percent of the total investment— $10,769,231. With a 10 percent debt constant, the annual interest payments on the first mortgage are $1,076,923. The equity, 30 percent of the total investment, is $4,615,385. Subtracting the annual debt service of $1,076,923 from the $2,000,000 net operating income yields a total of $923,077, which is a 20 percent return on the purchaser's equity.

If, instead of the purchaser making a 30-percent equity investment, a mezzanine lender invests half of the equity capital, a higher price can be paid for the hotel. Again, assuming that the purchaser's goal is a 20 percent cash-on-cash return on the stabilized year in which this hotel produces a $2,000,000 net operating income, the use of mezzanine financing can allow the purchaser to be more aggressive against the market and pay $11,326,531 for the hotel—a 9.1 percent increase. In this structure, the first-mortgage lender again makes a 70 percent loan to the total development cost. The purchase price is $11,326,531 plus the $5,000,000 renovation, making the total investment $16,326,531. The 70-percent first mortgage is now $11,428,571, and the annual debt service is $1,142,857. The mezzanine lender in this scenario has a 10 percent interest-only rate and participates in 20 percent of the resulting cash flow. The total debt service of the first-mortgage mezzanine lender is $244,898, resulting in a cash flow after debt of $612,245. Twenty percent of this cash flow is paid to the mezzanine investor and 80 percent is paid to the purchaser. Because the mezzanine lender put up half of the equity, the purchaser has invested only $2,448,980. After the debt service has been paid and 20 percent of cash flow is paid to the mezzanine investor, the cash flow available to the purchaser is $489,796, which is a 20 percent cash-on-cash return to the purchaser.

Obviously, if the purchaser were able to acquire this hotel at the original price of $10,384,615 and use the mezzanine structure, the purchaser's cash-on-cash returns would increase dramatically. In this example, the returns would be $553,846, which is a cash-on-cash return of 24 percent.

[4] Marketing a Hotel

A professionally assembled marketing package requires 150 to 200 work-hours. Because the marketing package should be designed to convince a purchaser to part with millions of dollars to own a hotel, it must be more than an accumulation of facts. Some packages contain volumes of information but are uninteresting and unpersuasive. A marketing package should succinctly describe a hotel's potential for future cash flow and capital gain increases. An accurate and effective description of this potential can justify a higher price than a review of a hotel's historical performance.

Consider two properties—Property A, a hotel at a 12 percent capitalization rate

with a cash flow that will remain steady for the next five years, and Property *B*, a hotel at a 9 percent capitalization rate, the cash flow of which will grow at 15 percent per year. Assuming that both hotels originally produce $1,000,000 in cash flow, their purchase prices would be $8,333,333 or $11,111,111, respectively. Property A's cash flow five years from now is still $1,000,000. Assuming that this hotel sells at a capitalization rate of 12 percent, the unleveraged internal rate of return is 12 percent. With Property *B's* cash flow increasing at a compounding annual rate of 15 percent, at the end of five years, its cash flow is $1,749,006. Assuming it sells at the same 12 percent capitalization rate, its unleveraged internal rate of return is 18.6 percent.

Realistically, Property *B's* historic rate of growth will allow it to sell at a lower capitalization rate than Property *A*, increasing the already-higher return. An effective marketing package should effectively explain the hotel's growth potential to justify a greater than a "back of the napkin" value calculation.

To market a hotel, significant work-hours are required to make successful sales presentations to purchasers. All information in a presentation should be provided to a prospective purchaser in the context of what that purchaser wants. In other words, each presentation must be custom-made for each prospective purchaser. This can be done only in a one-on-one, give-and-take presentation, and a substantial number of work-hours per presentation is required.

First, a prospective purchaser's existing business and its wants and desires must be understood. This requires an interview. An in-person, face-to-face interview is more effective than one conducted by telephone. To arrange a face-to-face meeting, one to two hours are required. If the prospect is in a different city, an entire day is required to accomplish the interview. Because other work can be done during travel, five hours is a fair estimate of the amount of time needed to accomplish the interview. One hour is required either by telephone or in person to present a hotel's full potential and two hours of follow-up per prospect are required, on average, to determine its interest. To generate ten interested prospective purchasers, at least 100 presentations must be made. This means that, at an average work-hour requirement of 10 hours per presentation, 1,000 work-hours are required to effectively market a hotel. This does not include negotiating the transaction, purchaser's due diligence, purchase and sale agreement negotiation, or the closing process. If performed by one person on a fifty-hour work week who exclusively markets that hotel, forty weeks would be required to perform the marketing function alone. This length in chronological sequence required would prevent a competitive market from being achieved. A prospect whose interest was generated during the first month would most likely not be willing to wait for the marketer to complete the comprehensive process through the tenth month. Negotiations in a vacuum—with only one prospective purchaser at a time— are likely to result. This takes the competitive environment out of the process and, most likely, will result in a lower transaction price.

Only a professional hotel brokerage organization can provide the required work-hours in a rapid and efficient manner. First, a professional brokerage firm with a long history in the industry has already performed the interview step before even taking the assignment to market a hotel, cutting the required work-hours in half. Second, if the brokerage firm has a multi-person sales force, multiple presentations can be made simultaneously. This can reduce a nine- to ten-month marketing process to a matter of weeks. Additionally, showings can occur back-to-back when a firm has a multi-person sales force.

It is an often-stated truism that "time kills all deals." The professional hotel brokerage firm should greatly increase an owner's closing percentage.

[5] Preventing Disruptions

All sellers must take measures to prevent disruptions at their hotels. If, for example, the direct management and leadership of a hotel becomes disgruntled or discouraged, the hotel's performance could decline. A negative trend in business could affect the price or derail a closing process.

The hotel brokerage professional can assist in minimizing disruption to the hotel's operations, and the owner can take several steps as well. First, the general manager of the hotel should be informed of the owner's intention to sell and should be made a part of the process. Obviously, the general manager can be quite apprehensive. An owner should structure a bonus for the general manager if the hotel is sold. This bonus should be significant and should be paid regardless of whether the general manager remains at the hotel to work for the new owner.

One potential cause of disruption is the presence of prospective purchasers at the hotel prior to the sale. Understandably, the purchasers will want to spend time at the hotel before buying it to learn as much as possible about it. Unfortunately, their presence could serve to disrupt or otherwise affect the direct management of the hotel. The hotel broker can alleviate this potential problem by providing comprehensive information to a prospective purchaser prior to the purchaser's ever inspecting the hotel. If the broker has diligently provided this information, inspection time at the hotel can be minimized.

» 17.03 LIKE-KIND EXCHANGES

Today's competitive business environment has forced many changes within the hospitality industry as well as the constant restructuring of hotel properties. In many cases, financing new hotel properties has also become increasingly difficult. Thus, it is more important than ever that hospitality business owners be creative wherever possible in developing cost-saving strategies to achieve their goals.

One strategy often overlooked by hospitality owners is the use of like-kind exchanges to acquire property. The following discussion reviews some alternative methods of like-kind exchanges, which may provide new business opportunities for the hospitality owner as well as lucrative tax benefits.

[1] Advantages

An exchange of hotels, or an exchange of business property for a desired hotel property, represents one creative means of acquiring a new property. This method can offer unique planning opportunities for the hospitality or business owner who wishes to relocate to another market. It can also provide significant tax savings for a new owner, because appreciated property can be exchanged without incurring any tax on the appreciated gain. The deferral of the gain is what makes like-kind exchanges such a valuable tool for hotel owners.

Consider the following example: a hotel owner in New York wishes to retire to Florida but remain active in the business. The individual might be able to find a property suitable to his needs in Florida, one that has an ambitious young owner anxious to relocate to a potentially faster growing market in New York. The two get together, simply exchange properties, and completely avoid tax liability on the appreciated gains of the two hotels. Other valid reasons for engaging in a like-kind exchange might be to reposition one's property into a different market, obtain property that will allow for expansion, allow investors into the hotel business with the exchange of dif-

ferent property; or to allow a hotel owner to leave the hospitality business and obtain other business property without paying any capital gains tax.

Business owners may also have non-business reasons for exchanging property under IRS like-kind exchange rules. It is a commonly used strategy in estate planning to defer taxes on appreciated property. For example, an owner would be required to pay substantial capital gains tax in an out-and-out sale of property that had significantly appreciated in value over the years. If the owner exchanges the property for property at another desirable location, however, all capital gains taxes are deferred until the property is eventually sold. In some cases, in fact, the gain on the property may never be taxed if the owner dies before it is sold and the property is passed on to the heirs.

IRS stepped-up basis rules essentially allow heirs to inherit property at the fair market value of the property at the time of the owner's death. This applies even if the deceased owner had very little basis left in the property. Thus, if the heirs sell the property at fair market value shortly after the owner's death, there is no gain to report. In this case, the basis equals the value of the property. This is known as receiving property that has been "stepped-up" to its fair market value at the time of death. Of course, estate taxation is a difficult, complex area of the law. A business owner getting on in years would be wise to talk to his tax adviser on whether the use of like-kind exchange as an estate planning tool would be advantageous or not in his or her specific circumstance.

There are several important reasons why the hotel industry is ideal for using business options such as like-kind exchanges. For one, the hotel industry is considered a specialized component of real estate and it is treated very favorably under like-kind rules. Second, the hotel industry is subject to market saturation. Therefore, there are a great many excellent hospitality properties operating in the market, providing a multitude of possibilities for an owner wishing to exchange properties to enter a desired market or better fit his or her strategic goals.

[2] General Requirements

A like-kind exchange is a reciprocal transfer of property, as distinguished from a transfer of property for money only. But an exchange can occur even where cash (boot) is part of the consideration, if the transaction otherwise qualifies as a like-kind exchange. Like-kind property must be both given up and received in the exchange in order to satisfy the "exchange" requirements.

There are several requirements that must be met for a taxpayer to take advantage of a like-kind exchange. The exchanged property must be:

1. Held for the productive use in a trade or business, or for investment; and
2. Exchanged solely for property of a like kind, which is to be held for either productive use in a trade or business, or for investment.

If a taxpayer has a qualified like-kind exchange transaction in any given year, he or she is required to file the transaction on IRS Form 8824 along with his or her regular tax return.

[3] Real Estate Qualifications

Whenever making business decisions in accordance with the Internal Revenue Code it is imperative to look closely at the language to determine the exact meaning of the

statutes. For example, "like-kind" as used in this chapter means "alike in terms of nature or character of the property." It does not refer to its grade or quality. Thus, one class of property cannot be exchanged for another class.

This means that real estate can not be exchanged for personal property. However, when real property is exchanged for real property, it does not matter whether the property is similar, or even whether one of the properties is unimproved. Thus, the exchange of vacant land for a hotel would qualify under the like-kind exchange rules. The existence or lack of improvements merely affects its grade or quality, not its class.

The following examples of exchanges have been held to qualify as like-kind transactions:

- Rental housing for farm property.
- A commercial building for a condominium interest in a newly constructed commercial building.
- Real property subject to a lease for real property not subject to a lease. The existence of the lease affects the grade and quality of the property, rather than its nature and character.

Consequently, a hotel could be exchanged for a different type of business real estate and be within the like-kind exchange guidelines. For example, a hotel owner could exchange his property for a bowling establishment. The transaction would still qualify under the like-kind exchange rules, because both the properties are classified as real estate.

There are certain properties that do not qualify for tax-free exchange (e.g., inventory stocks, bonds, and partnership interests). The property for exchange must be similar in nature or character to the transferred property, notwithstanding differences in grade or quality as shown in the preceding examples.

However, there are cases in which real estate exchanges are not considered as like-kind exchanges. Listed below are some circumstances under which a real estate transaction will fail to qualify under the like-kind exchange rules:

1. *Foreign property.* This is never considered like-kind property under the like-kind exchange rules.
2. *Sale of an apartment building in which the taxpayer used the proceeds from the sale and other property to acquire a like-kind property.* The fact that the taxpayer first sold the property invalidated any exchange opportunities.

It is important to keep in mind, however, that the IRS rules regarding property exchange transactions are mandatory, not optional. In a transaction structured as an exchange, all gain must be deferred on the property. Although this is generally good strategy, there are times when this should not be done. These occasions are discussed subsequently in this chapter.

[4] Utilizing Deferred Exchanges

One of the biggest controversies involving like-kind exchanges occurs when exchanges are deferred, or do not take place at the same time. Because the Supreme Court stated in the now famous *Starker* case that exchanges do not have to occur at the same time to qualify as like-kind, Congress acted in 1984 to stipulate exchange time limits. It was not until 1991, however, that the IRS finally got around to issuing regulations that provided rules for complying with the deferred like-kind exchange requirements.

A deferred exchange is defined as an exchange in which, under the terms of the agreement, the taxpayer transfers qualified property (relinquished) and after the transfer, receives qualified property (replacement property).

Strict requirements have been established concerning when exchanged property must be identified and accepted in the exchange for the "like-kind" aspect to qualify the exchange as tax free. The property will not qualify as like-kind property if:

1. The replacement property is not identified as property to be received in the exchange within forty-five days after the date on which the transferor transfers the old property (the identification period requirement); or
2. The replacement property is not received by the earlier of 180 days after the date on which the transferor relinquishes the old property, or by the due date (including extensions) for the transferor's tax return for the taxable year in which the old property is transferred (the exchange period requirement).

An example how of the deferred exchange rule might work is as follows: On May 17, pursuant to a deferred exchange agreement, hotel owner Astor transfers his 100 room hotel property with a fair market value of $200,000 to Baker for a hotel property to be identified later. On or before July 1, (the end of the 45-day identification period), Astor is required to identify the like-kind replacement property to be received from Baker. Astor must then receive from Baker on or before November 13 (180-day receipt requirement) the property identified as the like-kind replacement property.

Neither party can extend the foregoing limitation periods for any reason. Therefore, if a hotel owner fails to identify replacement property or take possession of the replacement within the required time limit, the transaction will not be treated as a like-kind exchange. The gain on the transaction would thus be taxable.

