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THIS ISSUE

A Note from the Chairs

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Welcome to the August edition of *Foundation,* Blank Rome's real estate newsletter. As the summer comes to an end, we want to take this opportunity to express our gratitude to our clients for trusting our Firm with their most critical legal matters and needs.

Looking back at the first half of the year, we are extremely proud of our real estate group's accomplishments. We are fortunate to have been involved in a number of large and exciting transactions, and are honored that our clients look to us for counsel and advice on such important matters.

Moving into the fall and winter seasons, we look forward to continuing and strengthening our relationships with our clients, and sharing real estate industry news and trends with our *Foundation* readers.

In this issue, we offer articles covering a wide range of topics. Our article on "Buy-Sell Triggers" discusses what should be considered before selecting this common joint venture exit strategy. In "Shopping Center Acquisitions," we provide key insights for purchasers of retail assets. "Casualty under a Lease" explores how "real life" elements of a casualty scenario play out against some typical—and not-so-typical—lease provisions. In "Nuances of Hotel Acquisitions," we lay out the particular distinctions that separate this type of transaction from other straightforward acquisitions. Lastly, "Consequences for Minority Partner Wrongfully Causing Partnership's Dissolution" warns of the potential implications of failing to understand your partnership provisions concerning dissolution.

We also take pride in sharing with you our real estate group's recent new hires, media placements, speaking engagements, and industry recognitions, as well as some noteworthy deals.

We value and cherish our relationship with you. We appreciate your confidence in us and will continue to work tirelessly to help you in every facet of your real estate needs. ◻

Buy-Sell Triggers: When Is a "Buy-Sell" the Right Strategy?

BY COREY TARZIK

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Sophisticated real estate investors form joint ventures with the understanding that they are each entering into the venture with disparate strategic interests, risk thresholds, capital accessibility, and investment timetables. Even presuming good faith among the co-venturers, business disagreements can and do arise from these divergent interests. In order to avoid having these disputes harm the viability of their joint investment, experienced real estate practitioners understand the value of incorporating appropriate dispute resolution and exit strategies into their formal joint venture documents.

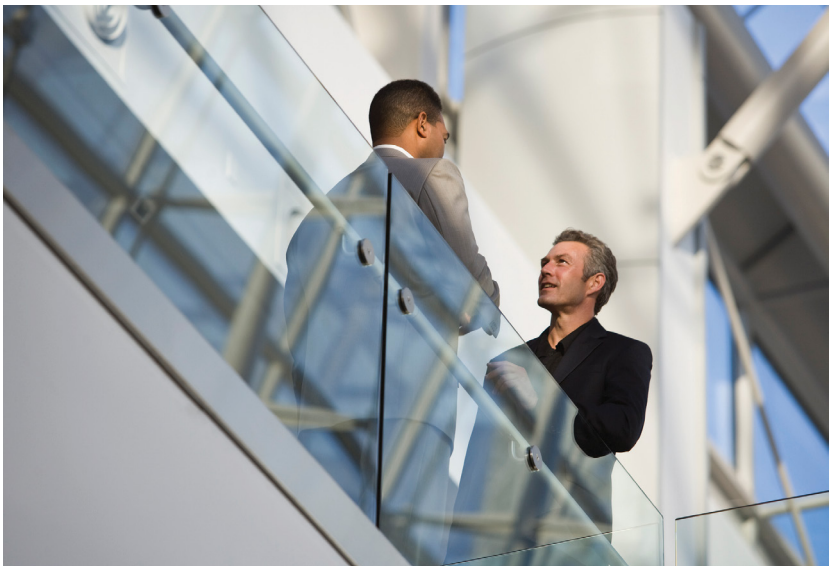
One of the more commonly used exit strategies in real estate joint ventures is the "Buy-Sell." The Buy-Sell has an ancient pedigree (it is recorded in the jurisprudence of the Babylonian Talmud), and is conceptually elegant in its simplicity. Essentially, the Buy-Sell allows either partner in a joint venture to initiate a sales process in which the initiating party may end up as either a buyer or seller of the other partner's ownership interest in the venture. The party invoking the Buy-Sell will formally designate an asset valuation at which the other party will be forced to either sell its ownership interest, or buy the invoking party's interest. Since the Buy-Sell process forces the initiating party to state a single price at which it is willing to both buy and sell, the Buy-Sell is correctly perceived as a fair and equitable procedure for unwinding an investment in which at least one of the participants needs to exit.

The Buy-Sell has other advantages as well. Unlike a forced market sale of the asset to an unrelated third-party, the Buy-Sell allows at least one of the existing partners to retain its ownership of the asset. In addition, the uncertainty of the outcome often encourages the discipline and cooperation needed for the parties to negotiate a mutually satisfactory resolution of their disagreements prior to the Buy-Sell initiation.

When Is a Buy-Sell Not the Right Strategy?

As mentioned, the most apparent advantage of the Buy-Sell is its inherent simplicity and fairness. However, not all real estate ventures are the right vehicle for a Buy-Sell, and it is important to understand when the Buy-Sell is or is not an appropriate strategy for any given investment.

Consider, for example, a partnership in which the majority partner owns 95 percent of the equity and is the sole decision-maker, while the other partner has a passive five percent ownership stake. Insofar as the majority partner has the unrestrained ability to operate, finance, and sell the asset at any time, it has no need for the liquidity or dispute resolution benefits of a Buy-Sell. Conversely, the minority partner's relatively small investment in the venture does not warrant the granting of such a significant right.



For joint venture partners who are about to embark upon a development project, the Buy-Sell poses somewhat of a quandary. On the one hand, business disputes are more likely in development deals than stabilized ones (and potentially more impactful), so co-venturers would certainly appreciate the pressure created by the possibility of a Buy-Sell to resolve

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Buy-Sell Triggers: When Is a"Buy-Sell" the Right Strategy? (continued from page 2)

their differences. On the other hand, development projects often proceed under intense time pressure, and the disruption and time delay inherent in the Buy-Sell process will very likely have a detrimental impact on the project's success.

The Buy-Sell is also not very useful for a venturer who does not have the same capital accessibility or relative buying power as its partner. A financially disadvantaged partner is at risk of having the financially stronger partner manipulate the proposed asset valuation in its favor. In these situations, the financially weaker partner may want to consider alternative exit strategies, such as put options or buy-out rights.

When a Buy-Sell Is the Right Strategy—Some Threshold Questions

For the stated reasons, Buy-Sells are most useful in stabilized deals where the two partners have more or less equal decision-making authority (or are at least constrained by a negotiated set of "major decisions" that require their mutual consent) and more or less equal buying power. But even in this context, there are some threshold questions that prospective partners should consider in light of the unique features of their specific real estate deal and business relationship:

- **Should the Buy-Sell be exercisable at any time, or only following a predefined "lock-out period"?** Unless there are extenuating circumstances, lock-out periods are very sensible insofar as they force the partners to learn to live with each other for a period of time without the hovering threat of a Buy-Sell distorting their respective decision-making processes.

- **Should the Buy-Sell be exercisable for any reason, or only following a "major decision" deadlock?** Stated differently, is the Buy-Sell being utilized as a liquidity mechanism for partners who cannot unilaterally convert their equity into cash, or is it intended only to resolve business disputes?

