

# Structuring Liquor License and Other Permit Clauses in Hotel Purchase and Sale Agreements

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# Structuring Liquor License and Other Permit Clauses in Hotel Purchase and Sale Agreements

The negotiation and structure of permit and license clauses in hotel purchase and sale agreements.

Thursday, September 27, 2018  
10 am Pacific | Noon Central | 1 pm Eastern

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# Why is the negotiation and structure of permit and license clauses important in hotel purchase and sale agreements?

- Permits are, of course, what permit any business operation to operate.
- There are, generally speaking, two different kinds of permits:
  - Permits which “run with the land”
  - Permits which are personal to the holder
- Permits which “run with the land” are permits such as occupancy permits, elevator permits, pool permits, boiler permits, etc. which are dependent upon the condition of the item being permitted, rather than the holder.
- Permits which are personal to the holder are permits such as business licenses, retailer’s tax registrations, and, most notably, liquor licenses.
- In most full-service hotels, liquor is a key amenity and is everywhere – restaurants, bars, mini-bars, etc. – and represents a significant revenue source. Liquor margins can be as high as 80% - 85%.
- Any purchaser of a hotel is therefore very interested in being able to replace or transfer the permits which are personal to the holder.

# Permits

- Permits such as business licenses and retailer's tax registrations tend to be ministerial – they are simply issued in the ordinary course of business upon submission of a completed application and payment of any fees
- A liquor license permit application is anything but ministerial.
  - Most jurisdictions tightly control the issuance of liquor licenses and the applicable “alcoholic beverage commission” (ABC) – or equivalent – demands disclosure and due diligence.
  - Jurisdictions can include not only state ABC's but also local ABC's at county and/or municipality (city or town) levels.

# Alcohol Beverage Permit Applications

- Alcohol beverage permit applications can take various forms, depending on the nature of the purchase and sale agreement.
  - Is the purchaser buying the property that owns or manages the alcohol beverage business or is it buying the equity of the company/entity that owns or manages the alcohol beverage business?
  - If the purchaser is buying the property, it usually means the purchaser must file an application to transfer the existing alcohol beverage permit or obtain a new permit.
  - If the purchaser is buying the equity of company/entity, it usually means the purchaser has to file an application for a full ownership change or a “change in control.” (Although, in some jurisdictions, an ownership change may still require a transfer or new permit application.)

# A Brief History of Liquor Regulation in the United States

- Prohibition began with the passage of the Eighteenth Amendment to the United States Constitution in 1919. From 1920, the manufacture, sale, or importation of liquor in the United States was prohibited.
- The Twenty-First Amendment to the United States Constitution was ratified in 1933. It repealed the Eighteenth Amendment.
- However, the Twenty-First Amendment left it to each state to regulate the importation of alcohol beverages into, and the sale and distribution within, each state (and left it to each state to decide even if they were going to remain “dry” or become “wet”).
- As a result, states have varying approaches to the licensing for sale of alcohol beverages at hotels, including:
  - How to license hotels
  - The types of permits or licenses required
  - The variety of permits required (such as different permits for different types of alcohol beverages - beer/wine/distilled spirits or different permits for different areas of the hotels or for in-room mini-bars)
- In addition to state regulation, counties and/or municipalities may also regulate liquor sales

# Hotel Purchase and Sale Agreements

- Hotel Purchase and Sale Agreements are in many respects like any other purchase and sale agreement for the transfer of land and improvements
- The Purchase and Sale Agreement should set out key terms such as purchase price, due diligence period, closing date, representations and warranties, conditions, and covenants
- Hotel Purchase and Sale Agreements are unique, however, in certain respects because they represent the purchase and sale of an operating business, and therefore need to consider:
  - The status and disposition of a third-party management agreement and/or franchise agreement
  - Covenants on how operations will continue during the pendency of the Purchase and Sale Agreement
  - Conditions to closing unique to hotels (e.g. management or franchise approval)
  - The Purchaser's obligations with respect to licenses and permits necessary to keep the business operating after closing, and what happens if the Purchaser doesn't obtain necessary permits

