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Hotels: Basics for the Real Estate Practitioner, Part 1

By Robin Zeidel

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Those of you who practice traditional “dirt” real estate may periodically come across a transaction involving hotels. When you do, you should be aware that hotels are quite different from other real estate asset classes. They involve many unique legal issues and norms and are the subject of hotel-specific case law and statutes.

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First and foremost, it’s essential to recognize that a hotel is an operating business. The real estate aspect of the asset is often a secondary consideration. Unlike a shopping center or multifamily development that relies on long-term leasing for revenue, typical transient hotels have few, if any, long-term occupants or fixed recurring income sources such as rent. Accordingly, each night there is the equivalent of potentially hundreds of one-day space agreements, with room rates that fluctuate based on the calculations of dedicated revenue managers. Further, amenities such as food and beverage, event space, and spas do not secure their space with a lease. Instead, they usually operate under management and consulting arrangements.

In some cases, the ownership, operation, and branding of a hotel property all reside within a single company or affiliated companies. But that is becoming increasingly rare. These roles are now generally split among various unrelated parties. Over the last few decades, hotel companies that once owned their real estate shifted to an “asset light” model, selling their real estate to third

parties or spinning off a separate real estate investment trusts (REIT) or other structures to hold the real estate. Most hotel companies with household names own little real estate and usually function as an operating company or a franchisor providing only the day-to-day management and/or branding of someone else's real estate.

The ownership of a typical hotel may be structured in a number of different ways:

- **Scenario 1.** One party owns the real estate and enters into a contract with the owner of the brand to operate the property with its employees under a hotel management agreement (HMA). HMAs typically give the hotel manager discretion and control over the day-to-day operation of the asset. For example, for a Sheraton-branded hotel, the owner would enter into an HMA with Marriott.
- **Scenario 2.** Instead of having Marriott manage the property, the real estate owner above licenses the Sheraton brand under a franchise agreement with Marriott. Under the agreement, the hotel brand does not directly control daily operations or provide the on-site employees, but the owner is obligated to comply with its brand standards. Even so-called "soft brands," which are a collection of distinct properties that benefit from the reservation system and loyalty program of a reputable, known company, such as Curio Collection by Hilton, have brand standards. The owner then hires a hotel management company that specializes in operating hotels in accordance with brand standards.
- **Scenario 3.** If the real estate owner does not want its hotel associated with a third-party brand, it can either operate the hotel itself or hire a management company. These are referred to as "independent" hotels. The owner may affiliate its hotel with an established group, such as Preferred Hotels & Resorts, Small Luxury Hotels of the World, etc., to leverage brand recognition and other support, or the owner will rely on online travel agencies, such as Expedia, to drive business.

As an attorney, it is vital to understand your client's role in the project, how the asset is structured, and the various stakeholders to protect your client while appreciating the concerns of the rest of the team, including equity investors and lenders within the tiers of the capital stack. Coordination is also required between hotel management and each of the amenities operators that could be retained by the hotel owner or the hotel manager.

In our next installment in this series, we will address the purchase and sale of a hotel property.

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Authors



Robin Zeidel

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Robin Zeidel is the founder of Zeidel & Associates P.C., a transactional law firm that represents developers and owners of hotels, restaurants, and office buildings. She can be reached at rzeidel@zeidellaw.com.

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