- **If the Buy-Sell is only applicable following a "major decision" deadlock, should there be formal procedures put into place before one party is entitled to initiate the Buy-Sell?** Mandatory meetings, submission of written proposals and supporting documentation, and a required "cooling off" period are prudent strategies to implement to ensure that there is a healthy dialogue among the partners before one of them precipitously and irrevocably triggers the Buy-Sell.

- **What type of "major decisions" should trigger a Buy-Sell?** Joint venture agreements often contain a lengthy list of "major decisions" encompassing many operational and strategic matters relating to the business of owning the real estate and operating the partnership, but only a deadlock about a certain subset of those matters justifies the dramatic intrusion of a Buy-Sell. For instance, although partners may agree that adopting an annual budget requires mutual consent, it does not necessarily follow that any dispute about the budget should trigger a Buy-Sell right. The more considered approach is to overlay the "major decisions" with "materiality" standards that warrant a Buy-Sell (*e.g.,* only disputes implicating 10 percent of the total budget trigger a Buy-Sell right). Similarly, in portfolio deals, it may be prudent to limit the applicability of the Buy-Sell to disputes impacting a certain percentage of properties in the portfolio.

> ► Essentially, the Buy-Sell allows either partner in a joint venture to initiate a sales process in which the initiating party may end up as either a buyer or seller of the other partner's ownership interest in the venture.

Conclusion

The Buy-Sell can be a very effective tool to encourage good conduct and fair dealings between partners, both during the term and at the unwinding of the venture. But investors and their attorneys should be wary of employing a "one size fits all" approach when incorporating the Buy-Sell into their venture documents. Rather, to ensure that their investment expectations are being met, the triggers allowing the venture partners to exercise the Buy-Sell should be carefully calibrated to the exigencies of their particular deal and business relationship. ◻

Shopping Center Acquisitions: 5 Key Points from a Purchaser's Perspective

BY DAYNA C. FINKELSTEIN

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We live in a time when online shopping has become an integral and natural part of our consumer experience. Despite this new normal, brick and mortar retail developments continue to thrive nationally, remaining a popular asset as the subject of real estate acquisitions. Retail acquisitions tend to have an added layer of complexity due in part to the nature of this asset class, and in part to the intricacies of retail leasing, including the complex relationship among retail tenants occupying space within the same shopping center. The following discussion sets forth five key points to keep in mind when you purchase a retail asset.

1: Included and Excluded Property

It is crucial that you know exactly what you are purchasing. Legal descriptions for retail assets are frequently the product of a larger historical legal description, shrinking over time due to outparcel sales, condemnations, or the subdivision of a larger area. Analyzing and tracing the legal description for the property, sometimes thought of as a purely legal task, is an important first step in any retail acquisition and often bleeds into a business discussion. This exercise will determine which parcels are included and which parcels are excluded from the contemplated purchase, and help determine which land should be insured in your title policy and shown on your survey of the property. Outparcels, or smaller lots often surrounding the larger center, may or may not be a part of the property that you are purchasing. It is important for you to determine whether the legal description is consistent with your understanding of what you are purchasing. Where adjacent or nearby outparcels are not owned in common with the remainder of the center, you can expect to find reciprocal easement and operating agreements between the outparcels and the property being purchased, laying out, among other things, the division of common area maintenance obligations for each respective property.

2: Use Restrictions

More so than other asset classes, underlying tenant leases and title documents for retail assets will contain a multitude of use and/or radius restrictions. Recorded use restrictions are often tucked into memoranda of leases or reciprocal easement and operating agreements encumbering the property. Such restrictions may grant exclusive use rights to a tenant who wants to preclude competition from other tenants in the same shopping center, or prohibit categories of other uses at the center that might be objectionable, incompatible, or overly burdensome on available parking. A similar type of use restriction is a radius restriction, which prohibits a particular use within the shopping center if it is within a certain distance of another use. Other radius restrictions go one step further, restricting leasing activity at any other centers within a certain distance from the subject property if those other properties are owned by the same party or any of its affiliates. The purpose of this type of radius restriction is to prevent competing users from operating in close proximity.

A violation of a use restriction may be difficult to remedy in the course of your transaction. Where the violating tenant is paying rent timely and is otherwise operating at the center without complaint from other tenants, it is unlikely that the seller will proactively police itself by forcing the violating tenant to cease operations and vacate the property as a result of this violation. In all likelihood, you would also not want the seller to exercise this remedy. The alternative for you is to be reactive and address this issue at the time (if ever) an enforcing tenant raises it. However, even where a practical solution is limited, you may view an existing violation as increasing your overall risk in the transaction, as tenants do have real rights and remedies under their leases with respect to use violations, which may be exercised in the future. Absent an express consent to such violating use, you should seek a clean tenant estoppel certificate from the tenant who has the right to enforce the violation, and also review the enforcing tenant's lease to determine whether the violation allows the tenant to reduce its rent or, more drastically, terminate its lease.

Identifying existing use restrictions is also important for determining what leasing activity is permissible at the center going forward, following your acquisition. You should review carefully any use restrictions appearing in title documents, in addition to those contained in unrecorded leases. Note that in addition to use restrictions, there could be other types of recorded restrictions. Other typical restrictions include those relating to building height, prohibited building areas, required parking ratios, and required setback lines. These types of

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Shopping Center Acquisitions: 5 Key Points from a Purchaser's Perspective (continued from page 4)

restrictions often exist separate and apart from, and may be more or less onerous than, the requirements imposed by the applicable zoning code.

3: Co-Tenancy Rights

In addition to use restrictions, another example of the interplay among tenants at a retail center is the co-tenancy rights under their leases. For example, if an anchor tenant goes out of business or otherwise ceases its operations at the center, this event may allow other tenants to exercise various remedies under their leases, such as paying a reduced rent. The rationale for this rent reduction is that the anchor tenant's presence helps increase foot traffic at the center, generating more business for the other tenants. You should determine whether tenants at the center have co-tenancy rights tied to the anchor tenant's success, so you can foresee any ripple effect from an anchor tenant's closure that may lead to the center's declining financial performance.

4: Future Developments

If you contemplate selling an outparcel or other portion of the center, then your due diligence before closing should address the following questions, among others:

- Is the portion subdivided from the rest of the center?
- If it had to stand alone operationally, could it do so, or would it need additional utility or other easements?
- Does it have its own access and parking or is it reliant on the larger center? If it is reliant, are the access and parking covered by existing agreements or will new agreements be required?
- Can the portion stand on its own from a zoning perspective?
- Should the portion be encumbered by new mortgages or should it be excluded?
- Should you acquire the portion with the same entity acquiring the rest of the center, or should you use a different entity for tax or other reasons?

It is also important to anticipate what your lender may require with respect to possible subdivision, easement, or other beneficial agreements that may be put in place following your acquisition. For example, the loan agreement may prohibit you from entering into an easement agreement without the lender's prior written consent. You should consider requesting that this consent requirement be deleted or, at least, that the lender not unreasonably withhold its consent.