# As a Seller, Why Do I Care About My Purchaser's Licensing Issues

- While licensing issues are, generally speaking, a Purchaser's obligation to satisfy, a Seller will want to know the Purchaser will be successful in obtaining necessary licenses.
- Besides purchase price, a Seller will want certainty of closing
  - Note, however, unless negotiated otherwise, it is generally left to the Purchaser to bear the risk that they are qualified to hold an alcohol beverage license

# As a Seller, Why Do I Care About My Purchaser's Licensing Issues, continued

- A Purchaser who cannot operate a hotel after closing will likely not proceed to closing. For a Purchaser, it's better to put earnest money at risk by not closing, than to put the entire purchase price at risk by not being able to operate.
  - No one wants to operate a hotel which previously has sold and served alcohol beverages and operates restaurants (and bars) without being able to continue to sell alcohol beverages for any period of time, even if brief
  - Service of alcoholic beverages is an important amenity and there is a lot of profit in alcohol beverage sales. Restaurants in the which do not have an alcohol beverage license will lose business.
  - Without proper alcoholic beverage licenses, the hotel also cannot operate its mini-bars, provide room service, or even provide complimentary alcohol beverage service.
- A lender or joint venture partner or other provider of capital will likely not permit a Purchaser to complete the purchase of a hotel which does not have the proper licenses to operate. They similarly do not like to see a hotel go dry. It devalues the business and/or impacts their investment.

# The Purchaser's Difficulty in Negotiating License Provisions in a Hotel Purchase and Sale Agreement

- At the early stages of a transaction, a Purchaser likely will not know the details of how to apply for a new liquor license or what disclosures are required.
- A Purchaser may not even know who the liquor license holder is for the hotel.
  - It could be the Seller
  - It could be an entity related to the Seller
  - It could be the property manager
  - It could be a related entity to the manager
  - It could even be an altogether unrelated third party
- A Purchaser may not know, at the negotiation stage, whether the Purchaser wants to hold the liquor license, have a related entity hold the liquor license, or have its property manager or unrelated third party hold (or continue to hold) the liquor license.
- Many Hotel Purchase and Sale Agreements therefore will use general language not wholly tailored to the specific jurisdiction or even to the specific transaction.

# Crucial Terms of a Hotel Purchase and Sale Agreement for Liquor License Issues

- The Seller's liquor license is not always an asset being purchased by Purchaser. However, when it can be purchased and transferred by the Seller to the Purchaser it has significant value that can be included in the purchase price.
- It is Purchaser's responsibility to apply for a new liquor license (or transfer the license or the ownership of the license).
- Seller shall cooperate in a commercially reasonable manner, at no cost or expense to Seller, with Purchaser in connection with Purchaser's applications for Purchaser's liquor license.
  - In many states, in which the license is "transferred" by the Seller to the Purchaser, the Seller as the "transferor" of the licensee must file certain documents or sign off on the application forms.
  - In some states, such as California, the Seller and Purchaser must enter into a specific alcohol beverage "escrow" for the purchase and transfer of the alcohol beverage license from the Seller to the Purchaser (the escrow is designed to protect certain of Seller's creditors who can seek payments out of funds equal to the value of the license that are escrowed)

# Crucial Terms of a Hotel Purchase and Sale Agreement for Liquor License Issues, continued

- Purchaser must file an application for Purchaser's liquor license prior to the Closing and with sufficient time to obtain the Purchaser's liquor license as of the closing.
  - In some states, a "temporary" permit can be obtained at the time of filing the license application or soon after to allow the Purchaser to commence operating while the state and/or local licensing authority processes the application for a permanent license
- Alternatively if necessary, because in some states the ability to get an alcohol beverage license or transfer the license can take a considerable amount of time and the parties do not wish to wait for the license to be issued or the transfer approved, the agreement should provide for the Seller to continue to "operate" the alcohol beverage business until the new license is issued or the license is transferred. This usually requires a further agreement known as an "interim beverage agreement" (more about that below)
- It is not a condition to Closing that Purchaser (or its manager) has obtained a new liquor license (or any other licenses in connection with the operation of the hotel).
- Seller makes no representations or warranties as to whether Purchaser will be able to obtain a liquor license.