For a hotel owner to properly identify any replacement property, he or she must send a description of the property in writing to the qualified parties before the end of the forty-fifth day. If the replacement property is transferred to the hotel owner before the forty-fifth day, the identification requirement is satisfied.

The hotel owner can identify more than one property when using the deferred exchange method. A hotel owner can, subject to the "three-property" and "200%" rules (explanation to follow), identify more than one replacement property regardless of the number of properties he has relinquished in the same exchange. Under the three-property rule, a hotel owner can select up to three properties without regard to their aggregate fair market value. Alternatively, a hotel owner, under the 200% rule, can select any number of properties as long as their aggregate fair market value does not exceed 200% of the aggregate fair market value of all the relinquished properties.

Using the preceding example, Astor on May 17 transfers his 100-room hotel valued at $200,000 to Baker. On or before July 1, Astor is required to formally recognize the like-kind replacement property. Astor identifies three potential hotel replacement properties (Properties 1, 2, and 3) in a written document that he signs and personally delivers to Baker on June 28. The written designation also provides that Astor will orally inform Baker by Aug. 1 which of the three identified hotel properties he wants to receive. Since Astor did not choose more than three properties, all three have been properly identified before the end of the identification period. It does not matter whether the aggregate fair market value (i.e. $500,000) exceeds 200% of the fair market value of the relinquished property ($400,000).

[5] Related Party Transfers

There are specific rules covering transfers among family members. There is a special two-year holding period requirement for exchanges between related parties. This rule requires the hotel owner to report to the IRS on the property in the sale year of the like-kind transaction and again at the end of the two-year holding period. The related party rule does not bar like-kind exchanges between related partners; it merely imposes a two-year holding period.

Related parties for purposes of this rule include most family members and corporations in which the party holds more than 50 percent ownership. Special rules also govern transactions between partnerships and their partners.

There are three exceptions to the two-year waiting rule, permitting a holder to claim a nonrecognition provision for the like-kind exchange:

1. Any disposition of the property after the death of either the taxpayer or the related person.
2. Any disposition that is caused outside the control of the taxpayer, such as an involuntary conversion.
3. Any disposition to the satisfaction of the IRS that the main purpose was not to avoid income tax on the transaction.

Any taxpayer who feels that he or she may qualify for an exception to the general rule must attach an explanation to his or her tax return explaining the qualifying exception.

[6] Determining Basis

Generally, the basis of property acquired in a like-kind exchange is the same as the basis of the property transferred. There is an exception, however, if money (called "boot" by accountants) or certain debt is involved.

Many times in a like-kind exchange, the properties will not be equal. The taxpayer may receive or give money, or other property, to equalize the transaction. As previously stated, the basis of property received in a like-kind exchange is the same as that of the property given up.

If money or other property not of a like-kind (boot) is received in the exchange, gain is recognized, but only to the extent of the money or boot received. If a party to the exchange assumes debt on the property, or acquires property from the taxpayer subject to a liability, then the debt assumption will be treated as boot.

It is important to remember that even if the taxpayer receives boot and shows a loss, the loss is not recognized under like-kind exchanges. Therefore, the taxpayer needs to be careful to analyze the transaction in terms of the possibility of realizing a loss. If a loss is probable, the trade must be structured so that the transaction does not qualify as a like-kind exchange. The same rules apply to recipients who receive money or property not qualifying as like-kind exchange property in a deferred exchange.

When a person gives boot instead of receiving boot, the non-recognition rules still apply to the person giving the boot. However, a taxpayer could recognize gain if certain nonqualified property is given as boot in the exchange.

A common practice is to give and receive property subject to a mortgage. The assumption of a liability or a transfer subject to a liability is treated as boot. The taxpayer who assumes a liability or accepts property subject to a liability receives boot.

If each party to an exchange assumes the liability of the other party, the liabili-

ties assumed by one party are offset against those assumed by the other. Only the excess is treated as part of the boot given or received. The following example will help explain how debt exchanges work.

Example: Hotel owner A in New England owns a property that has an adjusted basis of $80,000. It is subject to a $70,000 mortgage. He makes an exchange with hotel owner *B* for realty on another hotel in Florida worth $120,000, which is subject to a $50,000 mortgage. In addition, owner A receives $10,000 in cash. The gain A recognizes on the exchange is $30,000, computed as follows:

TABLE 17-1

Hotel owner *A* received:		
Property worth	$120,000	
Cash	10,000	
Mortgage on hotel given in exchange (treated as cash received):	70,000	
Total consideration:		$200,000
Hotel owner *A* gave in exchange:		
Hotel at its adjusted basis	$80,000	
Mortgage on Property received (treated as cash paid):	50,000	
Total given:		$130,000
Maximum recognizable gain to *A:*		$ 70,000

In this scenario, however, the amount of gain recognized is limited to the net cash received by hotel owner A. If the mortgage on the property given is counted as cash received and the mortgage on the property received as cash paid, or $30,000, it computes as follows:

TABLE 17-2

Mortgage on property given up by hotel owner *A* [$70,000] -
Mortgage on property received by hotel owner B {50,000) =
Net reduction of hotel [$20,000]

Owner *A's* indebtedness [$20,000] +
Cash paid to hotel owner *A* [10,000] =
Gain recognized by hotel owner *A* [$30,000]

The final calculation a hotel owner needs to make in analyzing a like-kind exchange is to determine the tax basis for the properties. The tax basis is the value that the IRS recognizes when and if a property is sold. Generally speaking, the basis of the new property is the same as the property exchanged. However, if boot was given or received in the exchange, the basis on the new property could be affected.

If any gain is recognized because of receipt of money or other boot, the basis of all the property received is adjusted to include the old property, increased by the gain recognized and decreased by the money received.

If a loss is realized, but not recognized in an exchange in which a taxpayer receives money or other boot, the basis of all the property received is the adjusted basis of the old property, decreased by the money received.

The following is a simple formula for determining basis of property acquired in a like-kind exchange:

TABLE 17-3

Adjusted basis of old property	$	.....
Add:		
Cash or value of non–like-kind property given	$	.....
Gain recognized	$	.....
Subtract from this total:		
Cash or non–like-kind property received	$	.....
Loss recognized on non–like-kind property given (excess of adjusted basis over trade-in allowance)	$	.....
The resulting total is the basis of the new property.		

Finally, a hotel owner must carefully examine his basis to determine whether property transferred will actually result in the deferral of a gain, and not a loss. This is an important concept to remember, because there are situations when it might be more beneficial for a business owner to structure such a transaction so that it is taxable. In this case the hotel owner will want to intentionally avoid meeting the like-kind exchange requirements, because the rules are not optional.

For example, a hotel owner may want to recognize gain, because he or she has just recently experienced a loss, which could be offset by a gain on the trade. This results in the hotel owner's getting a higher basis for the property received, which in turn, results in larger depreciation deductions.

The like-kind exchange rules are a valuable planning tool often overlooked by hospitality owners. Like-kind exchanges allow property relocation without recognizing any taxable gain on appreciated real estate. Like-kind exchanges can also be used as a strategy for family members wishing to exchange properties to better position family holdings. Finally, the like-kind exchange can be a valuable estate planning tool. Since step-up rules regarding estates value inherited property at fair market value at the time of an owner's death, taxes on his or her deferred gain may never be realized. Although like-kind tax rules appear complicated, the opposite can be true. The rules actually allow considerable flexibility in choosing properties to exchange. In addition, since any recognizable gains are usually very minor, compared with deferred gain on appreciated property, the tax benefits could be substantial.

CASE STUDY: >> 17.04 How Investor Raised Cash To Acquire A Profitable Hotel

Mr. Comer Mann, an experienced hotel investor, wanted to acquire a going hotel that produces an annual operating profit of $1.68 million. The hotel has been doing well for several years, and its profits show an upward trend, as can be seen from the following table:

Year	Gross Income From Operations	Net Profit From Operations
1992	$ 8,200,000	$1,300,000
1993	9,000,000	1,425,000
1994	10,100,000	1,680,000

The owner, recognizing the earnings trend, insisted on a total price of $22 million for the hotel, This price covered the land, building, and the supplies, furnishings, and equipment, In addition, he wanted it all in cash.

The hotel was owned free and clear of any mortgages or other liens or encumbrances. It is 40 years old; it has 635 guest rooms and meeting rooms, and has a small ballroom that can accommodate 200 people. The hotel also has a food and beverage operation that accounts for almost 30 percent of its gross revenues.

Mr. Mann believed that if he acquired the property he could increase its operating profits within three years to as much as $2.3 million annually, because the hotel business is booming and the present owner has become less attentive to controlling operating expenses. However, he could not acquire the property unless he found some way that made its acquisition feasible for him. Whatever financing plan he came up with would, or course, have to take into account his front-end fees, expenses, and some immediate profit, He expected these "add-ons" would amount to some $500,000 as follows:

Legal fees	$ 75,000	Accounting fees	25,000
Commissions and finder's fees	150,000	Promoter's profit	250,000

The total required was $22.5 million.

[1] METHODS CONSIDERED BY INVESTOR

Mr. Mann's task was to figure how approximately $1,680,000 of annual cash flow could service $22,5 million of financing. He began to think of the prices he would have to pay to attract various sources of investment funds.

[a] Why $22.5 Million Could Not Be Raised From Tax-Shelter Investors

The lowest price would be demanded by individual investors seeking a tax shelter in the form of large passive losses. If the reportable annual tax losses from the investment could be sufficiently high, these investors would be willing to invest with either no cash return or a cash return ranging up to 7 percent a year. But, there were two problems,

First, even though this was an older hotel with a lot of personal property which had short depreciable lives, not enough annual depreciation deductions could be generated during each of the first five years to satisfy an investor,

Second, a 100 percent equity investment can never be an attractive tax-shelter investment. The reportable annual losses can never be stretched to amount to a significant percentage of the capital contribution. For those investors who want to obtain reportable losses in the first five to eight years in an amount that is greater than their capital investment, their capital investment cannot represent a large proportion of the total cost of acquiring the depreciable assets.

[b] Why a Tax-Exempt Bond Issue Was Not Available to Investor

Mr. Mann knew that the next cheapest money would be municipal bond money, i.e., the proceeds from the sale of tax-exempt bonds issued by states, cities, and certain governmental authorities. Such investors require a return of 7 to 7.5 percent a year if the bond is issued by a creditworthy issuer and the annual interest payments are tax-exempt. Such financing may be available for the construction of new housing or industrial properties or for the rehabilitation of existing housing, but it is not available for the simple acquisition of an existing commercial hotel whose function will not be changed.

[c] Other Sources of Funds

Among the other possibilities that occurred to Mr. Mann were:

1. Selling off the land to an investor who wanted a very safe investment and did not need any reportable losses. If the land was not worth more than about 25 percent of the total value of the land and building, the safety of the investment would be so great as to warrant paying a price as low as 7.5 percent per year for the money.
2. Finding equity investors who wanted an annual cash return but did not seek large amounts of tax shelter. Mr. Mann knew that if there was no significant amount of tax shelter to offer, equity investors could be found but would require at least a 9 percent cash return. They would have to be convinced that, in the long run, they could do better investing in this property than in making long-term savings bank deposits, which would pay them 6 percent or so, and would be much less illiquid than a real estate investment. Mr. Mann believed that investors could be found who would put up part of the money he needed, but he did not believe he could raise the full $22.5 million solely from this source,
3. Conventional first mortgage lenders. This source used to be the obvious first choice for financing an acquisition. However, Mr. Mann realized that if he sought even a 70 percent mortgage, that is, a first mortgage of $15.75 million, he would probably have to pay a constant of about 11 percent, or $1,732,500, which would leave him no cash flow available to service the remaining $6.75 million which had to be raised.
4. Financing with first and second mortgages was obviously impossible in this transaction, because second mortgage money, even if it was available, would cost Mr. Mann between 3 percent and 8 percent per year more than first mortgage money. The property simply did not earn enough to carry such a debt structure.

Mr. Mann knew that he would have to break up the investment into a number of different positions that would offer different attractions for investors pursuing a range of different objectives. This is what he did.

[2] Investor Created a Ground Lease and a Leasehold Mortgage

Mr. Mann was able to arrange for the sale of the land, without the building or improvements, to a pension trust for the sum of $5 million; simultaneously, he leased the land back from the trust under a long-term net ground lease calling for a basic annual rent of $375,000. The ground lease was to run for an initial term of 25 years and figured to provide an annual return of 7,5 percent to the trust. The lease gave the lessee several options to renew for additional terms totaling 80 years. It also called for reappraisals of the land at the end of the first 15 years and thereafter at intervals of 10 years. The rent, on each reappraisal, will be fixed for the next 10 years at the higher of (1) the ground rent during the lease period then ending or (2) 7.5 percent of the fair market value of the land alone if the land was devoted solely to hotel uses.

Mr. Mann, having created the long-term ground lease, then obtained a leasehold and building mortgage loan of $9 million which was to run for a term of 15 years and bear interest at 9,5 percent. The annual debt service came to $945,000, or a 10,5 percent constant, When it matured at the end of 15 years, there would be a balloon of about $6 million,

The leasehold mortgage lender was a large savings bank. The mortgage covered both the lessee' interest in the ground lease and the fee title to the building. The mortgage was subordinate to the fee interest. Because of this, it was not necessary to obtain the consent of the pension trust, as owner of the land, to the terms of the leasehold mortgage. The lender agreed to this because it had appraised the entire property at $23 million, and regarded the land rent as representing only about 22 percent of the value or earnings. If the mortgagor defaulted under the mortgage, the lender could not foreclose the pension trust's fee interest, but could only become the lessee under the ground lease and the owner of the improvements.

[3] How Investor Then Syndicated the Enterprise and Created a Subleasehold Operating Position

Mr. Mann then decided he could raise the remaining $8.5 million by organizing a limited partnership to own the leasehold estate and the building, and selling (syndicating) $8,5 million of limited partnership shares to passive investors, Because the leasehold mortgage was a nonrecourse mortgage,

Mr. Mann was able to offer his investors tax deductions and no risk of personal liability.