5: Ongoing Work

This last issue is not specific to retail acquisitions, but is significant nonetheless. If not appropriately anticipated, issues involving ongoing work can cause delays at critical points in your transaction (often the days leading up to closing, or on the closing date itself). The ongoing nature of leasing activity and particularly the opening of a new tenant's business should raise the question as to whether any work will be ongoing as of closing or completed just prior to closing, and the corresponding question as to how you will obtain a clean title policy that does not take exception for filed or unfiled mechanic's liens resulting from such work. Even where work is completed prior to closing, the issue may still be relevant if the statutory period for filing mechanic's liens extends past such completion, such that contractors may still have the right following closing to file a lien for the completed work.

Local counsel should be engaged to advise on the intricacies of the mechanic's lien law in the state where the property is located, as these requirements can vary significantly by state. Getting a title company comfortable enough to delete an exception for mechanic's liens where the lien period still remains open as of closing can involve providing progress and/or final lien waivers from the prime contractor and its subcontractors, and possibly furnishing indemnities in favor of the title company from a creditworthy entity. The title company will also want to review the prime contractor's agreement, understand the total cost of the work, and determine the universe of subcontractors and other parties who may have lien rights.

Your purchase agreement should require the seller to provide certain items at closing relating to this issue, including anything reasonably required in order to have the applicable mechanic's lien exceptions removed by the title company.

Conclusion

The acquisition of a retail property can be one of the most challenging real estate transactions you will encounter. As the above discussion highlights, the interplay between various tenants, owners of adjacent properties, and governmental and private restrictions and agreements is like a puzzle, requiring significant care and diligence. As you embark on a potential acquisition, you should consider the points discussed above and consult experienced counsel and other professionals to help guide you through the maze. ◻

Casualty under a Lease; Feeling the Burn

BY STUART D. KAPLAN

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Despite the numerous provisions in a typical office lease that are triggered by the occurrence of a building fire or other casualty, rarely do attorneys have the "opportunity" to counsel their landlord clients on the operation of these provisions after an actual casualty. When they do, their clients will be impressed (or dismayed) by the interrelatedness among clauses governing insurance, restoration, the character of leasehold improvements, force majeure, and other issues. While not as unlikely as a condemnation, a building casualty is viewed by many lawyers as an improbable event. Accordingly, but unfortunately, casualty and insurance sections are often relegated by lawyers to "lower tier" status during lease negotiations, while provisions governing initial work obligations, assignment/sublet rights, maintenance expenses, and future occupancy rights receive greater attention.

Leasing practitioners are well advised, however, to think through the implications of a casualty and how such an event will affect the rights and obligations of the parties under their lease. Preparing a lease in a manner to adequately address these issues highlights the importance of parallel construction, clarity of language, and definitional and theoretical consistency. This article will share some practical suggestions derived from the author having advised clients through actual casualty experiences. As we explore how "real life" elements of a casualty scenario play out against some typical, and some not-so-typical, lease provisions, we will focus on the interplay under New York law between insurance coverage requirements, the parties' respective restoration obligations, and the nature of leasehold improvements.

The Facts

Let's presume, for our analysis, that the casualty occurred on a Saturday afternoon in a 30-story Class A office building in midtown Manhattan owned by your client, an institutional buyer and seller of commercial properties. A small aquarium in an executive office suite on the 10th floor of the building was wired improperly, causing an electrical fire when the stand holding the tank collapsed, sending it careening to the floor. The building's Class E fire alarm/life safety system was instantly triggered; the NYC Fire Department, responding with breakneck speed, hooked their hoses into the building's NYC Building Code-compliant standpipe water distribution system; and, within 10 minutes, the fire was extinguished with 30,000 gallons of water. In less than a half-hour from inception, the casualty is over.

► As we explore how "real life" elements of a casualty scenario play out against some typical, and some not-so-typical, lease provisions, we will focus on the interplay under New York law between insurance coverage requirements, the parties' respective restoration obligations, and the nature of leasehold improvements.

Actual flame damage and charring was limited to the 10th floor and a portion of the 11th floor. However, floors five through nine experienced moderate to heavy water damage from the extinguishment. Mild to significant smoke damage affected floors 10 through 15 and the entire building will retain a strong odor of smoke through the elevator shafts for another two to three weeks. Leasehold improvements and tenant build-outs were destroyed almost completely on floors nine through eleven and partially on floors seven, eight, and twelve. Only one building elevator—a critical tenant building service—was unaffected, three others are up and running with replaced

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Casualty under a Lease; Feeling the Burn (continued from page 6)

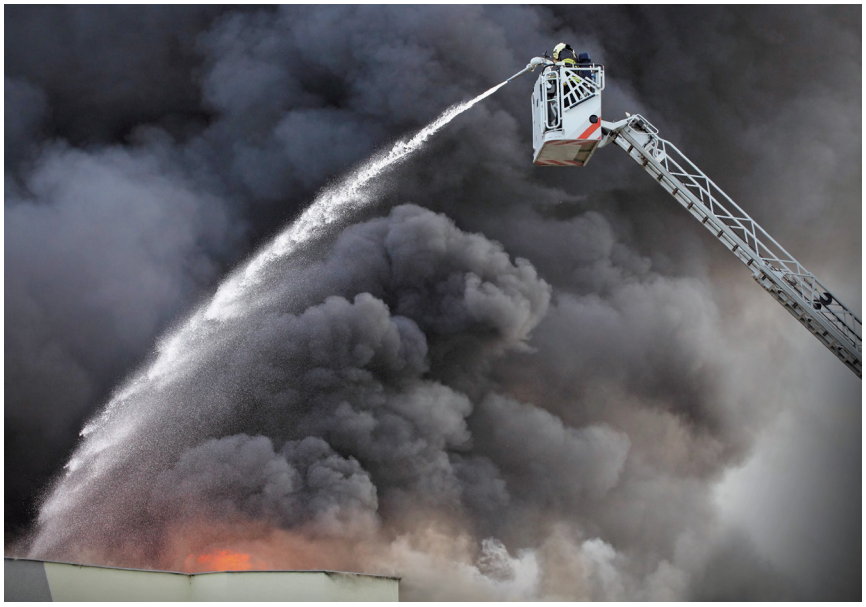
electrical components within four hours, and the remaining two should be in full service by Monday. Industrial hygienic crews have removed all standing water on floors seven through nine, which, along with the 10th and 11th floors, will be inaccessible to tenants for up to a week. Remedial fans have been installed as needed to continue with the water evaporation effort. Security guards will be manning the five affected elevators for the next few business days to allay passenger fears in the event a damaged elevator fails. Overall, there was little, if any, material damage to the structural portions of the building or any of its base building systems.

You receive an e-mail from your beleaguered client on Saturday night briefing you on the day's events and signing off with, "Let's speak first thing Monday regarding our rights and obligations under the leases of the affected tenants."

You begin to ponder some of the following issues in anticipation of Monday's call:

- **Notice of the Casualty.** The lease may require the tenant to notify the landlord immediately after the occurrence of the casualty. Such a provision is actually of little consequence in an office tower scenario since management will know about the casualty instantaneously as a result of the building's Class E alarm system. In fact, in our case, building management has already notified, by e-mail or telephone, the tenants on each of the affected floors of the casualty and whether their spaces will be accessible on Monday. Moreover, while tenant notice may be useful in the case of a rural warehouse facility, fires and casualties in major cities do not go unnoticed and, as we have seen, landlords certainly don't depend on tenant notice to begin remedial activity.