# Crucial Terms of a Hotel Purchase and Sale Agreement for Liquor License Issues, continued

- Impact of hotel management agreement
  - The hotel management agreement often determines which entity (owner vs. hotel management company) holds the alcohol beverage license and accordingly whether the Purchaser needs to obtain the license.
  - Fee structures vary and often include a management fee based upon a percentage of revenues from operations. Under state law, these arrangements can become problematic if the management company is unlicensed and the calculation of revenues includes net receipts or profits from the alcohol beverage license operations. The design of these types of state law provisions is to prevent circumvention of the state's licensing and investigatory process by third parties in a position to profit from the direct or indirect operation of an alcohol beverage licensed business.

# Crucial Terms of a Hotel Purchase and Sale Agreement for Liquor License Issues, continued

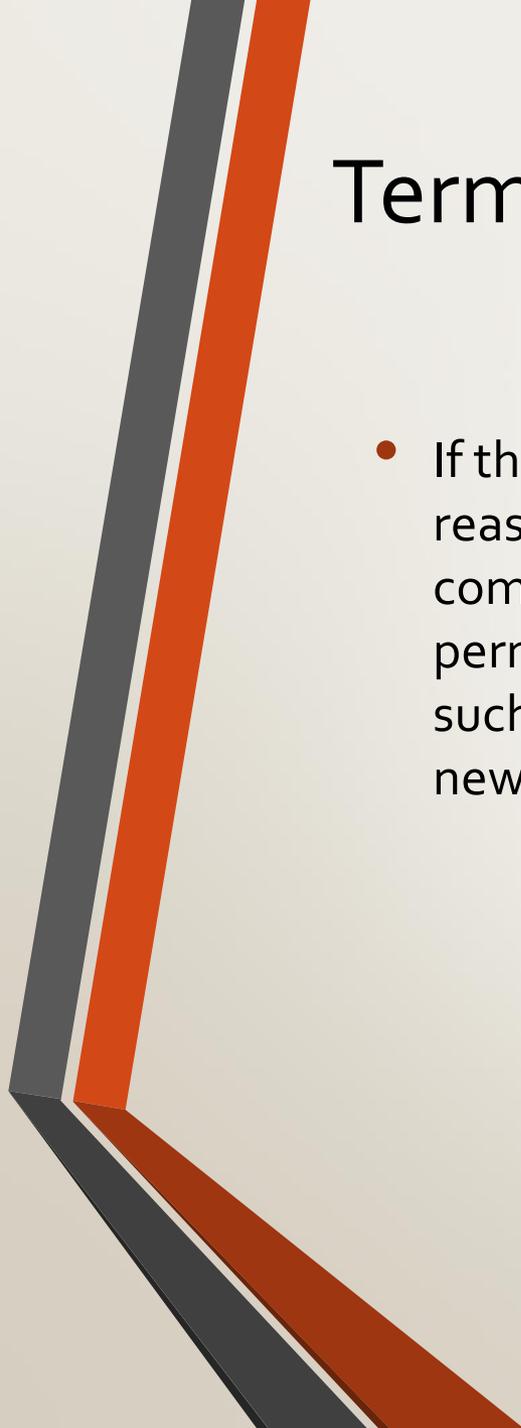
- From Purchaser's perspective, recommended Seller representations and warranties to Purchaser:
  - The licenses are free and clear of all liens, liabilities, encumbrances, and claims of third parties and it has the full right and power to sell and transfer the ownership of the company holding such licenses and the alcohol beverage inventory owned by such company is free of any such liens, liabilities, encumbrances, and claims of third parties.
  - Seller is not in violation of any alcohol beverage laws or regulations and is not aware of any reason why any alcohol beverage regulatory agency should deny the application for change of ownership of the company holding Licenses from it to Purchaser.
  - The Licenses are in good standing, not the subject of any pending or present administrative action brought by the alcohol beverage licensing authority and, to the best of its knowledge, there are no facts or circumstances which have occurred or exist which could result in the filing of any such action.