At the same time, he chose to create an operating position in a Hotel Operating Company (HOCO), a separate partnership composed of himself and five of his business associates. HOCO sublet the entire property from the partnership under a long-term net sublease which ran from the partnership, as sublessor, to HOCO, as sublessee. This net lease was also for an initial term of 25 years and gave HOCO options to renew for additional terms aggregating 80 years. The basic annual rent HOCO would pay under the sublease came to $1,745,000. This sum was arrived at as follows:

1. $375,000 (annual ground rent to the fee owner) plus
2. $945,000 (annual debt service under leasehold mortgage), plus
3. $425,000 (representing a 5 percent annual cash return before taxes to the syndicate investors), plus- a participation in future profits.

This basic rent was somewhat higher than the earnings produced by the hotel at that time. However, the pattern of increasing earnings made it reasonable for Mr. Mann to undertake the risk. What's more, the sublease gave the sublessee the option to walk away from the deal at any time after the first three years without the landlord's consent, and upon an assignment HOCO would have no further liability

The sublease also contained a profit-sharing formula. HOCO, the sublessee, could retain the first $155,000 of profits after paying $1,745,000 of basic rent annually. If profits exceeded $155,000, HOCO could keep one-half of the excess and pay the other half as coverage rent to the sublessor.

Mr. Mann could have used a general partnership as the legal vehicle for the syndication group. By creating an independent operating sublessee, he removed the risk of any of the investors being liable for the operation expenses of the property. However, he chose to use a limited partnership as the legal form because many investors have become accustomed to it. (They have some hesitancy about entering a general partnership even if they know they have been legally and totally separated from the conduct of the activities that could result in liability)

Mr. Mann had considered taking a limited partnership interest along with the investors, instead of creating the net sublease, The cash investors would have been entitled to the first available distributions up to $425,000 in each year. Then Mr. Mann's limited partnership interest would have received the next $155,000 of each year's distributable operating profits. If the annual operations produced more than $580,000 of distributable cash (after payment of ground rent and leasehold mortgage debt service), the excess would be divided half to Mr. Mann and half to the other investors. He decided against this course because he preferred to have the sublease, which was a separate, salable asset.

In addition to their 5 percent cash return, Mr. Mann could offer his syndicate investors the benefit of annual depreciation deductions of approximately $959,000 in the first five years of their investment as follows:

Asset	Basis	Recovery Period	Annual Depreciation
Building	$14,000,000	39 years	$359,000
Equipment, furnishings, & supplies	$3,000,000	5 years (average)	$600,000

After the fifth year of their investment, the syndicate investors would no longer receive depreciation deductions for the furnishings and equipment because their replacements would be paid for by the sublessee. At that point, however, they had the expectation of an increased cash flow, most or all of which would be tax-sheltered.

Exhibit 17-1 Contract of Sale—Hotel or Motel With All Personal Property

Agreement made _____*[Date]*, between _____, of_____ *[address]*, _____ *[city]*, _____ County, _____ *[state]*, referred to as seller, and _____, of _____ *[address]*, _____ ["O']) _____ County, _____ *[state]*, referred to as buyer.

SECTION ONE

SALE OF BUSINESS

Seller agrees to sell and buyer agrees to purchase _____ *[name of hotel or motel]*, located at ____ *[address]*, ____ *[city]*, ____ County, _____ *[state]*, more particularly described as follows: _____ *[set forth legal description]*, referred to as _____ *[hotel or motel]*, together with all right, title, and interest of seller in the furniture, furnishings, apparatus, linens, fixtures, and other equipment situated in or on the premises, as specified in Exhibit _____, which is attached and incorporated by reference.

SECTION TWO

PURCHASE PRICE

As full payment for the transfer of the above-described _____ *[hotel or motel]* and listed assets by seller to buyer, buyer shall pay to seller the sum of _____ Dollars ($_____). The purchase price shall be allocated among the assets as follows: _____ *[list categories and amounts as appropriate]*.

SECTION THREE

CONDITIONS OF PURCHASE

The purchase is subject to the following conditions:

(a) The customary objections contained in the certificate of title issued by _____ *[title company]* or any other title company the seller may designate;

(b) Special assessments and special taxes, if any, not confirmed by a court of record or confirmed after the date of the recording of the deed executed and delivered by seller, and as provided in this agreement, and all special assessments and special taxes thereon due after _____ [year];

(c) Zoning and building laws and ordinances and governmental rules and regulations;

(d) General taxes for the year _____ and subsequent years;

(e) Building lines, building and liquor restrictions of record, if any;

(/) Party wall rights or agreements, if any; and,

(g) All liens or encumbrances and things created, placed, or suffered to accrue, by buyer.

SECTION FOUR

EARNEST MONEY

Buyer has deposited with seller _____ Dollars ($_____), as earnest money, to be applied on the purchase when and if consummated, and buyer shall pay the balance of _____ Dollars ($_____) within the time and in the manner provided by this agreement.

SECTION FIVE

ESCROW

The closing of title shall be consummated through an escrow agreement, as provided by this agreement, with _____ *[escrow company], of* _____ *[address},* _____ *[city],* _____ County, _____ *[state]*. The charges of the escrow fee shall be _____ *[divided equally between seller and buyer or as the case may be}.*

SECTION SIX

DEPOSITS BY BUYER IN ESCROW

Within _____ days after this agreement is signed by both parties, buyer shall deposit with escrow the full purchase price of _____ Dollars ($_____).

SECTION SEVEN

DEPOSITS BY SELLER IN ESCROW

Contemporaneously with deposits by buyer in escrow, seller shall deposit with the escrow agent the following:

(a) A _____ *[warranty}* deed from seller conveying the above-described premises to buyer;

(ft) A bill of sale in customary form of all right, title, and interest of seller in all personal property located in or on the above-described real estate;

(c) All instruments necessary to enable the escrow agent, on payment of the unpaid balance of the purchase price, to procure the release of the present _____ *[mortgage or deed of trust]* held on the property, which, together with the indebtedness secured thereby, are held by _____ *[bank] of* _____ *[address],* _____ *[city],* _____ County, _____ [state]; and,

(d) Assignments of all leases with respect to the _____ *[hotel or motel}* and the originals of the leases so assigned.

SECTION EIGHT

RECORDING OF DEED

The escrow agent shall be directed to record the deed from seller to buyer on the deposit by buyer of _____ Dollars ($_____) and to secure the customary preliminary report of title of _____ *[title company}* covering the date of the deed and showing title in the grantee of the deed to the hotel property, subject only to the matters set forth in Section Three above, together with:

(a) Rights of parties in possession not shown of record;

(b) Mechanics' liens, if any, where notice of such liens appears of record.

SECTION NINE

DEFECTS OF TITLE

If the report of title of _____ *[title company]* discloses any defects in title other than the matters stated in this agreement, seller shall have _____ days from the date of receipt of the report from the escrow agent within which to cure the defects in a manner satisfactory to the purchasers. In case the defects in title should not be cured within _____ days, buyer may elect to grant to seller, by notice in writing, an additional _____ days in which to cure the defects in a manner satisfactory to buyer, or may terminate this contract, or may elect to take title as it then is, on giving to seller notice of the election and tendering performance on buyer's part.

SECTION TEN

INABILITY TO CURE DEFECTS OF TITLE

In the event that buyer withdraws from this agreement, buyer shall forfeit _____ Dollars ($_____) to seller, which sum escrow is authorized to pay out of the fund deposited by buyer in escrow. Seller shall accept the above sum in full payment of all claims, and the parties shall have no further liability to one another.

SECTION ELEVEN

CLOSE OF ESCROW

The date occurring _____ days after the date of notice in writing from the escrow agent to seller and buyer of the willingness of _____ *[title company]* to issue its certificate of title in its usual form, guaranteeing the grantee in the deed against any loss or damage to the extent of the purchase price by reason of any defects in the grantee's title to the above-described real estate, subject only to the matters and things set forth in Section Nine of this agreement, shall be the date of the actual closing. However, the apportionment of all prorations in connection with this agreement shall be as of the date of the deposit of the balance of the purchase price as provided in this agreement.

SECTION TWELVE

PRORATIONS

Rents, general real estate and personal property taxes, insurance premiums, and other like charges, if any, together with such other items as are usually prorated, shall be adjusted pro rata as of the date provided in Section Eleven, and all accounts receivable accruing from and after that date shall become the property of buyer, and all accounts payable from and after that date shall be assumed and paid for by buyer.

SECTION THIRTEEN

ACCOUNTS RECEIVABLE

Buyer agrees to make reasonable efforts to collect all accounts receivable and rents due and remaining uncollected up to _____ *[time]*, _____ *[Date]*, and pay them over to seller promptly when and as collected. Seller shall have the right to

audit buyer's records not more often than semi-monthly at a reasonable time during any business day until the accounts receivable and rents are fully liquidated. The provisions of this paragraph shall survive the delivery of the deed under this agreement.

Seller's accounts payable include goods delivered, services performed and work done through _____ *[Date]*. Buyer's accounts payable include all goods delivered, services performed and work done after _____ *[Date]*.

SECTION FOURTEEN

ESCROW ADJUSTMENTS

Adjustment shall be made at the office of the escrow agent on the date of closing. If the net amount of all the prorations shall show a balance in favor of seller, buyer will immediately deposit the amount of the balance with the escrow agent. If the net amount of all the prorations shall show a balance in favor of buyer, the balance shall be transferred from the purchase price.

SECTION FIFTEEN

SATISFACTION OF CONDITIONS

When all deposits have been made with the escrow agent, escrow shall be closed out in the customary manner pursuant to the escrow agreement to be agreed on between seller and buyer, it being understood that when the escrow has been closed, the property to be delivered to buyer will be subject only to items (a) through *(g)* specified in Section Three of this agreement, describing conditions of title.

SECTION SIXTEEN

POSSESSION

Provided all the deposits of buyer as required in this agreement have been made, buyer shall be entitled to take possession of the above-described premises and improvements on the date of the close of escrow, together with the personal property included in the sale.

SECTION SEVENTEEN

DEED RECORDING

Seller shall pay costs of the issuance of the certificate of a title, and buyer shall pay the costs of recording the deed.

SECTION EIGHTEEN

BUYER'S _____ *[MORTGAGE or DEED OF TRUST]*

If buyer desires to place a _____ *[mortgage or deed of trust}* on the above-described real estate for the purpose of securing a loan for any portion of the purchase price, the above-described escrow agreement shall be drawn in such a way as to permit the _____ *[mortgagee or trustee}* to deposit in escrow the proceeds of the _____ *[mortgage or deed of trust}* loan, and shall contain mechanics with respect to disbursement of the loan, for nothing to be included in the escrow agreement shall impair the rights of seller to receive payment of the purchase price in accordance with the terms and provisions set forth above.

HVS

SECTION NINETEEN

LIQUIDATED DAMAGES FOR BUYER'S DEFAULT

If the purchase and sale of the _____ *[hotel or motel]* is consummated in accordance with the terms of this agreement, seller shall retain buyer's earnest money and buyer shall receive credit on the purchase price for the amount of the earnest money. If the purchase and sale of the _____ *[hotel or motel} is* not consummated pursuant to the terms of this agreement, seller shall return buyer's earnest money, unless the purchase and sale are not made by reason of the fault of buyer, in which event _____ Dollars ($_____) shall be retained by seller as liquidated damages in full satisfaction of the liability of buyer,

SECTION TWENTY

LIQUIDATED DAMAGES FOR SELLER'S DEFAULT

If the purchase and sale of the _____ *[hotel or motel}* contemplated by this agreement is consummated in accordance with the terms of this agreement, buyer shall return seller's earnest money. If the purchase and sale of the _____ *[hotel or motel]* is not consummated pursuant to the terms of this agreement, buyer shall return seller's earnest money, unless the purchase and sale are not made by reason of the fault of seller, in which event _____ Dollars ($_____) shall be retained by buyer as liquidated damages in full satisfaction of the liability of seller.

SECTION TWENTY-ONE

RISK OF LOSS

If, prior to transfer of legal title or possession of the above-described premises to buyer, the premises are fully or materially destroyed by fire or other casualty without fault of the buyer or taken by eminent domain, buyer may terminate this contract without liability and recover any portion of the price paid. _____ Dollars ($_____) damage shall be considered material destruction of the premises.

SECTION TWENTY-TWO

NOTICE

Any notice required or desired to be given under this agreement may be given by registered mail to seller at _____ *[address]*, _____ *[city]*, _____ County, _____ *[state]*, and to buyer at _____ *[address]*, _____ *[city]*, _____ County, _____ [state], and notice so made shall, for all purposes, be as effective as though it was served on buyer and seller in person at the time of depositing the notice in the mail.

SECTION TWENTY-THREE

REAL ESTATE BROKER'S COMMISSION

It is expressly understood and agreed that the purchase price of _____ Dollars ($_____) is the net amount to be paid by buyer to seller in the event of the consummation of this sale. _____ *[Buyer or Seller]* shall pay the entire real estate brokerage commissions and charges of every kind that arise in connection with the sale of the property.

SECTION TWENTY-FOUR

BINDING ON ASSIGNEES

This agreement shall bind the parties and their respective heirs, representative, successors, and assigns.

The parties have executed this agreement at _____ *[designate place of execution]* on _____ *[Date]*,

[Signatures]

[Acknowledgments}

Exhibit 17-2 Contract of Sale—Hotel Furniture And Fixtures

Agreement made _____ [Date], between _____, of_____ *[address]*,_____ *[city]*, _____ County, _____ *[state]*, referred to as seller, and_____, of _____ *[address]*, _____ *\city*, _____ County, _____*[state]*, referred to as buyer.

SECTION ONE

SALE OF FURNITURE AND FIXTURES

Seller agrees to sell to buyer, who agrees to purchase at valuation and on terms mentioned below, all the stock, implements and utensils in trade, household furniture, fixtures, fittings and effects specified in the inventory, attached as Exhibit _____,
and incorporated by reference, now being in, on and about the _____ Hotel, its
cellars, stores, garage, outbuildings, yards and premises, which now are occupied by seller, situated at _____ *[address]*, _____ *[city]*, _____ County, _____
[state].