  What should be important to the landlord, however, is the notice likely required to be sent to the building tenants, containing an "estimate" of the "time reasonably necessary to demolish all damaged portions of the Premises and to repair or restore the Premises…." Hopefully (for the landlord), the lease does not require this notice and estimate to be delivered by a hard date in the near future (*e.g.,* 30 days following the occurrence of the casualty). The initial weeks immediately following a building fire are extremely hectic—emergency damage control and abatement activity by a myriad of specialty contractors busily continues, all in the face of various access restrictions initially imposed by the Fire Department for safety purposes, and then carried forward by each party's respective primary insurers as they assess damage and causation. Consequently, access to the various premises by architects, engineers, and other parties necessary to prepare the "estimate" will likely be delayed for several weeks or more. It is also during these initial stages that the landlord's and tenant's respective insurance carriers are staking their positions on how to best achieve minimal pay-outs under their policies (this being one of the strongest vectors affecting the entire restoration process). If the landlord is required to deliver the "estimate" in, say,



  60 days, that will be tight; 30 days will be virtually impossible. Accordingly, the landlord is best advised to agree to deliver the "estimate" within a "reasonable period of time," or even "as promptly as is reasonably practicable" following the occurrence of the casualty.

- **Who Restores What?** While landlords are generally responsible under the lease for restoring structural elements, common areas, and base building equipment, they will want to retain maximum flexibility regarding the obligation to restore leasehold improvements and tenant build-outs. Such work can be expensive and will vary from tenant to tenant, creating inherent inefficiencies and coordination and pricing challenges. Most well-drafted leases will give the landlord the option to either (a) restore these types of improvements utilizing the proceeds of the tenant's property insurance, or (b) require the tenant to perform such

work at its sole cost and expense (purportedly funded by the tenant's insurance proceeds). However, despite such options, landlords may be dismayed to learn at the time of the casualty that their tenants have failed to insure all or a portion of such improvements, whether due to a genuine misunderstanding in their expected scope of coverage, a simple disregard of their lease obligation, or inadequate wording of the lease insurance requirements. To further complicate matters, different tenants may have differing scopes of coverages. The result is that the landlord's insurer may be at war with numerous tenant insurers, often providing varying degrees of coverage. As the landlord's counsel, the starting point to avoid such chaos is (a) a clear and well-defined term in the lease that refers to that portion of the restoration work that the landlord may opt out of, and (b) to make sure that such defined term mirrors the improvements the tenant is required to insure under the lease.

- **Required Scope of Coverage.** While the landlord carries an "all-risks" casualty policy covering the replacement cost of the building (including all base building components), the lease may provide that such policy is subject to such "terms and conditions as the Landlord shall reasonably determine." While such "terms and conditions" may include deductibles, self-retention limits, and notice requirements, they may also permit the landlord's insurer to seek collection from the tenant's insurer before disbursing proceeds to the landlord. This sets up a tension between the landlord's casualty insurer and the tenant's property insurer as to who is going to pay for the restoration of the tenant's leasehold improvements. Layer on to this dynamic the wide range of insurable properties in play (from bricks and mortar to base building systems to leasehold improvements, IT systems, data files, etc.), the murkiness of New York law with respect to the legal nature of "fixtures," and the diverging interests of the competing insurers, and one sees why the lease needs to be as clear as possible regarding the casualty coverage a landlord expects its tenants to secure.

Any prudent tenant will maintain property insurance under its liability policy covering its personal property, trade fixtures, business equipment, and furnishings. However, from the landlord's perspective, it is critical that this policy names the landlord as a loss payee for "any and all leasehold improvements at the Premises, *regardless of whether such leasehold improvements were installed by or for the benefit of Tenant."* This phrase then becomes the definition of "Tenant's Insured Improvements" under the lease, and constitutes that portion of the restoration subject to the landlord's restoration option. With this coverage in place, the burden to pay for restoring any and all leasehold improvements at the premises at the time of the casualty—build-outs, tenant installations, and initial tenant work, regardless of who performed or initially paid for the work—would be on the tenant's insurer. Prior to lease execution, the landlord's counsel is advised to verify that the required insurance is in place.

- **Can the Tenant Insure What It Does Not "Own"?** The tenant may argue against the scope of such broad coverage, claiming that it does not have an "insurable interest" in the leasehold improvements, particularly those for which it did not reimburse the landlord at the inception of the lease, or that may have been built for a prior tenant. This position, however, is misguided since such coverage is indeed commercially available to tenants in New York regardless of who is considered to actually "own" the leasehold improvements. The notion of "ownership" in the context of leasehold improvements installed by or on behalf of a tenant is primarily tax-driven, utilized to establish the "permanency" of leasehold improvements for purposes of characterizing them as capital improvements (*See NYS Dept. of Taxation and Finance Bulletin ST-104* (TB-ST-104 issued July 27, 2012)). However, under New York law, regardless of who "owns" the leasehold improvements, the tenant has an "insurable interest" in all portions of the premises it is occupying under the lease, including the leasehold improvements (*See Sigola Manufacturing, Inc. v. Dairyland Ins. Co.,* 124 A.D.2d 654, 508 N.Y.S.2d 38 (2d Dept. 1986)). Specifically, a party has an insurable interest in property if it stands to suffer *any* loss, destruction, or pecuniary damage if the property is damaged or destroyed; actual ownership of the property is not a prerequisite to such an insurable interest. *(See Id).*

  Simply put, the mere fact that the tenant is not considered to "own" the leasehold improvements does not, as a matter of law, preclude its ability to insure the same.

Conclusion

Practitioners who negotiate casualty provisions in the abstract, without having had the benefit of applying real fact scenarios to such provisions, are at a disadvantage to those attorneys who have endured such experiences with their clients. While this article touches on only a few relevant issues, it demonstrates the benefit of practical experience in effectively representing parties as they navigate the casualty provisions during lease negotiations. ◻

The Nuances of Hotel Acquisitions

BY MATTHEW J. COMISKY

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The purchase of a hotel property creates numerous challenges because of the variety of issues and skill sets involved in evaluating, negotiating, and completing the transaction. The following discussion highlights several key issues to consider in such a purchase.

Asset Being Purchased

First and foremost, it is critical to understand exactly what you are purchasing—effectively, you are buying an income-producing property. But you are also buying an active business with significant other assets, such as furniture, fixtures, and equipment; a labor force engaged in management, cleaning, accounting, intake, and outtake; and restaurants, bars, catering facilities, and other amenities (such as a swimming pool, exercise facility, golf course, tennis courts, and spa).

These various facets of a hotel property pose a number of issues. For example, you want to make certain that the guest rooms are properly furnished, and that the furniture and electronics in each room are in good condition; the sinks, toilets and baths/showers are free of leaks; doors and entry locks work smoothly; and safes operate properly. You also need to ensure that the hotel is adequately stocked with linens, towels, toilet paper, tissues, soap, shampoo, and similar items, and that they are ordered and maintained in the ordinary course. Laundry rooms should be properly supplied. Restaurants and bars must also be supplied, as needed, with food, beverages, linens, tablecloths, napkins, tableware, pots, pans, and other cooking essentials.

