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When the 775-room New York Helmsley Hotel in midtown Manhattan went up for sale, Host Hotels & Resorts snapped it up for US\$313.5 million. In May, Pebblebrook Hotel Trust shelled out US\$137 million for the Mondrian Los Angeles, an iconic boutique hotel in West Hollywood.

To say the market for hotel purchases in key U.S. cities has been rapidly heating up over the past year is no understatement. Capitalizing on the combination of eager buyers and improving performance metrics in these markets, hotel owners have in many instances conducted bid processes to sell their hotels, attracting a range of potential purchasers, from REITs to real-estate private equity funds to foreign investors.

Bidders in these transactions compete not only on price but also on the terms of the purchase-and-sale agreement, or PSA. Frequently, the top bidders are required to submit a marked-up version of the PSA provided by the seller with their final bids, and sellers take into account the proposed PSA terms when determining the winning bidder.

Traditionally, PSAs afforded buyers a 30- to 60-day period to conduct due diligence before posting a non-refundable deposit and permitted termination of PSAs without liability in the event it was not satisfied with its due-diligence investigation for any reason. That standard has changed in recent competitive bidding situations. The bid process pressures potential purchasers to shorten or eliminate altogether the due-diligence period to stay competitive with other bidders, resulting in some cases in PSAs that require a non-refundable deposit on the day the PSA is signed with no buyer right to terminate based on its due diligence investigation.

A buyer might be forced to accept a shortened due diligence period to stay competitive in the bid process, but nonetheless they must conduct a thorough due diligence investigation before becoming contractually obligated to purchase the hotel. Following are some suggestions for managing a shortened due-diligence period:

- **Targeted due diligence requests.** Sellers of hotels frequently establish websites that include due-diligence materials. As soon as possible, assess what is available on the data site and provide a targeted list of supplemental due-diligence items to be reviewed as part of the due diligence process. The more targeted—and less generic—the list is, the better the chance that the requested items will be provided promptly. Focus on diligence items that tie back to the fundamentals of the underwriting of the deal. For example, deep knowledge of the hotel's sources of business and terms of the current management/franchise agreement are critical for purchasers looking to rebrand a hotel; and zoning and land use diligence would be a priority if redevelopment of the hotel were under consideration.
- **Leverage existing reports.** Many hotels being sold in this cycle were purchased or financed during between 2005 and 2007, with a full set of due-diligence reports prepared at that time (e.g., property condition reports, environmental reports, surveys, zoning reports). Request copies of the existing reports. Often, the consultant that prepared the existing report can update the report in less time—and at lower cost—than a consultant new to the

property.

- **Request estoppels early.** Many hotels are sold encumbered by a brand management or franchise agreement and also may be subject to a lease with a third party for the operation of a restaurant or spa. These agreements are critical to the operation and financial performance of the hotel, and a purchaser does not want to step into an existing dispute with a manager or tenant. Ask the seller to request an estoppel from the manager/tenant certifying that there are no defaults early in the process, so the estoppel is in hand by the time the due diligence period ends.
- **Maintain liquor license.** It is critical to the operation and profitability of virtually all full-service hotels that the service of liquor not be interrupted upon a sale of the hotel. State liquor laws vary widely when it comes to hotel sales. For example, some permit the hotel to continue to operate under the seller's license for a transitional period after the closing, while others require the new owner to have its own liquor license at the closing. In other instances, the hotel manager may hold the liquor license. Determine early in the process who holds the current liquor license and whether an interim beverage arrangement will be permitted and, if not, how long it will take for a liquor license to be issued to the purchaser. Document the timing and process in the PSA.
- **Escrow holdback.** Due diligence might reveal a problem with the hotel, such as a construction defect or American with Disabilities Act compliance issue, but a shortened diligence period may not provide adequate time for the buyer and seller to assess the scope of the problem and the cost to correct it. The buyer may propose a holdback from the purchase price to be held in escrow to cover the cost of repair; if the repair ultimately costs less than the holdback amount, the excess is refunded to the seller.
- **PSA terms.** A buyer may mitigate some of the risks created by a shortened due diligence period through the PSA terms. While the addition of extensive representations and closing conditions to the PSA will make a potential buyer's bid less competitive, carefully crafted representations and conditions may be acceptable to the seller. For example, a representation that requires the seller to identify all contracts relating to the hotel with a cost/value in excess of a specified dollar amount per year permits the potential purchaser to focus on the most material contracts. Also, a potential purchaser may add receipt of an estoppel from the hotel's manager as a closing condition, if the estoppel will not be received before the end of the due diligence period.

Today's competitive bidding situations increasingly require purchasers to agree to an accelerated due diligence period. In the face of this market reality, the potential purchaser must develop and execute a streamlined and focused strategy to ensure a thorough due diligence investigation before committing to purchase a hotel.

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