SECTION TWO

DATE OF VALUATION

The valuation shall be made on or before _____ *[Date]*, up to which time all depletions in respect of the above-described hotel and business shall be defrayed by seller, when the amount of the valuation shall be paid to seller, who will then deliver to buyer, or buyer's agent, full and peaceable possession of the above-described personal property and fixtures.

SECTION THREE

WHO SHALL MAKE VALUATION

The valuation shall be made by two persons, one to be chosen by each party, or by an umpire to be chosen by the appraisers before entering on the valuation; and in case either party shall neglect or fail to make the appointment within _____ days from the date of this agreement, or if either of the appraisers or the umpire shall refuse or neglect to proceed and complete the appraisal within _____ days of their appointment, the appraiser of the other of them shall proceed alone, and the appraiser's valuation shall then be binding and conclusive on both parties,

SECTION FOUR

DEFAULT; LIQUIDATED DAMAGES

If buyer refuses or neglects to pay the amount of the valuation on _____ *[Date]*, or if seller, on an offer, in writing, of the purchase money, delivered, or left at the hotel, refuses or neglects to deliver possession of the above-mentioned personal property and fixtures, the defaulting party shall pay to the other of them _____ Dollars ($_____) for liquidated damages between them; and this agreement shall become void.

Each party to this agreement has caused it to be executed at _____ *[place of execution]* on the date indicated below.

[Signatures and date(s) of signing]

HVS

CHAPTER 18

Hotel Franchises

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» 18.01 INTRODUCTION

A hotel franchise is essentially an agreement between a hotel chain (franchisor) and a hotel owner (franchisee) wherein the hotel chain allows the owner to make use of the chain's name and services (e.g., a central reservation system and defined operational procedures) in return for which the hotel owner pays the hotel chain a franchise fee. Under such an agreement, the chain has no ownership or financial interest in the hotel and is not directly responsible for its economic success.

Hotel companies involved in franchising generally start off as small chains made up of company-owned properties. Over time, they develop a concept, image, and brand name that prove successful in attracting customers. Specific operational procedures (known as the mode of operation) are established that produce a profitable level of efficiency. When the lodging product thus developed becomes successful, and it can be demonstrated that hotel owners using the brand name and mode of operation of the company will also be successful, the hotel company is able to franchise its concept and procedures.

One of the first franchise agreements in the hotel industry occurred in 1907 when Caesar Ritz allowed his famous name to be used on hotels in New York City, Montreal, Boston, Lisbon, and Barcelona. Modern hotel franchising started during the 1950s, when hotel construction resumed after the end of World War II. Hotel chains, realizing that their name, image, goodwill, established patronage, mode of operations, and reservation system all had value, turned to franchising their brand names and modes of operation as a rapid, inexpensive, and profitable means of expanding their holdings. Hotel developers were drawn to this idea because it gave a new hotel an immediate identity and a set of established systems and procedures that provided both lenders and investors with confidence that the property would be financially successful.

Some of the hotel chains that first offered franchises were Holiday Inns of America, Inc.; Howard Johnson's Motor Lodges; and Ramada Inn Roadside Hotels. The first Holiday Inn was a company-owned motel that opened in Memphis, Tennessee in 1952. By 1954, Holiday Inns started to franchise, and within a few years, franchises represented the bulk of the properties with which the company was involved.

Howard Johnson, a successful restaurant company that was founded in 1925, started franchising motor lodges in 1954. These were generally rooms-only facilities constructed in conjunction with freestanding Howard Johnson restaurants. The motor lodges and restaurants were often separately owned and operated.

Ramada Inn started out as a chain called Flamingo Motor Hotels in 1952. The name was later changed to Ramada Inn Roadside Hotels in 1958 when the company started successfully franchising.

Hotel franchising flourished during the 1960s and 1970s when a building boom, fueled by financing made available through real estate investment trusts (REITs), spurred the development of thousands of new hotel rooms. When the benefits of a chain affiliation became apparent to sophisticated hotel investors, particularly mortgage lenders, either a franchise or a first-tier management contract became almost a standard requirement of any development or acquisition deal. At present, very few hotels are developed as independents.

» 18.02 ADVANTAGES FOR FRANCHISORS

[1] Inexpensive, Rapid Expansion

Hotel companies that seek to become major chains often use franchising as a growth vehicle, because doing so generally requires a relatively modest capital investment compared with developing or acquiring properties on their own. In addition, franchising does not require the extensive management structure that is needed to operate a hotel management company. Depending on the up-front cost of a central reservation system, the capital required to start a franchise chain can be as low as several hundred thousand dollars for legal expenses, promotional material, and start-up costs. The bulk of the expenses for a franchise company consists of the advertising and promotional efforts needed to sell franchises and obtain the critical mass of franchisees required in order to have an economically viable chain.

Another cost-saving aspect of a franchise system is that development responsibilities are shifted to individual property owners. Because these parties typically have first-hand knowledge of local real estate and business markets, they are usually in a better position than a franchisor to acquire the best sites and to handle the overall development process.

The capital that makes a franchise organization grow comes from the owners of the individual hotels in the form of fees. Franchisees assume the major portion of the financial risk associated with opening a new hotel, but in return receive most of the economic rewards.

[2] Profitable Source of Revenue

The revenue generated by a hotel franchise chain typically starts with initial fees paid by franchisees when they join the franchise system, along with ongoing royalty fees. In addition, some franchisors require additional payments for services that they provide, such as marketing, advertising, reservations, frequent traveler programs, and training.

The expenses incurred by franchisors that are chargeable against these fees are generally for services provided by the franchisor and are usually minimal. Many of the services provided by franchisors generate fixed fees (e.g., centralized reservation systems, chain directories, and various administrative functions), so a franchise chain must have a sufficient number of properties under contract in order to be profitable. Once the number of franchisees reaches this level (the "critical mass"), the franchise company typically grows to become extremely profitable. Depending on the nature of the services provided by the franchisor and the fees charged the franchisees, this critical mass of properties can range in number from twenty to fifty.

Because many franchise companies also own hotels or operate properties under management contracts, franchising offers a means of spreading the fixed operating costs of the owned or managed facilities among franchised properties, thereby achieving the necessary critical mass in a shorter period of time.

[3] Customer Recognition and Brand Loyalty

Customer recognition is an important attribute for a hotel chain. While recognition can be created through advertising and promotion, one of the best methods of developing a known hotel brand name is to have a product for people to see and use. Having hotels in both popular destinations and in the cities en route to the destinations (known as feeder cities) provides potential customers with the opportunity to see or hear about the chain before selecting their overnight accommodations. Most people are very particular in their choice of sleeping facilities; product knowledge (either first-hand or second-hand) is an important factor in the selection process.

The rapid growth potential offered by franchising accelerates the essential process of creating customer recognition. Once customers recognize a hotel product and have been satisfied after using it, brand loyalty develops, which results in repeat patronage along with positive word-of-mouth promotion.

[4] Income From Brand Name, Trademarks, Image, and Goodwill

Most hotel companies that offer franchise affiliations started in the industry by developing or acquiring properties that they owned or managed. Over time they created a brand name and trademarks that in turn developed consumer image and goodwill. Further development of the companies included a mode of operation consisting of a home office management structure, operating systems and procedures, and in most instances, a central reservation system and marketing network.

This entire package, particularly the established consumer image and goodwill, has special value for an independent hotel in need of identity and image. Franchising converts this intrinsic value into income for the franchisor. There often is a direct relationship between a hotel chain's consumer image and goodwill and the volume of franchise fees generated on a per-property basis.

» 18.03 DISADVANTAGES FOR FRANCHISORS

[1] Loss of Operational Control

The operating responsibility for a franchised hotel lies with either the hotel's owner or the owner's agent (i.e., a management company). The franchisor exerts very little influence over the day-to-day operation of the property. Although franchise chains attempt to control the quality and image of each individual hotel through rules and regulations and periodic property inspections, the persistent fact that the franchisor does not really have basic control over an operation can sometimes result in lower standards of quality and service than the franchisor wishes to maintain. When this occurs, the guests who experience the substandard level of quality service form an incorrect image of the entire chain, which can easily have a detrimental effect on repeat patronage or word-of-mouth promotion.

For this reason, chains such as Hyatt and Westin did not franchise until just recently, citing for years their concern with the risk of losing the operational control of a hotel. Marriott has franchised for a number of years, but has attempted to maintain only a select few management companies that Marriott believed would maintain the levels of quality and service that it requires. Generally speaking, lodging chains associated with the higher classes of facilities are less likely to franchise than those that provide a lower level of service, because they are more concerned with the need to

maintain operational control. Two exceptions to this include Motel 6 and Red Roof Inns, although it appears that Motel 6 is anticipating offering franchises in the near future.

Franchise chains attempt to exert operational control by periodically inspecting each property to see that the facilities are well maintained and the hotel is operating at the prescribed standards. Backing up these inspections are extensive operating requirements contained in the franchise agreement. Objective standards set by franchisors, such as requirements that the hotel accept American Express credit cards, that the restaurant be open from 6 A.M. to 10 P.M., or that all guestrooms have a color television, are relatively simply enforced. Subjective standards are more difficult to evaluate and enforce. For example, determining whether an operator complies with regulations stating that a hotel must, at all times, be clean and well maintained or that an operation must be "first-class" can be difficult.

The ultimate penalty franchisors can wield in order to enforce their various regulations and standards is the termination of the franchise. Unfortunately, the time it takes to actually terminate a franchise, particularly if the franchisee is uncooperative, can range from several months to one or more years. The termination process becomes even more difficult if litigation is involved and the dispute involves a subjective regulation.

Perhaps the greatest loss of control for a hotel franchisor is the prevention of its expansion by franchisees concerned about the impact of new hotels being developed in their area that are affiliated with the same brand. For a hotel company that does not offer franchises, the decision to have multiple properties in a given market is made purely in-house on a corporate level. However, because the franchisee does not expect to compete either with the parent lodging company's own brand or with other brands that are owned by the company, franchisors must prove that such development would not impact the existing franchisee.

For these reasons, loss of operational control can be a significant deterrent for a hotel chain that is evaluating the potential of franchising. Not only is it difficult for a franchisor to enforce its standards, but the process of terminating a franchise can be time-consuming. The potential liability is a substandard hotel that could tarnish the image and goodwill of the entire chain.

[2] Difficulties With Owners

A hotel franchise company generally has to work with many property owners and management companies. The hotel industry is largely ego-driven, so the chances are good that the objectives of a franchise company will not always mesh with the motivations and styles of all of the individuals with which it works. In fact, franchisees often band together and form a franchise association that represents their interests when disputes with their franchisor arise.

In any case, the end result of maintaining a number of business relationships is that hotel franchise companies often have to spend a considerable amount of time and money attending to their franchises in order to keep their system functioning in an efficient and orderly manner.

[3] Liability Without Control

When a franchised hotel is involved in litigation, particularly in suits involving liability claims, the franchisor is often named as a defendant. Even though the hotel chain is often found to have no control over the incident and therefore to bear no

liability, the cost of legal defense can often be considerable. Occasionally, franchisors are found to be liable even though they do not have direct control over the operation of a hotel. This liability exposure can be and generally is limited through insurance, which in itself can represent a considerable expense.

[4] Quality, Service, and Cleanliness Control Problems

As described earlier, controlling the level of quality, service, and cleanliness at individual properties is not easily accomplished by franchisors. Because these subjective elements are always open to different interpretations, property owners are sometimes able to get by with lower standards than those intended by the franchisor.

Periodic property inspections followed by counseling with on-site management are the usual steps taken by franchisors seeking control of a property. Some chains offer extensive training programs and operating manuals that describe the various operating procedures that must be used to maintain the standards that they set. In any event, maintaining acceptable levels in these areas can often involve a large amount of effort and expense on the part of a franchisor.

[5] No Control Over Pricing

Another element beyond the control of a franchisor is the establishment of uniform room rates and pricing policies for individual franchisees. For some types of lodging chains, particularly those catering to price-sensitive travelers, a uniform pricing strategy is highly desirable. Uneven pricing from one hotel to another can confuse customers and adversely affect the image of the entire chain.

[6] Costly Start-Up

When a hotel chain first begins franchising, the company generally experiences a negative cash flow until the number of its properties reaches the necessary critical mass. Cash flow should turn around when the critical mass is reached, but the franchisor must have sufficient funds set aside to provide the necessary services to the franchises it has on board during the build-up period.

[7] Mandatory Disclosure Document

All forms of franchising are strictly regulated by both the federal government and certain state agencies. Aimed at protecting the small investor from risking life savings on fraudulent franchise schemes, these regulations require full disclosure of many of the important business aspects of a franchise investment. This level of disclosure eliminates the possibility of franchisors creating individual agreements for each potential franchisee and adjusting terms through negotiation. As a result, most terms of a franchise agreement are fixed and are not subject to alteration.

The Federal Trade Commission (FTC) is the primary governmental overseer of franchising in the United States. In order to offer (sell) a franchise, potential franchisors must first file with the FTC a disclosure document known as a Uniform Franchise Offering Circular (UFOC). While this document does not receive either an

approval or disapproval from the FTC, it must be accurate and current. The following list contains the major items that must be addressed in a UFOC.