With respect to restaurants, bars, gift shops, and convenience stores, you should determine whether they are operated by third-parties, under leases, licenses, or management agreements, and ensure that inventory levels are maintained through the closing.

There are also customary contracts that the seller will want to assign and that you may or may not want to assume. The most typical contracts that are assigned, due to early termination fees, are for elevator maintenance, postage machines, and copiers.

Necessity of Guaranty or Holdback

Many hotels are owned by single purpose entities. When the purchase price is paid in full, these entities are likely to distribute the profits quickly to their members and discontinue operating the entity. If the seller has post-closing obligations or liability (*e.g.*, indemnities, liability for breach of representations or covenants, or environmental issues), and you are concerned that it may not remain a viable company, you will want to retain part of the purchase price in escrow, or obtain a guaranty from a credit-worthy entity, to secure these obligations and liability.

Real Estate Matters

You should conduct standard real estate due diligence concerning title, zoning, development potential, property condition, environmental condition, and the like.

Financials

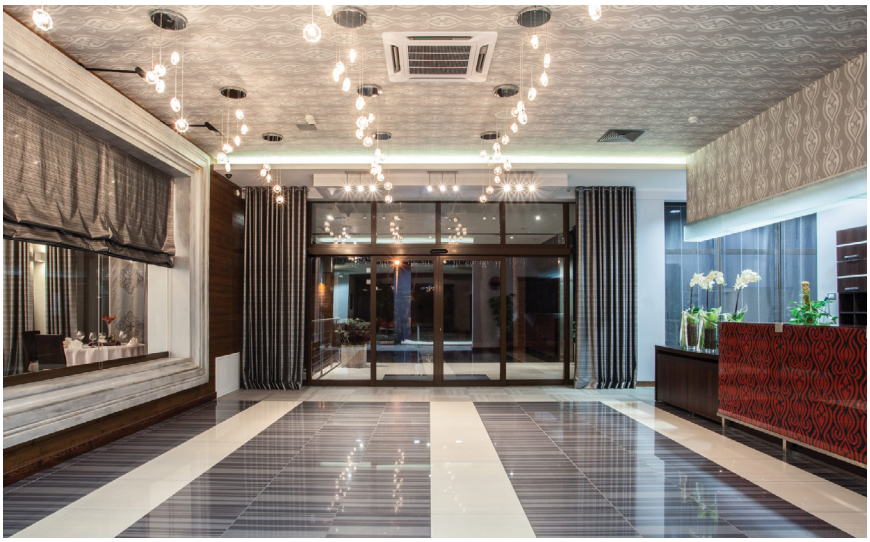
Because you are purchasing an active business, it is critical that the financial statements are analyzed in order to assess the value of the business. Although the value of the land and improvements are important, it is the operating cash flow that will make or break the transaction.

Licensing

The licensing requirements to operate a hotel are generally not overwhelming. Essentially, you only need to make sure that your purchasing or operating entity has the required operating license and that any local or state licenses for the facility itself are current through the closing date without violation. Liquor licensing issues, however, are far more complex—most states require that a formal process be followed for the issuance or assignment of a liquor license and the sale of unopened beer, wine, and alcohol containers. In most states, open containers are not salable, and no transfer of alcoholic beverages is permitted until the existing license is assigned or a new license is issued.

Employees

It is important to ensure a smooth transition with the hotel personnel following an acquisition. The transition method you should choose will partly depend on whether the personnel are employed by your company or a separate operator or manager, and whether any such operator or manager will be retained by you. If you do not retain the operator or manager, then, in order to comply with the Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2101–2109 (the "WARN Act"), the employees will usually have to be terminated as of the date of closing and then the requisite number of employees (generally most, if not all) will be rehired by you or a new operator or manager. The WARN Act was adopted to require employers to give employees at least 60-days prior written notice of a plant closing or mass layoff. Even though the purchase of a hotel does not seem to involve a "plant closing" or "mass layoff," it does fall within the provisions of the Act. Since a 60-day notice is almost never given unless there is a proposed shut-down of the hotel or some other extenuating circumstance, hotel sale agreements generally require the purchaser to indemnify the seller against any WARN Act violations, and most employees are rehired to avoid such a violation. In many hotels, there are also collective bargaining agreements that need to be reviewed, and are usually assigned to the purchaser at closing.



Insurance

In addition to obtaining the traditional coverage for general liability, casualty, and workers compensation, you may also need to obtain flood insurance or dramshop/liquor liability insurance. Further, if the seller has "claims-made" insurance (rather than "occurrence"-based), you should require the seller to provide a tail insurance policy, which will help to backstop certain pre-closing liabilities of the seller.

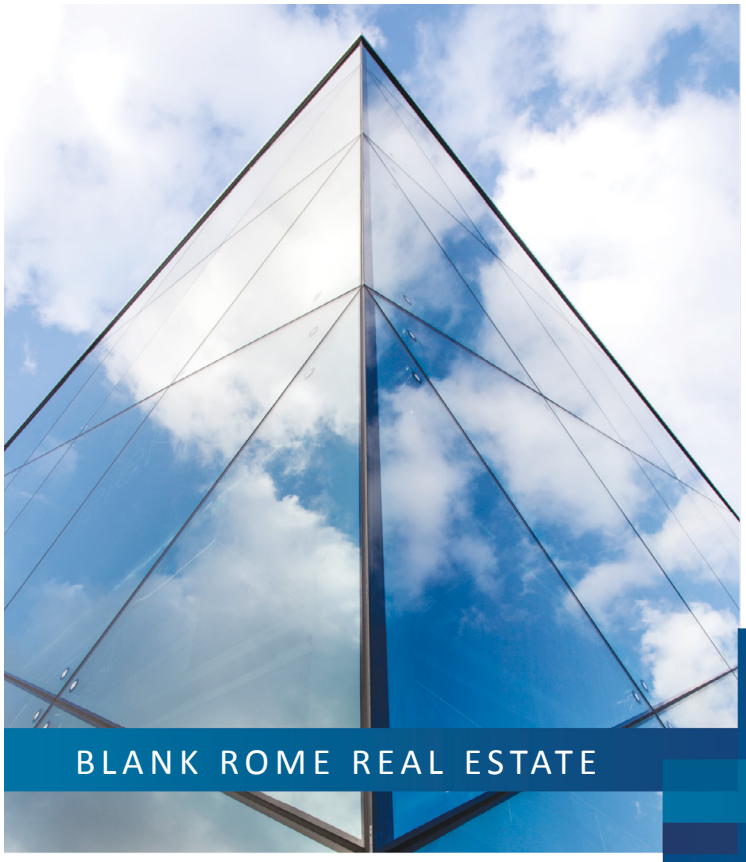
Franchise

Most hotel owners enter into franchise arrangements to create recognition and marketability for the hotel, which impose significant costs on the owner for the use of the franchisor's technology, logos, and marketing materials. These arrangements also are intended to open up a huge network, which generates the majority of customer traffic to the hotel. Although limited service hotels are typically run by owner-operators or management companies, the franchisor is sometimes engaged to manage full-service hotels. Each arrangement has its associated costs and requires review and evaluation of the franchise documents and economics.