# Crucial Terms of a Hotel Purchase and Sale Agreement for Liquor License Issues, continued

- Recommended Seller representations and warranties, continued:
  - Seller has complied with all applicable federal, state and local laws, rules and regulations, and regulatory approvals and any other forms of authorization to do business applicable or relating to the Licenses.
  - Seller has paid or provided for all debts and obligations, including without limitation, all state, federal, and local taxes, arising out of or resulting from the conduct of the business conducted under the Licenses.
  - There are no special conditions upon the Licenses that would prevent their transfer to a third party or that would in any way restrict Purchaser in its contemplated ownership and operation of the company using the Licenses.
  - Seller will diligently and in good faith cooperate with Purchaser to effect the transfer of ownership of the company that holds the Licenses or, when applicable, the transfer of the Licenses.
  - Seller's cooperation shall include, but is not limited to, the filing and/or execution of, or causing the filing and/or execution of, any required application forms by Seller for the Licenses.

# Due Diligence Period

- Some Sellers are more sensitive to attention from governmental agencies
- If a Seller has had some less than positive experiences, or is in the middle of a license renewal, a Seller may not want the Purchaser submitting documents to a governmental agency out of a fear of increased scrutiny or simple confusion as to who the applicant is.
- Some Sellers therefore will restrict the Purchaser's ability to communicate, file any application or otherwise commence any procedure or proceeding with any governmental authority for the transfer of any liquor license (including posting or publishing any notices required for the transfer of liquor licenses) prior to the expiration of the due diligence period.



# Termination of the Purchase and Sale Agreement

- If the Purchase and Sale Agreement is terminated for any reason and Purchaser has filed an application or otherwise commenced the processing of obtaining new licenses and permits, the Seller should require that Purchaser withdraw all such applications and cease all activities with respect to such new licenses and permits.

# Interim Beverage Agreements

- If the Purchaser has not obtained a liquor license by closing, what should happen?
- The transaction may fail, but presumably neither the Purchaser nor the Seller want the transaction to fail.
- If permitted under the laws of the particular jurisdiction, a Seller may cause the holder of the existing liquor license to enter into an interim beverage agreement with Purchaser or Purchaser's designee for the continuation of the sale and consumption of alcoholic beverages at the Hotel after the Closing and before such time as the Purchaser (or its designee) obtains a new liquor license.
  - A few states have specific laws or regulations that allow for this but most states begrudgingly have either policies that allow for such an agreement or merely tolerate them and don't bring enforcement actions to prevent or deter them from occurring.
  - There can be "technical issues" in some states if actual control and/or receipt of the profits of the business remains with the Purchaser who could be construed to be "availing" itself of the Seller's license.