1. *Introduction.* Brief introduction and warnings that the material should be read carefully and that a lawyer or an accountant should be consulted. Notice from the FTC that even though the offering circular has been filed with that agency, the agency has not checked it and does not know whether it is correct.
2. *The franchisor and any predecessor*. Description of the franchisor and the franchised business. Date when the franchisor started the business, its business address, any previous owners. An overview of the franchised business, its concept and strategy.
3. *Identity and business experience of the persons affiliated with the franchisor; franchise brokers.* Biographical sketches of the directors, principal officers, and other executives who have management responsibility in the franchisor's business.
4. *Litigation history*. Description of any past or present litigation involving the franchisor or the persons affiliated with the franchisor described in Item 2.
5. *Bankruptcy*. Fifteen-year bankruptcy history for the franchisor, its predecessor, or any of the persons affiliated with the franchisor described in Item 2.
6. *Franchisee's initial fee or other initial payment.* Description of the initial fee paid by franchisee to acquire the franchise. Description of the franchisor's expenses that are paid from the initial fee.
7. *Other fees and expenses*. Description of the other fees and expenses payable by the franchisee during the term of the franchise, which typically include royalty fees; accounting and auditing fees; advertising fees; expansion fees; initial leasehold construction fees; furniture, fixture, and equipment fees; insurance fees; ongoing maintenance fees; refurbishing fees; telephone reservation referral fees; transfer fees; and training fees. Statement of whether these charges and fees are to be paid to the franchisor, or expenses are to be paid to other parties (e.g., contractors, furniture and equipment dealers, and accountants).
8. *Franchisee's estimated initial expense*, A broad estimate of the major expense categories involved in developing and starting a lodging facility typical of what will be franchised.
9. *Obligations of the franchisee to purchase or lease from designated sources.* Terms of any requirement for franchisee to purchase or lease anything from either the franchisor or suppliers designated by the franchisor.
10. *Obligations of the franchisee to purchase or lease in accordance with specifications or from approved suppliers.* Terms of any requirement for franchisee to use either approved specifications or suppliers when purchasing.
11. *Financing arrangements.* Terms of any agreement by franchisor to provide any financing to the franchisee.
12. *Obligations of the franchisor*. Other supervision, assistance, or services. List of the services and obligations of the franchisor, which are generally subdivided into pre-opening obligations and continuing obligations.
13. *Exclusive area or territory.* Details of any exclusive areas or territories granted by the franchisor.

14. *Trademarks, service marks, trade names, logotypes, and commercial symbols.* Description of the various marks and trade names owned by the franchisor and available to the franchisee. Description of any known infringement or agreements limiting the use of these marks.
15. *Patents and copyrights.* Description of any patents and copyrights owned by the franchisor. Terms of issuing and maintaining operating manual supplied to franchisee, including any provisions regarding confidentiality.
16. *Obligations of the franchisee to participate in the actual operation of the franchised business.* Rules pertaining to whether the franchisee must actually operate the hotel or can hire a professional management company. Restrictions, if any, regarding the conduct of other hotel business activities and the diversion of business to other hotels are also described.
17. *Restrictions on goods and services offered by the franchisee.* Definition of what goods and services can be offered by the franchisee at the franchised premises.
18. *Renewal, termination, repurchase, modification, and assignment of the franchise agreement and related information.* Various aspects of the franchise terms including length of initial term and renewal term; termination by franchisee; termination by franchisor, with and without notice; obligations upon termination or expiration; franchisee's interest upon termination or non-renewal; transfer of interest by franchisor; transfer of interest by franchisee;
transfer upon death or mental incapacity; franchisee sale of its securities;
corporate transfers; non-waiver of claims; covenants not to compete; and modifications of agreement.
19. *Arrangements with public figures.* Description of any public figures involved with the franchise.
20. *Actual, average, projected, or forecasted franchise sales, profits, or earnings.* Any statement or projection of sales, profits, or earnings, made by the franchisor.
21. *Information regarding franchises of the franchisor.* Data relating to the number of franchises currently in existence and the projected franchise sales for one year.
22. *Financial statements.* Recent audited financial statements of the franchisor.
23. *Contracts.* Complete copy of franchise agreement and other contracts that must be executed by the franchisee.
24. *Statement of prospectus accuracy.* Representation by franchisor that prospectus is accurate.
25. *Acknowledgment of receipt by a prospective franchisee.* Statement by prospective franchisee noting the date of receipt of the UFOC.

The UFOC must be given to a prospective franchisee at the earlier of the first "personal meeting" or "the time for making disclosures." The FTC defines the "time for making disclosures" as ten business days prior to the earlier of (1) the execution by a prospective franchisee of any franchise agreement imposing a binding legal obligation or (2) the payment by a prospective franchisee of any consideration in connection with the sale or proposed sale of a franchise. In addition to the FTC disclosure requirements, several states impose additional franchise regulations, some of which are more stringent than the federal rules.

The ultimate effect of this level of disclosure is to establish uniformity in franchise structures, requirements, and fees, and thus eliminate any advantage a franchisor may have over a franchisee in terms of bargaining power.

» 18.04 ADVANTAGES FOR FRANCHISEES

[1] Instant Recognition and Shortened Start-Up Period

The primary benefit of a franchise affiliation for a hotel is the instant name recognition that it provides. Hotel patrons traveling to new destinations often look for a lodging facility with a recognizable name and image because they want to know that the quality of the accommodations and service at the hotel they choose will meet the expectations they have that are based on prior experience with (or recommendations of) the same product. Although an independent hotel without a chain identity may well develop its own reputation and patronage, the period of time needed to penetrate the market in this fashion may extend over many years. Another decided advantage for new hotels with a recognizable affiliation is that they generally experience a faster build-up of patronage. This shortens the normal start-up period, so that a hotel with a chain affiliation will reach a stabilized occupancy level more quickly than would a new, non-affiliated hotel.

[2] Attraction of Different Market Segments to Different Franchises

Over time, hotel chains develop specific images in various market segments. For example, Marriott Hotels, Hyatt Hotels, Westin Hotels, Sheraton Hotels, and Hilton Hotels generally achieve high penetration in the meeting and convention market segment. Courtyard by Marriott, Embassy Suites, and Doubletree Hotels have a strong following in the commercial segment, while Holiday Inns, Hampton Inns, and Comfort Inns have strong followings in the leisure market. Residence Inn by Marriott, Homewood Suites, Villager Lodges, and Studio Plus Suites are oriented toward extended-stay guests.

The market strengths of each lodging chain can directly benefit the hotels that take on their franchises, so a hotel owner looking for a franchise affiliation should thus be aware of the market strengths of each available franchisor and determine which affiliation will make the best use of both the available market and the subject property's contemplated or existing facilities.

[3] Proven Method of Operation and Product Merchandising

Successful, established hotel chains generally allow potential franchisees access to the manuals and training programs that they have developed as internal guidelines for their mode of operation and product merchandising. By reviewing these materials, a franchisee can be certain that the franchisor has tried and proven systems and procedures that will increase the chances of franchise success.

New franchise companies typically have several company-owned hotels that serve as laboratories for developing systems and procedures. Prospective franchisees, lenders, and investors look at the operating results of these properties and use them as a means of confirming the ability of the franchisor to run viable, profitable hotels.

» 18.05 DISADVANTAGES FOR FRANCHISEES

[1] Excessive Cost if Incorrect Franchise Is Chosen

The selection of a franchise is one of the most important decisions that a hotel owner must make. Choosing the wrong franchise almost always adversely affects operating results. For example, an affiliation with a luxury-quality, convention-oriented lodging chain will negatively affect a hotel that, based on local market conditions and characteristics, should be oriented toward the budget-rate, leisure market segment. Some of the costs that can result from selecting the incorrect franchise include:

- Operating losses during the period the ineffective affiliation is in use;
- Cost of acquiring a new franchise;
- Cost of purchasing new identity items such as signs, logos, and monogrammed items; and
- Operating losses during the initial occupancy build-up period under the new franchise.

[2] No Guarantee of Success

Hotel franchisors typically have no financial interest in the properties they franchise and make no representation that a particular franchise will be an economic success. In fact, franchisors occasionally set operating standards that may in themselves be costly to the franchisee, such as requiring a hotel to upgrade its facilities even though such upgrades may not have a direct impact on the operating profitability of the hotel.

Even though franchise offerings are regulated by the FTC and some state agencies, franchise salespeople have occasionally resorted to unethical practices in order to sell new franchises. The compensation received by many of these salespeople is based on the number of franchises they sell, so without strict supervisory control, some salespeople may attempt to sell franchises either to unqualified owners or to projects that have no economic feasibility. Such conduct was partially responsible for the overbuilding that took place during the early 1970s.

As discussed previously, hotels spend anywhere from .75% to 9.34% of total revenues to affiliate with a national lodging franchise. This percentage is often the largest single expense incurred by a hotel after payroll and typically makes up the largest expense in the hotel's marketing budget. As with any substantial cost or investment, purchasers of a service like to see the benefit that they are receiving for their money.

With regard to the economic benefit of hotel franchise fees, we are provided only with the claims and promises provided by the franchisors themselves. Some franchise companies refuse to provide performance statistics of any kind, fearing that such claims would constitute guarantees which if not achieved would leave them open to ridicule and perhaps litigation. Other companies provide statistics such as system-wide reservation contributions, but these statistics are closely guarded and vary from chain to chain as to what is considered a reservation and/or denial. Furthermore, in comparing the gross delivery of reservations for a given period, many of which are composed of room-nights booked months and sometimes years in the future, against the actual occupied rooms in that period can be quite misleading.

Initiated by the University of Denver School of Hotel, Restaurant and Tourism Management, Richfield Hospitality, one of the largest independent hotel management companies, used this model as a basis to survey forty-three of its hotels, which oper-

ate under thirteen different franchises. The model attempted to quantify three areas of franchise performance:

1. The benefit of programs and services offered by the franchise;
2. The consumed reservation room night contribution of the reservation system; and
3. The drive-by value of the franchise name.

The findings enabled Richfield to rank the various franchises based on these three categories as shown in Exhibit 18-1.

Exhibit 18-1 Franchise Rankings

Hotel Franchise Portfolio	Franchise Programs and Service	Reservation Contribution	Drive-by Value
A	1.0	3.0	4.0
B	7.0	4.0	6.0
C	10.0	1.0	1.0
D	5.0	2.0	7.0
E	3.0	13.0	11.0
F	8.0	6.0	9.0
G	12.0	10.0	13.0
H	2.0	5.0	5.0
I	13.0	8.0	3.0
J	9.0	9.0	2.0
K	11.0	11.0	10.0
L	4.0	4.0	12.0
M	6.0	6.0	8.0

The franchises surveyed include Best Western, Clarion, Comfort Inn, Days Inn, Hilton, Holiday Inn, Howard Johnson's, Knights Inn, Quality Inn, Radisson, Ramada, Sheraton, and Travelodge. The survey results indicated that each franchise offered different benefits to the hotels that operate under their flag. Several of the best performing franchises in terms of their actual room night contribution were viewed by many general managers as not very effective in their programs and services provided. Similarly several franchises that did not contribute significantly to the hotel's occupied rooms through their reservation service were perceived by the general managers to provide strong benefit in terms of the flag's drive-by value.

Although it is not known whether the University of Denver model and the Rich-field study adequately quantified all of the aspects of return on investment, the relative rankings of the different chains provide insight into the substantial differences in performance that can be expected on the basis of property type and location relative to the particular affiliation. HVS is currently taking this study to the next level by rolling it out on a national basis.

The goal is to quantify the benefits offered by all the major national franchises and analyze the information to see how these benefits relate to the size, type, loca-

tion, and competitive situation of a particular hotel. The success of the survey is of course contingent on the contribution of the independent owners and management companies from which the survey information is polled. Although such information may be available from the franchises themselves, we believe that the owners and operators themselves will provide the most objective and pertinent information available. After all, it is not the value of a particular franchise to the franchise company itself that is being assessed; it is the value of the franchise to the franchisee that poses one of the biggest questions in the minds of hotel owners and operators in the lodging industry today.

[3] Nontransferable Franchises

Some hotel franchisors do not allow existing owners to freely transfer a franchise to a new owner in the event of a sale. Some of the transfer restrictions typically imposed by franchisors include:

- Payment of a transfer fee;
- Approval of new owner by franchisor;
- Application for an entirely new franchise;
- Refurbishment of hotel to meet current franchise standards; and
- Right of first refusal on transfer.

Ultimately, the risk posed to the seller by these transfer restrictions is that the franchise may not be renewed or that it can be renewed only for a price. For example, a transfer may require spending hundreds of thousands of dollars in order to bring a hotel up to current standards. Anything that could inhibit the transfer of a valuable franchise could also adversely affect the market value of the property.

[4] Short Term of Franchise

Franchisees and potential buyers face the risk that the reversionary value of an investment in a hotel will be discounted if its franchise cannot be renewed or extended. Since the economic lives of hotels generally span thirty to forty years, and franchise terms typically range from ten to twenty years, continuation of a favorable franchise affiliation is important, A change of name and image midway along a hotel's economic life can result in severe marketing and financial difficulties. For this reason, first-tier hotel management companies typically require contracts that extend beyond twenty years in order to preserve the name integrity of the chain.

[5] Little Control Over Other Franchisor Affiliations

Most franchise agreements are not overly restrictive regarding the number of new hotels in the market area with which the franchisor can be affiliated. Occasionally, a franchise will grant a property owner an exclusive area for a specific period of time. In most cases, however, a franchisor is free to add a new product to a market whether it is another franchised hotel or a property managed or owned by the franchise company. With the recent trend in product segmentation, franchisors sometimes claim that adding a product to a market area that caters to a different market segment or price

classification will not adversely affect an existing franchisee. While this may have been true during the late 1980s, when demand for accommodations was extremely high, many hotels located in the same market area that formerly targeted different segments of the traveling public found themselves competing directly for business during the lean years of the early 1990s. Proliferation of new brands virtually stalled as new development of hotels became a nearly impossible task. However, with the strong operating performance of most hotels from 1994 through 1996, many new brands targeting specific segments are set to come on line during the latter half of the 1990s.

[6] Adherence to Chainwide Standards

The various regulations and standards developed by franchisors are designed to cover all the hotels in the chain and ensure uniform mode of operation and image. Occasionally, these standards may be inappropriate for a specific property, or unsatisfactory to a particular owner, but franchisors generally do not allow any deviation from their system. The chainwide standards that can negatively affect individual hotels include:

- Required year-round operation;
- Set operating hours for restaurants, lounges, and room service;
- Minimum staffing level requirements, such as 24-hour door attendants and bell hops;
- Participation in chain advertising and frequent traveler programs; and
- Required amenities (e.g., a swimming pool, a restaurant, room service, a lounge, or free parking).