Conclusion

As you can see, a hotel acquisition presents various nuances that are not typically found in a straight real property acquisition, and it is very important to examine these nuances prior to entering into the purchase agreement. The above discussion provides a high-level summary of the most critical issues affecting your potential acquisition, but since there are numerous other issues that may need to be addressed, you should engage experienced counsel to help you navigate this multifaceted transaction. ◻

Blank Rome Real Estate Group Rankings in *Chambers USA 2016*



Chambers USA 2016: Blank Rome's real estate group "scores highly for its proactive outside counsel to clients in corporate real estate transactions and title issues." The group "also fields a team of skilled negotiators and litigators."

Sources say: "They're very good from top to bottom. They're very professional, trusted advisers and partners, and they provide a personal level of attention. We're very fortunate." • "They are efficient, responsive and they focus on the risk management standpoint of compliance."

Chambers USA 2016 Honors Blank Rome Real Estate Practice and Attorneys

Matthew J. Comisky

Comisky@BlankRome.com

PARTNER

***Chambers USA* states:** "Matthew Comisky maintains expertise in all aspects of real estate development, leasing and financing. Impressed clients describe him as 'very knowledgeable, very efficient and a good educator. He's a mentor as well as an attorney.'"

Jason R. Eig

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PARTNER

***Chambers USA* states:** "Jason Eig is a 'good, practical attorney,' say sources. He has a strong track record in real estate acquisitions, both of single assets and property portfolios. Clients praise his 'real attention to detail, vast amount of experience' and his 'great business mind.'"

Peter F. Kelsen

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PARTNER

***Chambers USA* states:** "Peter Kelsen is a leading zoning lawyer, providing expert counsel to a range of clients including developers, owners, local authorities and finance companies. He is admired by clients for being 'very knowledgeable and professional. He follows through on the details and is a solutions person. We really enjoy working with him.'"

Martin Luskin

MLuskin@BlankRome.com

PARTNER

***Chambers USA* states:** Martin Luskin's 'good business acumen' earns him considerable praise from market sources. One commentator explains: 'He's just an amazing businessperson as well as a lawyer.' He advises upon a wide variety of real estate transactions, including acquisitions, dispositions and joint venture agreements."

Philip R. Rosenfeldt

Rosenfeldt@BlankRome.com

PARTNER

***Chambers USA* states:** "Philip Rosenfeldt is held in high esteem for his advice on the full spectrum of real estate topics, including loans, development and sales and acquisitions. He benefits from his experience acting on a diverse range of projects including retail, office buildings and residential development."

To view Blank Rome's *Chambers USA 2016* rankings, please visit www.blankrome.com/chambersusa2016.
The quotes, commentary, and rankings referenced in this document are published in *Chambers USA 2016.*

New Hires

Since the April 2016 edition of *Foundation*, Blank Rome welcomed new partners, associates, and counsel across the Firm's offices and practices. Below are new hires that joined the Firm's real estate group, as well as others who will enhance service offerings to all of our clients.

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BLAKE E. SACHS

AFleishman@BlankRome.com

ASHLEY FLEISHMAN

GRichner@BlankRome.com

GREGORY F. RICHNER

Ashley Fleishman and Gregory F. Richner joined Blank Rome's New York office, and Blake E. Sachs joined Blank Rome's Houston office, as associates in the real estate group.

sdpdissoqueen@BlankRome.com

STACY D. PHILLIPS

MLerner@BlankRome.com

MARC LERNER

KMartin@BlankRome.com

KEVIN MARTIN

PMartin@BlankRome.com

PAULINE MARTIN

Four attorneys from Los Angeles' top family law firm, Phillips Lerner, joined Blank Rome's matrimonial and family law group, bringing the Firm's nationally recognized practice to nearly 30 attorneys. The team includes **Stacy D. Phillips**, Partner; **Marc Lerner**, Of Counsel; **Kevin Martin**, Partner; and **Pauline Martin**, Of Counsel, who boast extensive experience advising high-net-worth clients on some of the most important legal transitions in their lives, including divorce, custody, paternity, and domestic partnerships. Please click **here** to learn more.

IHerman@BlankRome.com

IRA L. HERMAN

Ira L. Herman, a former partner at Thompson & Knight LLP, joined Blank Rome's New York office as a partner in the finance, restructuring, and bankruptcy group, where he focuses his practice on distressed public debt issues, insolvency matters involving upstream and midstream oil and gas companies, and distressed M&A, in addition to traditional bankruptcy and insolvency matters. Please click **here** to learn more.

SLevy@BlankRome.com

SAMUEL D. LEVY

Samuel D. Levy, a former partner at Wuersch & Gering LLP, joined Blank Rome's New York office as a partner in the corporate litigation group, where he focuses his practice on general commercial and business litigation, from inception through trial and appeal. Mr. Levy also has extensive experience in the luxury retail space, where he frequently works on licensing, antitrust, and commercial disputes between manufacturers, distributors, and retailers. Please click **here** to learn more.

To view all of Blank Rome's recent hires, please visit www.blankrome.com/news.

Media

Rosenfeldt@BlankRome.com

PHILIP ROSENFELDT

Blank Rome Partner Philip Rosenfeldt was quoted in Pa. Law Firms Face Challenge in Matching 2015's Real Estate Boom, published in *The Legal Intelligencer* on May 3, 2016, regarding the variety of deal types and geographic activity that kept Blank Rome's real estate practice busy last year, predicting that 2016 would be on par with last year or maybe even better.

Kelsen@BlankRome.com

PETER KELSEN

Blank Rome Partner Peter Kelsen was quoted in:

Jewelers Row Condo Tower Plan Hits Zoning Speed Bump, published in the *Philadelphia Inquirer* on August 18, 2016, regarding the Philadelphia's Jewelers Row project and design-review process.

Divine Intervention Reshapes Two City Blocks, published in the *Philadelphia Business Journal* on August 4, 2016, regarding his involvement with the Mormon Church on the zoning of three projects as well as assembling the two blocks where the projects are being built.

Johnson Calls for Construction Moratorium at Broad & Washington, published in *Philadelphia Magazine* on May 5, 2016, regarding the legality of single-property construction bans.

Blank Rome Points of Interest

Speaking Engagements

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PHILIP ROSENFELDT

Blank Rome Partner Philip Rosenfeldt will be speaking at the International Conference of Shopping Centers Law Conference on October 26, 2016, discussing issues regarding expiring or outdated reciprocal easement and similar agreements.

RRoberts@BlankRome.com

RHINA ROBERTS

Blank Rome Associate Rhina Roberts co-moderated the "Lender Panel on Assumptions" at Fannie Mae's Multifamily Legal Issues Forum with Joyce Roth, Chief Legal Officer of NorthMarq Capital, at the Fairmont Hotel in Washington, D.C., on May 3, 2016. The panel focused on loan assumptions and how they are processed, reviewed, and approved by Fannie Mae. Ms. Roberts also launched the Lenders' Counsel Working Group in an attempt to increase communication and provide real-time feedback on legal issues relevant to Fannie Mae's Multifamily Legal Department.