# Interim Beverage Agreements, continued

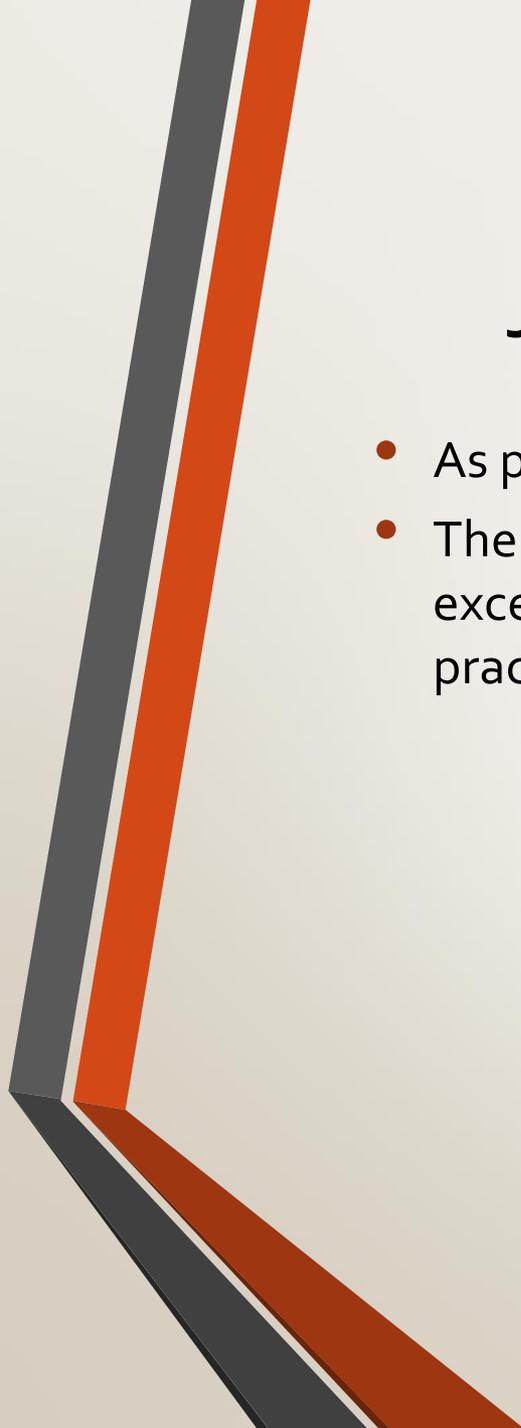
- If necessary, the Seller and Purchaser should use commercially reasonable efforts to cooperate with each other (at no cost or expense to Seller) to obtain any approvals to an interim beverage agreement.
- The interim beverage agreement should be in place only for a defined period (subject to potential extensions).
- The Purchaser should indemnify the Seller for all losses, damages, liability, etc. for anything which happens while Purchaser is operating under Seller's liquor license.
- Control of the business and profits of the business should belong to Seller because it's the Seller's alcohol beverage license
  - Generally, however, a Purchaser and Seller will structure an interim beverage agreement in which there is little or no profit (for instance, an expense such as a management fee equal to all revenues except \$100 or some other nominal amount)

# Regulatory Considerations

- The practice of alcohol beverage law, especially on the subject of licensing, is heavily nuanced by unpublished or “private ruling” interpretations of statutes and regulations.
- For license application process there should be careful consideration of the acquired hotel’s future ownership and management structure with an understanding that such structure will come under close scrutiny.
  - In most states, officers, directors and greater than 10% equity holders will be vetted by the state and local authorities.
  - This process will likely include fingerprinting and background investigations.
  - Some states will also require up the chain corporate ownership disclosure of indirect equity holders with equity ownership in excess of a certain percentage, typically 5% or 10%.
  - For private equity and other investment-type buyers, this may require disclosure of indirect equity ownership well above the direct investment level for a given transaction.

# Regulatory Considerations, continued

- Some Purchasers who seek to obtain or hold interests in alcohol beverage licenses need to ensure that there are no regulatory obstacles to their holding or having such interests.
- Potential foot faults include:
  - Inadequate financial resources
  - State residency requirements
  - Criminal history
  - “Tied-House” issues (simultaneous ownership of interests in manufacturers, importers, or wholesalers).



# Jurisdictional Considerations

- As previously mentioned, State and local oversight.
- The Federal government does not regulate retail licensees except to the extent of manufacturer and wholesaler trade practices.

# Red Flags

- The licensing qualifications
- Pending licensing disciplinary actions or investigations that can hold up transfer of a license or issuance of a new license for the same premises.