Property owners who would be adversely affected by these standards are sometimes able to work out exemptions with franchisors before signing an agreement.

[7] Benefits Dependent on Number of Properties in Chain

Just as a franchise chain has a critical mass for the franchisor at which franchise revenues cover the costs of licensing and maintaining franchises, so too does a franchise chain have a critical mass for the franchisee, at which the economic benefits of the franchise affiliation exceed the cost of acquiring and maintaining it. The benefits of a franchise affiliation that are directly related to the number of properties in the chain include:

- Reservation referrals from other properties;
- Word-of-mouth referrals from patrons with favorable experiences;
- Advertising and marketing assistance;
- Additional chain services; and
- Sophisticated central reservation system.

A potential franchisee should evaluate the price/value relationship of joining a hotel chain, particularly in light of the fact that some new franchisors will reduce initial and continuing franchise fees during their start-up period to reflect the reduced level of benefits that they provide compared with an established chain.

[8] Lack of Control Over Chain Quality and Image

Individual franchises have little control over any of the operating policies of the franchisor that adversely affect the overall quality and image of the franchise chain, and so are essentially at the financial mercy of the franchisor. An analysis of the hotel franchise organizations that started during the 1950s and the 1960s yields examples of chains that faded in popularity and others that increased in strength because of their ability or inability to maintain efficient operating policies. Necessary policies for a franchise company include:

- Mechanism for terminating franchises that do not maintain an appropriate level of quality and service.
- Mechanism for removing hotels from the system that are not functionally up-to-date.
- Periodic update of marketing strategies and chainwide customer image.
- Consistent product and unified image.

A twenty-year franchise commitment will typically expose the owner of the affiliated hotel to at least one complete turnover in the management of the franchise company. New policies and management outlook evolve on a continual basis, and this may or may not be a positive influence on the entire lodging chain.

» 18.06 SERVICES OFFERED BY FRANCHISORS

Like any other long-term financial situation, a hotel franchise has certain risks and benefits. Hotel owners can minimize the possibility of an unpleasant experience by carefully reviewing the services offered by individual franchisors and dealing only with reputable franchise companies.

[1] Site Selection and Market Analysis

Hotel franchise chains often help prospective franchisees to select a suitable hotel site and analyze the characteristics of the surrounding market area. In this regard, however, their assistance is reactionary in that franchise companies generally only comment on a potential site chosen by the franchisee; they do not actually seek out suitable locations.

Franchisors also typically recommend independent hotel appraisers who can perform market analyses for potential franchisees. Franchisors are also often able to assist appraisers by providing important data such as the room rates and occupancy levels of competitive lodging facilities, the number of fill nights at other chain properties in the market area, and reservation data regarding the amount of satisfied and unsatisfied lodging demand in the immediate area.

[2] Provision of Plans and Specifications

Hotel chains that seek to have a uniform image or character for their properties generally provide prototypical architectural plans to the franchisee that can be modified and adjusted to fit a particular site. The benefit of these plans to the franchisee is two-

fold: they often reduce development cost, and they assure a well-conceived, functional property. Some franchisors also provide detailed specifications for construction and furnishings in order to maintain the quality standards of the chain. Potential hotel developers should realize that most hotel chains have strict guidelines concerning plans and specifications for constructing and furnishing their facilities. Consequently, developers should make no significant expenditures for architectural plans until a franchise has been selected and the required specifications have been obtained.

[3] Development Assistance

Hotel franchisors are often able to provide assistance during the construction of a hotel. At the minimum, a hotel chain usually wants the opportunity to approve plans and specifications prior to construction and to inspect for compliance during development and after the project is completed. Some franchisors, however, have in-house development experts who will provide extensive support in all phases of the development process. The cost of these services is generally an additional charge over the normal franchise fees.

[4] Assistance in Obtaining Financing

Franchisors generally do not secure financing for franchisees, but they do sometimes assist in assembling loan packages for lenders. A good hotel chain typically develops relationships with the various financial components necessary to obtain financing, which include firms that perform market studies and appraisals, mortgage bankers and brokers, construction lenders, permanent lenders, real estate investment trusts, mortage conduits, and investors. In addition, large hotel companies such as Marriott, Promus, Choice, and HFS offer potential franchisees direct financing of their own. This was a necessary vehicle created by these companies during a period in which the economics for expansion were present but the financial sources for hotel construction were not. As traditional third-party financing has returned to the market in recent years, these programs at the major hotel companies have been scaled back.

Because financing is an important aspect of a hotel development or acquisition, more franchisors can be expected to take an active role in obtaining funds in the future. A franchise package that offers not only the normal franchise benefits but some form of financing commitment is an unbeatable combination for attracting franchisees.

[5] Publicity and Promotion Assistance

Generally, hotel chains that sell franchises have prepared professional advertising and promotional campaigns that include logos; trademarks; signs; property; billboards;
and print, radio, and television ads. Franchisees can usually obtain these advertisements and promotional materials from the franchisor and immediately use them in the proper media.

[6] Centralized Purchasing

Many franchisors offer centralized purchasing services that are able to take advantage of quantity discounts available to large volume buyers, passing these savings on to

the individual franchisees. Not only can the financial benefits of centralized purchasing be substantial, but the ease of ordering, receiving, and accounting is often greatly simplified. Vendors, realizing the purchasing power of an entire organization, are also more likely to provide better service. Centralized purchasing not only reduces the cost of buying products such as furniture and operating supplies but decreases the price of such services as advertising, accounting, and legal counsel. Centralized purchasing is generally a voluntary service; in most instances, the franchisee is free to purchase supplies, furnishings, and equipment from any vendor in the market as long as the specifications of the item purchased meet the franchisor's approval.

Another advantage gained by the buying power of a lodging chain is that individual franchisees are able to receive reductions in credit card commissions.

[7] Referrals Between Properties

One of the primary benefits of belonging to a lodging chain is the referral of business between the properties within the chain. In effect, each property in the chain functions as a marketing office that creates room-nights of demand for other hotels throughout the chain. For example, when a patron is checking out of one hotel, the front desk personnel should determine whether the traveler requires a reservation at the next destination. If so, a sale should occur, and a reservation should be made with another franchisee in the chain. Similarly, when meeting and convention groups have been satisfied with the service and accommodations they received by one hotel in a chain, they should be referred directly to other chain hotels for future meetings. Individual franchisees benefit by keeping hotel patrons "within the chain" through property level referrals.

Hotel owners who are prospective franchisees should investigate whether a franchisor actively encourages referral activity between properties, and if so, whether there is chain representation in the feeder cities where this type of reservation activity would originate.

[8] Centralized Reservation System

Another major benefit of a franchise affiliation is the centralized reservation system that ties the entire chain together. Most hotel chains offer a reservation system consisting of a central reservation office with a toll-free telephone number. Staffed by trained personnel, the central reservation office takes all reservation requests and records the following information:

- The hotel within the chain that is the most convenient destination to the caller.
- The availability of accommodations at the requested hotel on the desired date(s).
- Available room rates.
- A reservation, if the caller so chooses.
- Guarantee of the reservation, if necessary.
- Any special request.
- Information about the caller (e.g., name, address, and telephone number).

This data is stored in the central reservation computer for future statistical analysis and, if necessary, is also transmitted to the property to confirm the reservation and identify the patron.

Hotel franchise reservation systems vary in sophistication. Potential franchisees should investigate the workings of each reservation system to determine which will work best for their particular operation. The aspects of the system that should be analyzed include the following;

- The number of reservations the central system actually generates for the properties within the chain. (The franchisee should trace this data to individual properties that have locations similar to the subject property, and then analyze the reservation data on both a monthly and weekly basis.)
- The number of reservations that represent actual room-nights and the number that result in no-shows.
- The number of reservations that are currently unaccommodated within the potential franchisee's market area, and to what properties unaccommodated reservations are currently referred.
- The identity of the properties in the chain from which the subject property can expect to receive reservation overflow. Reservation system computers are programmed to refer unaccommodatable reservations to another property within the chain, usually the closest based on travel time. This procedure should, however, be verified to ensure that the potential franchisee's hotel will receive its fair share of overflow reservations.
- The identification of the potential franchisee in the reservation system. For example, a hotel might be known as the Sleep-Inn Downtown or Sleep-Inn Convention Center or Sleep-Inn Airport or Sleep-Inn Interstate. Incorrect information conveyed by a name or description could divert reservations and patronage to other properties even if they are less well located to the traveler's final destination.

Hotel franchise companies with centralized reservation systems are generally able to provide franchisees with market analysis based on their reservation data. These reports can provide important market research information to the franchisee. The reports containing this research information that are usually available to franchisees include:

- *Reservation originations.* A listing of where reservations originate, categorized either by zip code or by telephone area code. This information is useful in planning future marketing programs.
- *Reservation denial report, A* listing of the number of potential patrons who attempted to make a reservation at a specific property but, because the property was fully booked, could not be accommodated. This information is important for quantifying unaccommodated demand, which provides an indication of the need to expand a property.
- *Occupancy comparisons. A* report showing how a specific property's occupancy percentage compares with other hotels of the same franchise in the property's market area, state, and region. This information is useful in evaluating operating performance.

A potential franchisee should request to see examples of the different reservation system reports offered by franchise chains in order to determine which offers the most useful information.

[9] Proven Mode of Operation

A franchisor should provide the franchisee with a tried and proven mode of operation that includes all the systems and procedures that are necessary in order to operate the franchise efficiently. In most instances, the information regarding the implementation of the mode of operation is communicated either by training programs or by an operations manual offered by the franchisor.

Some chains offer extensive schools or seminar programs to familiarize management level personnel with the chain's mode of operation and general philosophies. Other franchisors have detailed operating manuals that provide recommended solutions to almost any problem that the management of the property may encounter. While the assistance provided by the franchisor will not substitute for actual hotel operating experience, it is important to use the experience of the hotel chain in order to reduce the number of operational errors and to conform with the chainwide image and mode of operation of the franchisor as well.

[10] Marketing Offices

Most hotel chains, particularly those with a group marketing orientation, maintain national and regional marketing offices that generate meeting, convention, and group business. This service is particularly beneficial for those hotels that anticipate heavy usage in the meeting and convention segments. The time and effort required to establish the marketing infrastructure to effectively penetrate the meeting and convention segment can be overwhelming for an individual hotel; tapping into a chain's database of group business can offer a substantial advantage. The potential franchisee should verify that such information does exist and will ultimately produce meeting and convention room-nights for the subject property.

[11] Property Inspection and Evaluation

Quality assurance is an important activity for franchisors. A hotel chain is only as good as its poorest hotel, so constant inspection and evaluation on the part of the franchisor is necessary to maintain a consistent level of physical and service quality.

Most hotel chains typically inspect their properties two to four times per year. A score is usually awarded based on a 1,000 point system. Franchisees that do not achieve a satisfactory score are usually provided with a set time frame to correct the issues that brought them below the given standard. The purpose of these inspections is to monitor quality standards and familiarize the on-site management with the techniques used to maintain the required level of quality. Because rigid enforcement of quality standards is extremely important for the success of a franchise system, the methods of regulating property level quality should be closely evaluated by potential franchisees.

» 18.07 FRANCHISE FEES

When evaluating a possible hotel franchise, one of the most important economic considerations is the structure and amount of the franchise fee. Hotel franchise fees are the compensation paid to the franchisor for the use of the chain's name, logo, identity, image, goodwill, operating systems and procedures, marketing plans, and refer-

ral and reservation systems. Franchise fees are normally formulated using an initial fee paid upon applying for the franchise plus continuing fees paid periodically during the term of the franchise.

[1] Initial Fee

The initial fee typically takes the form of a minimum dollar amount based on a hotel's room count. For example, the initial fee may be a minimum of $45,000 plus $300 per room for each room over 150. Therefore a hotel with 125 rooms would pay $45,000 and a hotel with 200 rooms would pay $60,000. The initial fee is paid upon submission of the franchise application. It covers the franchisor's cost of processing the application, reviewing the site and market potential, evaluating the plans or existing layout, inspecting the property during construction, and providing services over the pre-opening or conversion phases.

If the hotel is existing and the franchise represents a conversion, the initial fee structure is occasionally reduced. Some franchisors will return the initial fee if the franchise is not approved, while others will keep a portion (5% to 10%) to cover the cost of reviewing the application.

Other costs associated with the initial acquisition of a national franchise may include the cost of signage and any specialized computer software or hardware needed to interface with the franchisor's central reservation system. An existing hotel contemplating an affiliation also bears the possible burden of repurchasing towels, brochures, operating supplies, and paper items imprinted with the national franchisor's logos. It is also possible that the potential affiliate may have to undertake a property refurbishment or renovation (ranging from installing a higher grade of carpeting to enclosing a property's exterior corridors). These costs must be considered when measuring the cost/benefit of affiliation, and varies from hotel to hotel and between the various franchise organizations.

[2] Continuing Fees

Payment of continuing franchise fees commences when the hotel assumes the new franchise affiliation; these fees are paid monthly over the term of the franchise agreement. Continuing fees generally include a royalty fee, an advertising or marketing contribution fee, and a reservation fee. In addition, continuing fees may include a frequent traveler program and other miscellaneous fees.

[a] Royalty Fee

Almost all franchisors collect a royalty fee, which represents compensation for the use of the chain's trade name, service marks and associated logos, goodwill, and other franchise services. A significant profit is generally factored into the royalty.

[b] Advertising or Marketing Fee

Chain-wide advertising and marketing consists of national or regional advertising in various media, the development and distribution of a chain directory, and marketing geared toward specific groups and segments. In many instances, the advertising or marketing fee goes into a fund that is administered by the franchisor on behalf of all members of the chain. In this situation, these dollars must be utilized for the purpose

of promoting the chain, and do not normally represent a source of profit to the franchisor.

[c] Reservation Fee

If the franchise chain has a reservation system, the reservation fee supports the cost of operating and paying for the central office, telephones, computers, and reservation personnel. Like advertising or marketing fees, the reservation fee is designed to cover the cost of the reservation system, and generally provides little profit to the franchisor.