CPagan@BlankRome.com

CARMEN PAGAN

Blank Rome Associate Carmen Pagan presented a CLE course, "Are You Ready to Close?—Fundamentals of Due Diligence: Lenders' Perspective," to the New York City Paralegals Association during its Real Estate Boot Camp on April 14, 2016. Participants learned how to prepare proper due diligence checklists for a variety of real estate transactions, including affordable housing acquisitions, conventional loans, bond financing, constructions loans, and other mortgage loan structures.

Recognitions

TOP RANKED USA CHAMBERS AND PARTNERS 2016

BLANK ROME LLP

Blank Rome's real estate group and attorneys, as well as many of the Firm's other practice groups and attorneys, were highly ranked in the 2016 edition of *Chambers USA* as "leaders in their fields." For more information, please see page 11.

A Cautionary Tale: Consequences for Minority Partner Wrongfully Causing Partnership's Dissolution

BY RACHEL SIMS

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RACHEL SIMS
ASSOCIATE

Do you understand the provisions of your partnership agreement? If not, a recent decision from the New York State Appellate Division, Second Department, establishes that your failure to understand partnership provisions concerning dissolution may cost you dearly.

Two months ago, in *Congel v. Malfitano,*[1] the Second Department, in a case of first impression, considered whether a "minority discount" may be applied in determining the value of a partnership interest for a minority partner who wrongfully caused a partnership's dissolution, where the remaining partners chose to continue the partnership business. The Second Department unanimously concluded that such a discount may be applied, and should have been applied under the facts of this case.

As a result of this ruling, the minority partner faces the loss of millions of dollars, which he could have avoided if he had fully understood the terms of the partnership agreement.

Relevant Background

The partnership at issue is the Poughkeepsie Galleria Company Partnership (the "Partnership"), which was formed in 1985.[2] The Partnership owned and operated the Poughkeepsie Galleria Shopping Center, a 1.2 million square-foot shopping mall located in Dutchess County, New York.[3] Marc A. Malfitano ("Malfitano") was a general partner who owned a 3.08 percent interest in the Partnership.[4] Believing the Partnership to be at-will because the partnership agreement did not provide for a definite term, by letter dated November 24, 2006, Malfitano advised his fellow partners that he had unilaterally elected to dissolve the partnership, claiming a "fundamental breakdown in the relationship between and among us as partners."[5] But Malfitano made a fatal mistake. Although the partnership agreement did not contain a specified term of duration, it did include a provision whereby the partnership could be dissolved upon an election of a majority of the partners.[6]

► As a result of this ruling, the minority partner faces the loss of millions of dollars, which he could have avoided if he had fully understood the terms of the agreement.

(continued on page 17)

A Cautionary Tale: Consequences for Minority Partner Wrongfully Causing Partnership's Dissolution **(continued from page 16)**

In response to Malfitano's unilateral election to dissolve the partnership, in 2007, members of the Partnership's executive committee sued Malfitano asserting that he had wrongfully elected unilaterally to dissolve the Partnership in violation of the partnership agreement in order to force the Partnership to "buy out…his interest at a steep premium."[7] Malfitano denied the wrongful dissolution, arguing that the partnership was at-will and he counterclaimed for the value of his interest in the Partnership.[8]

► But Malfitano made a fatal mistake. Although the partnership agreement did not contain a specified term of duration, it did include a provision whereby the partnership could be dissolved upon an election of a majority of the partners.

A series of interim trial court and appellate court rulings followed. In short, the trial court found, and the appellate court affirmed, that the partnership was not at-will, "since the partnership agreement, which indicated that the partnership shall dissolve upon an election of a majority of the partners, provided for a 'definite term' within the meaning of Partnership Law §62(1)(b)."[9] On summary judgment, the trial court determined and the appellate court affirmed that, by sending the November 24, 2006, letter, Malfitano caused the wrongful dissolution of the partnership in contravention of the partnership agreement.[10] The Second Department remitted the matter to the trial court for further proceedings on the issue of damages.

New York Partnership Law §69(2)(c)(II) is triggered when a dissolution is caused in contravention of the partnership agreement and the non-dissolving partners elect to continue the business in the same name (as the partners did here). In that situation, the partner who caused the wrongful dissolution shall "have the value of his interest in the partnership, less any damages caused to his copartners by the dissolution, ascertained and paid to him in cash…but in ascertaining the value of the partner's interest the value of the good-will of the business shall not be considered."[11]

Results of Non-Jury Trial on Issue of Damages

A non-jury trial was conducted on the issues of (1) the damages incurred by the plaintiffs as a result of the wrongful dissolution of the partnership, and (2) the value of Malfitano's interest in the partnership, in order to determine the amount Malfitano was entitled to recover pursuant to Partnership Law §69.[12] At the start of the trial, the parties stipulated that as of November 24, 2006, the date of the wrongful dissolution of the Partnership, the unadjusted value of Malfitano's total interest in the Partnership was $4,850,000.[13] Both parties offered expert testimony as to whether the stipulated value of Malfitano's partnership interest included a component of goodwill, for which a deduction was required pursuant to Partnership Law §69(2)(c)(II), and whether Malfitano's interest should be reduced to account for marketability and his status as a minority partner.[14] The plaintiffs' valuation expert testified that in determining the fair market value of Malfitano's 3.08 percent interest, a "minority discount" should be applied and that the appropriate minority discount was 66 percent.[15] Malfitano's valuation expert testified that he did not apply a minority discount in his valuation because he "was advised, under the relevant statutes, that a minority discount was not applicable."[16]

Application of a Minority Discount

A minority discount is applied to "reflect the lack of control that a minority owner has in the operations of the partnership."[17] When valuing shares of corporate stock, "the theory behind a minority discount is that the non-controlling shares of stock are not worth their proportionate share of the [company's] value because they lack voting power to control corporate actions."[18] "And like a corporate minor shareholder, a limited partner generally has no voice in the management of [a] partnership and cannot control investment policies or partnership distribution, so a minority discount may apply to the value of [a partnership] interest as well."[19]

At the end of the trial, the trial court determined that the value of Malfitano's interest in the partnership amounted to only $857,164.75.[20] In reaching this conclusion, the trial court deducted the damages to the plaintiffs, including legal fees, caused by Malfitano's wrongful dissolution of the partnership. The trial court also applied a 15 percent discount for good will and a 35 percent marketability discount, but declined to apply a minority discount, determining that it could not do so "based upon case law involving valuation of a minority shareholder's stock in a close corporation."[21]

Trial Court's Analysis

In making its determination not to apply a minority discount, the trial court relied on the New York Court of Appeals' decision in *Matter of Friedman v. Beway Realty Corp.*[22] and the Second Department's holding in *Matter of Murphy v. U.S. Dredging Corp*.[23] In *Matter of Friedman,* a minority shareholder in a close corporation brought a proceeding pursuant to Business Corporation Law ("BCL") §623, which gives "minority stockholders the right to withdraw from a corporation and be compensated (at fair value) for the value of their interests when the corporate majority takes significant action deemed inimical to the position of the minority."[24] *Matter of Murphy* involved a similar determination pursuant to BCL §1118, which "governs the rights of minority stockholders when the corporation has elected to purchase their interests" also at fair value, following the minority stockholders' "petition for corporation dissolution under BCL §1104-a for oppressive majority conduct."[25]

The Court of Appeals held in *Matter of Friedman,* that in determining the fair value of a dissenting shareholder's shares under BCL §623 and §118, a minority discount should not be applied because, among other things, it would "necessarily deprive minority shareholders of their proportionate interest in a going concern…[and] would result in minority shares being valued below that of majority shares, thus violating our mandate of equal treatment of all shares of the same class in minority stockholder buyouts."[26] The Court of Appeals also expressed a concern that applying a minority discount in BCL §623 and §118 proceedings would "unfairly enrich [] the majority stockholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder" and would "inevitably encourage oppressive majority conduct, thereby further driving down the compensation necessary to pay for the value of minority shares."[27] In accordance with the holding of *Matter of Friedman,* the Second Department in *Matter of Murphy* concluded that "New York law does not permit a minority discount."