[d] Frequent Traveler Program

Some franchisors maintain incentive programs that present awards to guests for frequent stays. The programs are designed to encourage loyalty to the affiliation.

[e] Other Miscellaneous Fees

These fees may include fees payable to the franchisor for additional systems or procedures; they are generally minimal in cost and do not represent profit. In addition, those franchisors that provide extensive training programs for their franchisees levy training fees that cover the cost of the instructional programs.

Sometimes the franchisor offers additional services for a fee. These services include consulting, purchasing assistance, computer equipment or satellite communication equipment rental, optional training programs, on-site opening assistance, or additional advertising services. The fees for these services are typically not qualified in the disclosure documents.

[3] Continuing Fee Assessment

Continuing franchise fees are assessed on the basis of several formulas. Royalty fees are generally based on a percentage of rooms revenue (which can vary as much as 1 percent to 6.5 percent). Advertising, marketing, and training fees are generally calculated on a percentage of rooms revenue (ranging from 1 percent to 4.5 percent), but sometimes are based on a dollar amount per available room per month. Reservation fees may also be based on either a percentage of rooms revenue (1 to 8 percent) or a dollar amount per available room per month ($2 to $6) but in some instances are assessed by an amount per reservation sent to the property through the central reservation system ($1 to $5.50). These various formulas may be used by themselves or they may be combined with each other. For example, the marketing fee for a franchise may be the greater of $2.00 per available room per day or 2 percent of rooms revenue. Many also have first-month contingency fees in lieu of recorded revenues (e.g., a royalty fee of $24.00 per room for the first month and then 5% of gross revenues in the ensuing months).

Each one of these fee structures offers advantages and disadvantages for the individual property. A fee based entirely on a percentage of rooms revenue is favorable for hotels that derive significant income from food and beverage sales. Fees based on an amount per available room are fixed, and tend to benefit hotels with high volumes and penalize properties with lower results. Paying a reservation fee based on the number of reservations received is fair, as long as the reservations equate to occupied room nights and not to no-shows.

Many franchisors are now requiring franchisees to bear their fair share of the costs associated with operating a frequent traveler program. Frequent traveler program assessments are typically based on a percentage of total or rooms-only revenues generated by a member of the program at a hotel (1.0% to 6.5%), or a fixed dollar amount per room occupied by a frequent traveler member ($1.60 to $5.00). Many programs also require hotels to contribute a one-time participation fee of $5.00 to $10.00 per guestroom, while others use a combination of all three methods.

The specific fee structures required by a franchise company must be disclosed in the UFOC that it must file with the FTC, so potential franchisees can evaluate the fee structure of prospective franchise companies and determine whether the price/value relationship warrants the acquisition of a particular franchise. Exhibits 18-3, 18-4, and 18-5, developed from information contained in UFOCs, provide comparisons of the fees charged by various franchise companies. Each table deals with a different class of lodging facility (i.e., economy, mid-rate, and first-class) and the data in them is derived from the operating information in Exhibit 18-2.

Exhibit 18-2 Lodging Facility Class Distinctions

	Economy Hotel	Mid-Rate Hotel	First-Class Hotel
Room Count	100	200	300
Average Room Rate (Year 1)	$35.00	$65.00	$95.00
Room Rate Growth	5% per Year	5% per Year	5% per Year
Occupancy			
Year 1	60%	60%	60%
Year 2	70%	70%	70%
Year 3	75%	75%	75%
Projection Period	10 years	10 years	10 years
Total Room Nights	266,450	532,900	799,350
Total Rooms Revenue During **10-Year Projection Period**	$11,794,243	$43,798,356	$96,027,117
Total Food and Beverage Revenue During 10-Year Projection Period	N/A	N/A	$57,616,270
Number of Reservations From Franchisor	15% of occupied rooms	15% of occupied rooms	15% of occupied rooms
Percent of Rooms Occupied by Frequent Travelers	N/A	8% of occupied rooms	8% of occupied rooms
Percent of Rooms Occupied By Third Party Reservation Travelers	N/A	5% of occupied rooms	5% of occupied rooms
Average Length of Stay	2 nights	2 nights	2 nights

Our model assumes that each affiliation is capable of generating the same portion of occupancy from its reservation system. In truth, some affiliations generate more demand and some contribute less.

The following three exhibits summarize the franchise fee information relating to each franchise affiliation. The first column in each table identifies the name of the franchisor. The second column shows the amount of the initial fee based on the room

count assumed for each class of facility. The next five columns represent the continuing fees, which are subdivided into royalty, reservation, marketing, frequent traveler program, and miscellaneous cost. The continuing fees were calculated annually over the ten-year projection period and represent the total ten-year amount that would be paid by the franchisee. The next column represents the sum of the initial and continuing fees. The last column shows the percentage relationship of the total projected franchise fees to the total projected rooms revenue.

A total of fifty-seven franchise groups, in which twenty-six budget, eleven mid-rate, and twenty first-class franchisors participated, were included in the analysis. The trend toward continued franchise expansion and segmentation was exhibited by a 19 percent increase in the number of 1994 study participants.

The Budget Host organization lead the analysis, with only 0.75 percent of its projected ten-year revenue going toward expenses related to franchise fees. Other organizations achieving low percentages included Preferred Hotels at 1.49 percent, Best Western at 1.94 percent, Microtel at 2.70 percent, and Best Inns at 4.12 percent. The percent of rooms revenue figures ranged from 0.75 percent to 9.34 percent in the budget category, 1.94 percent to 8.99 percent in the mid-rate category, and 1,49 percent to 9.91 percent in the first-class category. Low percentage leaders in each category were Budget Host, Best Western, and Preferred Hotels, respectively. The overall range was a low of 0.75 percent to a high of 9.91 percent with a median of 6.57 percent.

Budget Host, Best Western and Preferred Hotels are, technically, not franchises, but rather associations or referral organizations. Because these groups are structured for the benefit of their member hotels, fees are oriented more toward covering operating costs rather than producing large profits. Their percentages are therefore somewhat representative of the actual cost of operating a franchise organization and provide an indication of the margin of profit realized by other chains.

A Marriott affiliation is still the most expensive; Marriott is currently the only franchisor whose continuing fees are based on a percentage of the combined rooms and food and beverage revenues. Marriott's frequent traveler award program also contributes to the above-average cost of this affiliation. However, few would argue with the success of Marriott's proven operating abilities, as well as its favorable customer image and good will. Often a direct relationship exists between a hotel's good will and its potential for asset value enhancement. Therefore, while affiliating with such a franchisor may well prove feasible and prudent, it will be comparatively costly.

As Exhibit 18-6 shows, the overall franchise class average showed steady growth over the past five years. The budget class maintained a three-study average of 5.7 percent, the mid-rate class carried a 6.7 percent average, and the first-class group had a three-study average of 6.4 percent. The budget group exhibited the lowest averages over the past five years, while the mid-rate group logged the highest.

Most hotel lenders believe that to be competitive in today's hotel market, a strong franchise affiliation is essential. Customers want to know the level of quality for which they are paying, and would rather not take the chance of having an unpleasant surprise from a "no-name" lodging facility. Hotel lenders also typically insist on a franchise affiliation of some type because it reduces the perceived investment risk. The big question is whether to opt for a Best Western affiliation at 1.94 percent of rooms revenue or for a Days Inn affiliation at 8.97 percent.

The selection of a chain affiliation should be evaluated carefully to determine when the price/value relationship is favorable to the hotel owner and when that relationship shows promise for long-term stability. One of the tools available to compare the relative cost of a franchise chain affiliation is the preceding analysis. Armed with this information, owners can address additional costs pertinent to their particular properties and determine the overall cost of affiliation.

HVS

Exhibit 18-3 Summary Table of Chain Franchise Fees—Budget Hotels

Chain	Total Initial Cost	Total Royalty Costs	Total Reservation Cost	Total Marketing Cost	Total Frequent Traveler Cost	Total Misc. Cost	1994 Total Ten-Year Cost	1994 Total as a % Total Revenue
Americinn	$20,000	$589,712	—	$235,885	—	—	$845,597	7.2%
Best Inns	13,875	235,885	$117,942	117,942	—	—	485,644	4.1
Budget Host	3,500	51,875	30,000	—	—	$3,500	88,875	0.8
Budgetel	25,000	589,712	117,942	117,942	—	1,000	851,596	7.2
Comfort Inn	40,000	588,918	164,871	255,494	—	9,600	1,058,883	9.0
Downtowner Inns	10,000	471,770	24,000	117,942	—	—	623,712	5.3
EconoLodge	25,000	471,315	164,771	255,295	—	9,600	925,981	7.9
Fairfield Inn by Marriott	37,500	471,770	160,907	294,856	—	6,500	971,533	8.2
Friendship Inn	20,000	352,911	164.471	254,994	—	9,600	801.976	6.8
Hampton Inn	35,000	471,770	—	471,770	—	36,700	1,015,240	8.6
Holiday Inn Express	40,000	589,712	189,582	235.885	35,745	10,600	1,101,524	9.3
Howard Johnson Inns	35,000	471,770	294,856	235,885	—	6,650	1,044,161	8.9
Master Host Inns & Resorts	15,000	530,741	24,000	117,942	—	—	687,683	5.8
Microtel	25,000	294,856	—	—	—	—	319,856	2.7
Nendels	10,000	353,827	216,354	182,500	—	—	762,681	6.5
Passport Inns	10,000	412,799	24,000	117,942	—	—	564,741	4.8
Red Carpet Inns	15,000	471,770	24,000	117,942	—	—	628,712	5.3
Rodeway Inns	25,000	354,211	164,871	255,394	—	9,600	809,076	6.9
Scottish Inns	10,000	412,799	24,000	117,942	—	—	564,741	4.8
Shoney's Inns	25,000	412,799	117,942	117,942	55,000	—	728,683	6.2
Signature Inns	25,000	471,770	412,799	—	—	—	909,569	7.7
Sleep Inn	35,000	471,415	255,395	166,871	—	28,800	957,481	8.1
Super 8	20,000	471,770	—	353,827	—	—	845,597	7.2
Thriftlodge	30,000	471,770	—	508,270	—	—	1,010.040	8.6
Travelodge	30,000	471,770	—	508,270	—	—	1,010,040	8.6
Villager Lodge	15,000	589,712	121,592	117,942	—	—	844,247	7.2

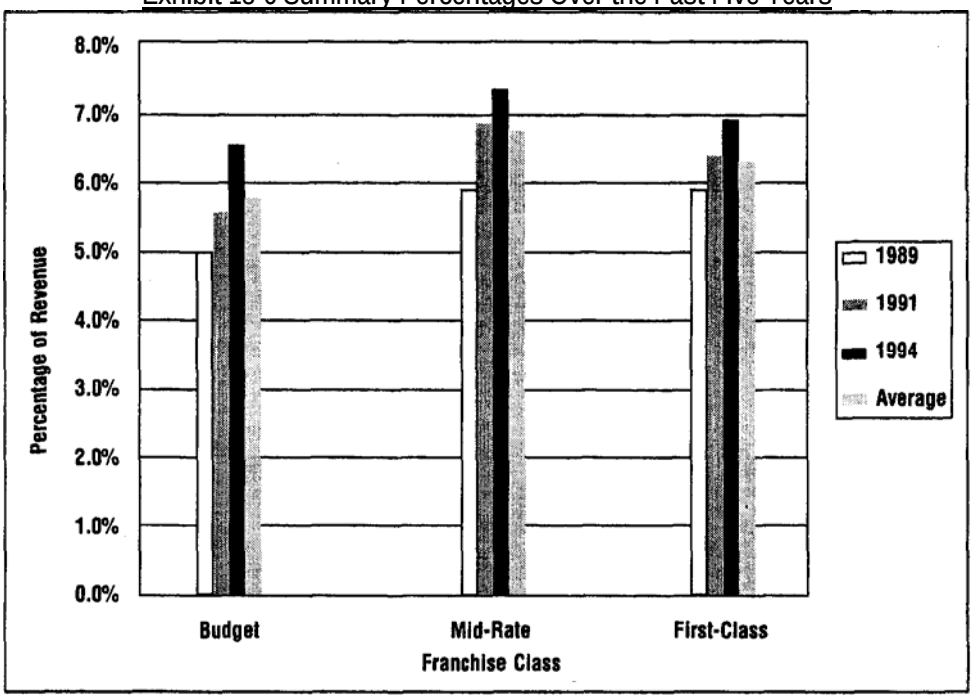
Exhibit 18-4 Summary Table of Chain Franchise Fees—Mid-Rate Hotels

Chain	Total Initial Cost	Total Royalty Costs	Total Reservation Cost	Total Marketing Cost	Total Frequent Traveler Cost	Total Misc. Cost	1994 Total Ten-Year Cost	1994 Total Cost as a % of Total Room Revenue
Best Western	$42,000	$ 46,160	$311,593	—	—	$449,865	849,618	1.9%
Comfort Suites	60,000	1,751,934	523,746	$772,294	—	9,600	3,117,574	7.1
Country Lodging by Carlson	20,000	1,268,043	439,643	2,144,010	—	—	3,871,696	8.8
Courtyard by Marriott	80,000	2,126,572	501,656	875,967	—	52,000	3,636,195	8.3
Days Inn	80,000	2,846,893	1,007,362	—	—	4,750	3,939,005	9.0
Holiday Inn	80,000	2,189,918	584,764	656,975	$227,911	13,350	3,752,918	8.6
Howard Johnson	70,000	1,751,934	1,094,959	875,967	—	6,650	3,799,510	8.7
Park Inn	31,000	1,740,807	3,650	870,487	—	—	2,645,944	6.0
Quality Inn	60,000	1,757,734	523,946	772,694	—	9,600	3,123,974	7.1
Quality Suites	60,000	1,751,934	523,946	772,694	—	9,600	3,118,174	7.1
Ramada	70,000	1,751,934	—	1,970,926	—	6,650	3,799,510	8.7

Exhibit 18-5 Summary Table of Chain Franchise Fees—First-Class Hotels

Chain	Total Initial Cost	Total Royalty Costs	Total Reservation Cost	Total Marketing Cost	Total Frequent Traveler Cost	Total Misc. Cost	1994 Total Ten-Year Cost	1994 Total Cost as a % of Total Room Revenue
Clarion	$90,000	$2,866,409	$1,084,972	$1,552,090	—	$9,600	$5,603,073	5.8%
Doubletree	30,000	2,880,814	3,360,949	—	—	—	6,271,763	6.5
Doubletree Club	30,000	2,880,814	3,360,949	—	—	60,000	6,331,763	6.6
Doubletree Suites	30,000	2,880,814	3,360,949	—	—	—	6,271,763	6.5
Embassy Suites	150,000	3,841,085	120,034	3,360,949	—	—	7,472,068	7.8
Guest Quarters Suites	30,000	2,880,814	3,360,949	—	—	—	6,271,763	6.5
Hawthorn Suites	120,000	3,841,085	2,400,678	—	—	—	6,361,763	6.6
Hilton Garden Inn	55,000	4,801,356	1,920,461	960,271	584,371	—	8,321,459	8.7
Hilton Inn	55,000	4,801,356	1,920,461	—	584,371	—	7,361,188	7.7
Hilton Suites	55,000	4,801,356	1,920,461	960,271	584,371	—	8,321,459	8.7
Holiday Inn Crowne Plaza	120,000	4,801,356	1,178,691	1,920,542	502,341	19,600	8,542,530	8.9
Homewood Suites	90,000	3,841,085	—	3,841,085	—	53,700	7,825,870	8.1
Marriott	90,000	7,487,115	359,708	960,271	614,574	—	9,511,667	9.9
Omni	50,000	2,880,814	—	3,360,949	—	—	6,291,763	6.6
Preferred Hotels	19,000	390,000	1,008,285	—	—	12,950	1,430,235	1.5
Radisson	45,000	3,841,085	419,659	3,760,624	389,683	139,886	8,595,937	9.0
Sheraton	60,000	4,801,356	1,199,519	960,271	385,599	284,768	7,691,514	8.0
Sheraton Suites	150,000	5,761,627	1,043,436	960,271	384,099	254,793	8,554,226	8.9
Westin	50,000	4,801,356	960,271	1,920,542	623,493	90,000	8,445,662	8.8

Exhibit 18-6 Summary Percentages Over the Past Five Years



» 18.08 HOTEL FRANCHISE SELECTION PROCESS

The selection of an appropriate franchise affiliation is one of the most important decisions to be made during the entire hotel development or acquisition process. The chain affiliation of a hotel affects the property's image, market orientation, ability to benefit from referral business and a central reservation system, ability to compete in the local market, potential for future competition, and ability to generate profits. A poor choice of franchise can seriously affect the competitiveness of a hotel and its ultimate profitability and financial success.

[1] Market Study and Appraisal

Selecting a hotel franchise is essentially a matter of first identifying what sort of hotel represents the highest and best use of a property and then determining which hotel chain affiliation would best complement the type of hotel chosen. The key to determining the highest and best use of a property is a thorough market study and appraisal. As described earlier, a market study and appraisal is an evaluation of the market potential of the subject area. Based on the locational and competitive factors determined to be influencing the subject property, recommendations are made in the study regarding market orientation, types of facilities required to cater to this orientation, and the appropriate class or level of quality for the facility. Once these characteristics have been determined and the highest and best use established, appropriate franchise affiliations can be investigated on the basis of their ability to complement and create demand for the subject property.

Developers should evaluate the important factors regarding franchises before proceeding to the next step in the selection process. The first factor that should be

considered is that a hotel chain will not consider granting a franchise that will be directly competitive with another lodging facility that it owns, manages, or has franchised in the same market area unless there is sufficient existing and unaccommodated room-night demand. The presence of a competitive property within the market should not deter a potential franchisee from investigating whether the franchisor will consider a franchise application. In some cases, a franchisor may be considering the termination of a franchise, which could mean an available opening for a new property. However, the presence of another property in the same market area should alert the hotel owner to research other franchise opportunities.

The second factor to be considered is whether or not a franchisor has any properties in the feeder cities to the subject's market area. It is important from a marketing point of view that a franchisor have representation in the cities that will provide demand to the subject property's market area. Familiarity with a product often influences the selection of a lodging facility.

[2] Analysis of Suitable Franchise Affiliations

Once several suitable franchisors have been found, the prospective franchisee should contact the appropriate franchise salespeople and request a copy of their company's UFOC. This document will contain a wealth of information, but additional investigation will probably be necessary. The following checklist contains questions that the prospective franchisee should ask in order to properly evaluate a franchise affiliation and make a suitable selection.

- ☐ How long has the chain been in business?
- ☐ Is the chain growing?
- ☐ How many properties did it have five years ago?
- ☐ How many properties does it have at present?
- ☐ How many properties is it expected to have two, five, and ten years from now?
- ☐ How many properties are owned, managed, or franchised by the chain?
- ☐ Has the product or concept been market tested?
- ☐ How many franchises were terminated over the last five years?
- ☐ What were the reasons for terminating these franchises?
- ☐ What are the names, addresses, and phone numbers of franchisees that can be contacted for references?
- ☐ What percentage of the chain's properties are up-to-date in design, and what percentage are currently being refurbished?
- ☐ How many reservations per property does it produce, on an annual, monthly, and weekly basis?
- ☐ Does it tie into airline reservation systems?
- ☐ How effective is the reservation system for other properties in the market area? For similar properties outside the market area?
- ☐ What types of reservation reports are available?
- ☐ What is the typical percentage of no-shows from the reservation system?
- ☐ What is the operating performance of other chain hotels within or near the

subject's market area?

- ☐ What services are offered by the franchisor? Is there an additional charge for these services?
- ☐ What is the chain's reputation among travelers?
- ☐ Does the franchisor sell franchises only to individuals it considers qualified?

[3] Negotiation of Final Terms

Because a franchisor is generally required to amend the UFOC whenever any important terms of a franchise agreement are changed, most hotel chains will not negotiate variances to their standard agreement. Occasionally, however, some additions and modifications such as the following can be obtained.

Exclusive territory. Sometimes franchisors will grant exclusive territories to franchisees who promise to develop a certain number of properties in the area within a specific period of time. Having franchise control over a geographic region often creates value for the holders of these exclusive territories, who can sometimes sell the franchise rights to others.

Protected areas. Franchisees are sometimes able to negotiate an agreement by which the franchisor cannot own, manage, or franchise another property within a specified geographic area for either a certain period of time or until a certain level of operating performance has been achieved at the franchisee's property (e.g., occupancy over 70 percent for two consecutive years). A protected area is an important benefit if it can be obtained from a franchisor.

In regard to the final selection of a franchise company, potential franchisees should strive to make their choice as early as possible in the development or acquisition process. Because most franchisors have specific requirements for layout, design, quality, and furnishings, it is advantageous to involve the franchisor before any architectural plans or specifications are made. The franchisee should always ask for an exclusive area, since this technique is an effective means of prohibiting new competition. If the franchise chain that is chosen is new, the franchisee should ask for reduced fees until the chain reaches a certain size. Finally, since the reservation system is one of the key elements to a franchise affiliation, the franchiser should try to obtain some guarantee that the system will be effective and generate actual room-nights for the facility.

» 18.09 FRANCHISE AGREEMENTS

Once an offer to grant a franchise has been made by the franchisor and accepted by the franchisee, a contractual agreement is drawn up that details the responsibilities of the two parties. The general provisions of franchise agreements typically provide an overview that attempts to make the franchise system and concept appear to be unique so the franchisor can consider the license it grants (the franchise) to be proprietary. Most licenses for franchises are granted for a specific location, so the franchise agreement should include a description of the exact location of the hotel. If the franchisor allows a restricted area, the details of this area should be contained in the agreement.

[1] Term of Agreement

Hotel franchise agreements typically range from ten to twenty years. Sometimes they provide extensions at the option of the licensee. Franchisees should seek a term for as many years as possible if they have the ability to freely terminate the franchise should the benefits it generates not measure up to expectations of the franchisee. If there is a cost associated with termination, the franchisee should ask for short terms with several options to extend. Most lenders want franchise terms to extend over the life of the mortgage on the property. In addition, lenders generally want the right to either terminate or take over the franchise for the remaining term in the event of a foreclosure. Mortgagee provisions of this kind are known as "comfort letters."

[2] Proprietary Information

Most franchisors consider all of the publications and written material that they generate for the benefit of their franchise holders to be proprietary. These include operations and training manuals, educational material, conferences and seminars, methods, techniques, formats, specifications, procedures, architectural plans, and so forth. Franchise agreements generally stipulate that this information must be treated confidentially and that its disclosure must be limited.

[3] Relationship of Parties

All parties to a franchise agreement are considered independent and are not able to bind each other. To limit liability, most franchisors stipulate in their franchise agreements that signs be posted at the front desk stating that the hotel is independently owned and operated under a license with the franchisor. Franchisors generally require indemnification from their franchisees for any claims or actions brought against them.

[4] Hotel Image and Operating Standards

One of the most important sections of a franchise agreement is the one containing provisions regarding the maintenance of a hotel's image and general operating standards. These provisions relate to franchisor control over not only the physical quality of a lodging facility, but also the level of service and guest satisfaction. Franchisors generally require contract provisions that allow them to monitor the condition and appearance of the hotel and to establish standards for grading compliance. Some chains insist on requirements that hotels that hold their franchises be upgraded at regular intervals so that they remain in conformance with company standards. If alterations are to be undertaken or if the hotel must be rebuilt after a casualty or condemnation, the franchisor will generally want the right to approve plans and specifications. In order to control the quality of furnishings, equipment, and supplies, franchisors also often develop strict specifications that must be followed when purchasing, including the use of approved vendors. Operational procedures are controlled by setting forth requirements in the agreement that the franchisee follow the standards established in the operating manuals provided by the franchisor. Operating standards

also generally include restrictions regarding the franchisee's operating competing hotels, diverting business, employing company personnel, and working for another franchisor. Insurance coverage is another important operating standard for franchisors, so they include provisions related to the amount and types of insurance that must be carried by the franchisees in the agreement.

[5] Training and Guidance

Hotel chains generally require some form of training or orientation for senior level management in order to familiarize personnel with the various systems, procedures, programs, and policies developed by the franchisor. The franchise agreement should specify the nature of this training, which can range from regular classes conducted by the franchisor at an educational facility to simple training manuals. A certain amount of ongoing guidance and consulting is also normally provided, but if the time involved in these activities becomes excessive, the franchisor will usually require a fee.

[6] Reservation Systems and Advertising

Most franchised hotel chains offer some form of reservation or referral system that is paid for either by the continuing franchise (royalty) fee or by a separate reservation fee that is stipulated in the franchise agreement. A reservation fee can be assessed on the basis of a percentage of rooms revenue or on some other formula related to the number of reservations received. Some hotel chains establish advertising funds to be used for such activities as national or regional advertising and specialized marketing. Most of these funds are established and administered by the franchisor, but are funded by the individual hotels within the chain.

[7] Fees

As noted previously, most franchises require prospective members to pay an initial license application fee. The amount and details of the fee should be set forth in the franchise agreement. The license application fee is generally payable upon application and is considered earned by the franchisor when the application is approved. The agreement should specify the procedure to be followed if the franchise is not approved. For example, a percentage of the fee may be retained by the franchisor to offset the cost involved in processing the application.

[8] Reports, Inspections, and Audits

Most franchise agreements establish the right of the franchisor to inspect the books, records, and financial reports of the franchisee, particularly if the franchise fee is based on a formula tied to the financial operating results of the franchisee. Provisions relating to the types and timing of reports that must be submitted to the franchisor are set forth in this part of the agreement.

Franchisors periodically inspect the properties in their chains to determine whether the standards set forth in their franchise agreements are being maintained. If it is necessary to verify the accuracy of the financial data, a franchisor usually has the right to conduct an audit.

[9] Assignment

A franchise can be assigned by either the franchisee or the franchisor, and while both parties will generally want the right to freely transfer the franchise, usually, only the franchisor has the ability to do so. The franchisee must request approval in accordance with the franchise agreement.

Naturally, the primary concern of the franchisor is to maintain the chain's level of quality, so a new franchisee must be closely reviewed. Franchise agreements generally set forth the basis for approving an assignment as well as the procedure for notification. Some franchisors require that a property be brought up to current standards before it can be assigned, which can entail a substantial expenditure and thus make the property more difficult to transfer. Most franchisors want the right of first refusal in the event they might desire to acquire the property upon a contemplated transfer.

[10] Termination

Most franchise agreements do not permit the franchisee to terminate the agreement before the end of the term. If the agreement is terminated, the franchisee generally has to pay damages to the franchisor that usually amount to two to three times the franchise fee paid over the past year. Since the cost of terminating a franchise can be expensive, it is important for franchisees to make a good initial selection in order to reduce the chance of an early termination.

Most franchise agreements grant the franchisor extensive rights regarding franchise termination. Some of the more common termination provisions include failure to open the property; failure to operate the property; failure to have proper moral character; violation of a law or ordinance; bankruptcy; failure to maintain insurance;
failure to pay franchise fees; and failure to comply with franchisee agreement. In most instances, the franchisee has a right to cure the default before the franchise is terminated.

Franchise agreements generally establish certain obligations on the part of the franchisee in the event that the franchise is terminated or expires. Some of these obligations are: payment of all monies owed to the franchisor including liquidated damages, if appropriate, and removal of signs, systems, marks, and identity items. Some franchise agreements even require that the telephone number of the hotel be returned to the franchisor.

The selection of an appropriate franchise affiliation affects a property's ability to compete in the local market, generate profits, achieve a certain image or market orientation, and benefit from referral business. Because the success of a hotel is predominantly based on the cash flow it generates, owners and lenders must quantitatively measure the benefits and services of a national affiliation against the total cost of such a commitment.

Continued brand recognition, consistency, and franchisor staying power also are important factors in an owner's or lender's decision to add or change a franchise affiliation.