The Second Department's Reasoning in Allowing a Minority Discount Here

In making its determination that a minority discount should have been applied in valuing Malfitano's partnership interest, the Second Department specifically noted that the concerns expressed by the Court of Appeals in *Matter of Friedman* when making a "fair value" determination in the context of BCL §623 and §118 proceedings were not implicated here.[28]

Contrary to *Matter of Friedman* and *Matter of Murphy,* which involved "a determination of the 'fair value' of a dissenting shareholder's shares pursuant to BCL §§ 623 and 118," this case involved the determination of the "value" of the shares of a partner who wrongfully caused the dissolution of a partnership under Partnership Law §69(2)(c)(II).[29] Thus, as the First Department reasoned in *Vick v. Albert,*[30] "applying

(continued on page 19)

A Cautionary Tale: Consequences for Minority Partner Wrongfully Causing Partnership's Dissolution (continued from page 18)

a minority discount in the context of valuing a partnership interest would not contravene the distinctly corporate statutory proscription…against treating holders of the same class of stock differently, or undermine the remedial goal of the appraisal statutes to protect shareholders from being forced to sell at unfair values, or inevitably encourage oppressive majority conduct." (Internal quotations omitted)[31] Moreover, here, the dissolution was caused "not by any action on the part of the majority, but rather, was caused by the 'wrongful []' conduct of a minority partner." Thus, the concern that imposing a minority discount in valuing a dissenting shareholder's stock would encourage oppressive majority conduct "is not relevant here."[32]

The Second Department also pointed to a decision by the Supreme Judicial Court of Massachusetts, which interpreted a partnership statute identical in all relevant respects to Partnership Law §69(2)(c)(II).[33] *Anastos v. Sable*[34] involved a partnership formed to own and operate a manufacturing facility, where the plaintiff dissolved the partnership in contravention of the partnership agreement, and the defendant elected to continue the partnership business rather than liquidate.[35] In determining the value of the dissolving partner's interest in the partnership, the *Anastos* trial court applied a minority discount. On appeal, the Massachusetts Supreme Judicial Court affirmed the trial court's decision, stating that "the remaining partners chose to exercise their statutory right to continue the partnership business for the remainder of the partnership term, so the partnership business is not winding up, and must therefore be treated as a going concern. Because the [dissolving partner] cannot compel liquidation of the business at the point of dissolution, we read [the Massachusetts statute] as offering a nonliquidation based method of calculating the value of his partnership interest."[36]

Finding the reasoning of the *Anastos* court "to be sound," the Second Department explained that here, as in *Anastos,* "the partnership remains a going concern and [Malfitano] has no right to compel a liquidation sale of the partnership's shopping mall and receive a proportionate share of the liquidation value of that asset."[37] Thus, a minority discount may properly be applied to account for Malfitano's lack of control in the partnership as a going concern.[38] The Second Department also found to be credible the plaintiffs' expert testimony that a minority discount was appropriate and remitted the matter to the trial court for a new calculation of damages that incorporates a 66 percent minority discount to be applied to the value of Malfitano's interest in the partnership.

Partners Take Caution

The ruling in the *Malfitano* case demonstrates the importance of understanding the terms of a partnership agreement and, importantly, the potentially devastating consequences of causing a dissolution of a partnership in contravention of a partnership agreement when the remaining partners choose to continue the business. ◻

1. 2016 N.Y. Slip Op. 03845 (2d Dep't May 18, 2016)
2. *Id.* at *1.
3. *Id.* at *1-2.
4. *Id.* at *2.
5. *Id.*
6. *Id.; see also Congel v. Malfitano,* 61 A.D.3d 807, 808 (2d Dep't 2009).
7. 2016 N.Y. Slip. Op. 03845, at *2.
8. *Id.*
9. 2016 N.Y. Slip. Op. 03845, at *2; 61 A.D.3d at 808.
10. 2016 N.Y. Slip. Op. 03845, at *2; *Congel v. Malfitano,* 61 A.D.3d 810, 811 (2d Dep't 2009).
11. 2016 N.Y. Slip. Op. 03845, at *2, citing Partnership Law § 69(2)(c)(II).
12. *Id.* at *2.
13. *Id.*
14. *Id.*
15. *Id.* at *3.
16. *Id.*
17. *Id.* at *3.
18. *Id.*
19. *Id.* at *3-4.
20. *Id.* at *2.
21. *Id.* at *2-3.
22. 87 N.Y.2d 161 (1995)
23. 74 A.D.3d 815 (2d Dep't 2010)
24. 2016 N.Y. Slip. Op. 03845, at *4.
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.*
30. 47 A.D.3d 482 (1st Dep't 2008)
31. 2016 N.Y. Slip. Op. 03845, at *4, citing to *Vick v. Albert.*
32. *Id.* at *4.
33. *Id.* at *5.
34. 443 Mass 146 (2004)
35. 2016 N.Y. Slip. Op. 03845, at *5.
36. *Id.* at *5.
37. *Id.*
38. *Id.*

Noteworthy Real Estate Deals

Blank Rome LLP recently represented:

- **9901 La Cienega (Los Angeles) Esong, LLC, a member of the U.S. OCG family of companies,** in connection with its $52.5 million purchase of the 405-room Holiday Inn Hotel at the Los Angeles International Airport, and the $31 million first mortgage loan from Industrial Commercial Bank of China used to facilitate the acquisition of the hotel. U.S. OCG, a subsidiary of Esong Group (China), is a global investment firm that focuses on commercial real estate acquisition and management.

- **Welcome Group,** in connection with its acquisition of a 175-room, full-service hotel and conference center located in Scranton, PA, known as "The Hilton Hotel and Conference Center," and its refinance of a currently-owned Hampton Inn located in West Springfield, MA. The Hilton purchase was structured as an equity acquisition to address various tax considerations, and a loan was obtained from Citigroup Global Markets Realty Corp., secured by mortgages on both properties.

- **CTL Capital LLC,** in a $197,150,000 securitized mortgage loan to an entity controlled by Lexington Realty Trust, to finance the construction of a research and office campus in Lake Jackson, TX. The campus, expected to be substantially completed in the fourth quarter of 2016, is net-leased to The Dow Chemical Company (soon to be Dow Dupont) for a 20-year term upon completion.

- **National Down Syndrome Society,** a pro bono client, in the sale of its headquarters building in New York City to a private real estate investment and management company, and the lease of new office space in a Midtown office building.

Contact Members of Blank Rome's Real Estate Group

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